

READINGS

ANOTHER'S CASTLE

Housing Partnerships: A New Approach to a Market at a Crossroad

by Andrew Caplin, Sewin Chan, Charles Freeman, and Joseph Tracy

(MIT Press, 1997) 265 pages

Reviewed by William A. Fischel

Suppose your investment advisor proposed the following deal. You put almost all of your personal savings in the stock of a single company. The company makes one product, and it has one plant. The supposed company is involved in an industry that is favored by federal tax laws and that has generally grown in value more rapidly than average. But the industry is subject to large swings in value caused both by the national economy and by local and idiosyncratic conditions.

You would probably decline to undertake such a risky venture. Yet most people make just that investment when they purchase a home. About two-thirds of American households own their homes at any given time. Homeowners cannot diversify their portfolios to reduce the risk inherent in owning a large asset that is fixed in location. They can insure the house against damage from fires and floods, but they cannot insure against market meltdown or regional economic swings.

The reason for the lopsided allocation of personal wealth is federal tax law. The true subsidy is not, as is conventionally believed, the deductibility of mortgage interest and property taxes. It is that owner-occupants are not taxed on the income from services that they, as property managers, provide for themselves, as tenants. The only country that taxes imputed income from owner-occupied housing is Switzerland, and it has the industrialized world's lowest owner-occupancy rate, about 30 percent.

Lowering the homeownership rate to Swiss levels might not be viewed as a good thing in the United States, though. There is a widespread belief in this country that owning one's home makes for better citizens and better communities. That belief is sustained by economic evidence. Local land use decisions, school quality, and tax rates all affect the value of owner-occupied homes, and that fact induces homeowners to pay more attention to local political decisions and neighborhood conditions than they otherwise might.

So we have a problem. Homeownership is an awfully risky

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way for most individuals to accumulate wealth. A change in the tax laws making homeownership a less attractive investment would reduce that problem by inducing people to rent and put their savings in diversified mutual funds and such. But doing so would undermine the homeownership ideal that many people think is important.

Housing Partnerships proposes a solution to that dilemma. Caplin, Chan, Freeman, and Tracy want to create a market mechanism that will, in effect, reduce the dollar amount of individual homeownership while increasing (or at least not reducing) the number of owner-occupants of homes. Their idea is to encourage institutional investors to purchase half of the equity in owner-occupied homes from those homeowners who want to sell. (Half is a convenient division point, not an absolute necessity in their proposal.)

Here is how it would work: Suppose that I own my home and have \$120,000 in equity. An institutional investor, say a retirement fund, offers to buy half of my equity. I sell it and now have a check for \$60,000 (less the transaction costs and possible market discounts) that I can put in a mutual fund or use to pay for my son's college tuition. I have diversified my risk and allowed myself to take advantage of possible good returns from the stock market.

Why couldn't I just get a second mortgage for \$60,000 to do those things? The bank might not let me. It might figure that if housing values in my area declined in the future, I might walk away from the loan. Even if the bank let me borrow, I might be wary about having too much debt. But if the bank is wary of lending me \$60,000, why would some institutional investor think it is worthwhile to give me \$60,000 simply for a stake in my house? The investor, whom the authors call the "limited partner," does not get to live in my home or receive any annual payment from me. The limited partner only gets a share of the equity when I finally sell my home. Thus if the total value of the home grows so that the total equity at the time I decide to sell is \$200,000, the limited partner gets \$100,000, and I get \$100,000.

Limited partners would be interested in buying an asset having no cash flow because that asset is like no other. Fluctuations in owner-occupied housing value do not tend to correlate with the fluctuations of other types of assets in the economy. Large investors are on the lookout for assets that enable them to diversify the risks of their portfolios. And owning a piece of the owner-occupied market would be a good hedge against inflation. Since limited partnerships could be packaged and resold in a secondary market much like that for mortgages, investors all over the world could participate in

that market. Housing partnerships would be similar to Real Estate Investment Trusts, which package and resell equity in commercial real estate.

The equity-sharing proposed by *Housing Partnerships* is not the same as insurance (via futures markets) against regional housing market fluctuations. Such insurance has been proposed by Robert Shiller in his 1993 book, *Macro Markets*. The authors of *Housing Partnerships* regard Shiller's work as complementary to theirs. But Caplin, Chan, Freeman and Tracy do not propose to spread risk with an organized futures market like Shiller's. They simply divide the unavoidable risks of homeownership in two by splitting the residual claim.

Other people besides mature homeowners would also be interested in joining a housing partnership. First-time buyers often have to stretch quite a bit to make a down payment on their home. A partner would reduce the down payment by making half of the purchase price. Many young buyers could consider buying a home, especially in locations like California, where housing prices are high and highly variable. (Some universities in California now offer housing to incoming faculty in a form similar to the partnership proposed in the book.) Reducing the down payment burden would thus increase the number of homeowners.

The housing partnership idea is not all benefit and no cost. Otherwise, as the authors point out, the idea would have been adopted long ago. The owner-occupants of the home are called the "managing partners." They get to live in the house, but they also have to take care of it. That makes decisions more complicated. If the managing partner decides to redo the kitchen, that may change the benchmark value of the house. Because the cost of the new kitchen might not be the same as the new kitchen's addition to the house's value, the two partners would have to agree on the latter value. In the other direction, the managing partner might not be inclined to paint the house as often as the limited partner would, and the house might unduly decline in value. The problem is not as severe as having a divorced couple continuing to own a house that one former spouse occupies, but that analogy might give worldly readers an outer-range estimate of possible conflicts.

The marvel of this book is that the authors have actually thought through a lot of possible conflicts. If the devil is in the details, they've done some preemptive exorcism. The book is not perfect in that respect, though. One error is their assertion on pages 186 to 188 that real estate agents are unreliable guides for home buyers because the agent normally works for the seller. The authors advance that argument as a reason for their partnership proposal, since the professional "limited partner" would be a more experienced buyer. That may be true, but their claim that real estate sales people routinely short-change buyers overlooks that the agents and the firms they work for are forward looking. They do most of their business in a geographically concentrated area, so they have reputations to worry about. An agent who has treated buyers fairly—remember, the buyers now live in the community—gains a good reputation among potential sellers and is also the best candidate to list the house when the buyers eventu-

ally become sellers. In a book that takes a sophisticated view of markets, the authors' uncritically populist view of real estate agency is a little puzzling.

There are enough good ideas and solid explanations in this book to overwhelm its lapses, though. It carefully describes the existing housing-finance market in order to advocate policies to facilitate the housing partnership, making the it an accessible, readable guide to housing finance for both investors and policy makers. Even readers who are skeptical of the ultimate utility of *Housing Partnerships* will gain a deeper understanding of the role of housing markets in the national economy.

TAXING OURSELVES

A Citizen's Guide to the Great Debate Over Tax Reform

by Joel Slemrod and Jon Bakija

(The MIT Press, 1996) 299 pages

Reviewed by David F. Bradford

I hope it is clear why the subject of tax reform belongs in a publication devoted to studying regulations. If not, consider, dear reader, what you know about tax sheltered retirement saving or tax planning to time, or defer, capital gains. Consider what you suspect about the tax aspects of corporate mergers and acquisitions. Then multiply everything by at least ten. The U.S. federal income tax constitutes a regulatory structure that surely rivals in complexity and impact on economic behavior those directed at telecommunications, financial institutions, environmental quality, and preventing monopoly, all combined.

On the jacket of *Taxing Ourselves*, I am quoted as saying, "Slemrod and Bakija have packed a wealth of solid economics into this readable treatment of tax reform issues. It will be a great resource for students, in school and out, and should be required reading for policymakers and journalists." As sometimes happens, I based my assessment on a combination of a quick skim of the manuscript and my confidence in the senior author, Joel Slemrod. (No slight is thereby intended to Jon Bakija; I was simply unacquainted with his work.) It is therefore with some relief that I have found my opinion only enhanced by a careful reading of the published book. The authors have done a remarkable job.

So much for the bottom line. Here is how the book is put together. It is divided into three parts. Part I gets into the reform of the U.S. federal income tax on individuals and corporations. Neither federal payroll, estate, gift, or excise taxes, nor

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state and local taxes are discussed. One chapter summarizes complaints about the system (too complicated; too costly to enforce and comply with; discourages work, saving, innovation, and entrepreneurship) and sketches the more (national retail sales tax) and less (revisit 1986) radical reforms that have been circulating in recent public debates. Another chapter puts the income tax in quantitative context: how it compares with other sources of revenue, how it has varied over time, how the American system compares with those in other countries, how the tax is constructed out of inclusions, deductions, credits, exempt amounts, and rate schedules.

In the three chapters of Part II, the authors take the readers on a sprint through tax economics. A chapter on fairness develops the notions of horizontal and vertical equity, especially as the latter relates to altering the degree of inequality of incomes. Those concepts are fleshed out with data on the current situation and recent changes. The authors explain the distinction between sending a check to the government and experiencing the economic incidence of a tax system, i.e. actually footing the bill, though perhaps indirectly. For example, corporations don't bear taxes; people do. The authors also present estimates of how burdens of federal taxes are distributed. They go usefully beyond the conventional classification of people by current income and family status to consider such dimensions as lifetime income level and birth cohort. A chapter is devoted to the influence of tax policy on "economic prosperity," including a survey of the impact of taxes on labor supply, savings, and growth. Reflecting Slemrod's important research, the third chapter of Part II looks at the related subjects of tax complexity and compliance costs.

Part III is introduced by a chapter that develops a three-way parsing of reform proposals. They are classified based on whether they involve a single rate (VAT, RST, Hall-Rabushka flat tax), a consumption base (ditto plus personal expenditure tax, represented, alas, by the Domenici-Nunn USA Tax, not the superior Cash Flow Tax described in the Treasury's 1977 Blueprints for Basic Tax Reform), and/or a "clean" base (ditto plus the traditional tax reform agenda). A chapter is then devoted to each of the major thrusts of reform options: one to proposals that would move to a consumption base (which the authors treat as shifting to entirely new systems of taxation) and one to step-by-step attacks on such shortcomings of the existing system as its failure to index the base for inflation, double-taxation of corporate business, and inconsistent treatment of personal saving. A brief concluding chapter sets out a "voter's guide to the tax policy debate," drawing together lessons taught in the body of the book.

Two qualities set this book apart from others. One is its grounding in up-to-date economic research, to which Slemrod has made significant contributions. The discussion is laced with references to the latest findings about responsiveness to taxes, costs of compliance, and the like. The second exceptional quality is the book's success in conveying a high level of economic sophistication in terms the serious lay person should be able to understand. I was not bothered by any com-

promises with technical rigor, in spite of the very sparing use of economists' jargon and the absence of apparent formal apparatus. (Deadweight loss does not make the index, nor, I think, is it used in the text.) The book is full of lively but not condescending anecdotes and illustrative material that draw the reader through some pretty tough stuff.

Examples include:

- (1) In describing the potential economic growth consequences of a switch to a consumption tax the authors explain why projected increases in output or income fail to capture the sacrifice in nonmarket labor time or early consumption that may be involved. They introduce instead the notion of "welfare" (happiness or utility) and present appropriately corrected measures that reflect the increased work and lost leisure embedded in the uncorrected estimates of economic growth.
- (2) The authors correct the common but fallacious view that, because it would require a higher rate of tax, a consumption tax would discourage work effort more than does an income tax. The higher tax rate worsens the tradeoff between current work and current consumption but the tradeoff between current work and future consumption is improved. The net effect is ambiguous.
- (3) Transition costs are clearly explained as is the importance of the details of how one might get from where we are to alternative reform systems. This is especially important in considering the possibility of some consumption type taxes.

This book does call up a few quibbles and criticisms. In company with most other commentators, the authors use the term "capital income" without defining it. In their usage, it appears to cover payoffs to risk taking, innovation, and entrepreneurial effort, as well as, simply, waiting, postponing consumption. The point is important because consumption-based taxes are said to exempt capital income from taxation. In fact, most systems reasonably described as based on consumption differ from the ideal income system only in the treatment of waiting and not in the other dimensions. The reward for postponing consumption, for simply waiting, is the riskfree return. A proper income tax imposes a tax on the riskfree return; a proper consumption-type tax (with constant rate over time) does not. In contrast, rewards to risk-taking, entrepreneurship, and innovation are taxed by both approaches.

A similar remark applies to the book's use of the term "wage tax." Economists are used to thinking in terms of a world in which a person obtains earnings from work and chooses how to allocate the proceeds to consumption over time. In other words, we think in terms of a lifetime budget constraint. In that model world, there is a very general equivalence, correctly explained by the authors, between a uniform tax on earnings and a uniform tax on consumption. So a wage tax and a consumption tax are equivalent, and they both exempt capital income.

The ordinary citizen-reader of this book is most unlikely to

understand those terms in their technical economic meaning. A wage tax is something paid by rank and file workers, and capital income is what Bill Gates gets. It is my hunch that the authors are not immune to the ordinary citizen's misunderstanding of those terms, and the failure to make the necessary distinction has something to do with their view that adopting a consumption base would necessarily be a radical change.

Remember that the essential difference between ideal consumption and income taxes is the nontaxation of the risk-free return on saving by the former. Can it be that allowing people to obtain the real, risk-free rate of return would be so radical? The real Treasury bill rate has averaged something like 0.5 percent over the last hundred years or so. Even if one argues that the brand-name quality of T bills pushes their yield below "the" risk-free rate, I should think a high estimate would be 2 percent.

My hunch is that the Treasury, too, failed to differentiate capital income into its return-for-waiting and rewards to entrepreneurship, innovation, and risk-taking components in analyzing the distributional impact of flat tax proposal. In a flat tax system with single marginal rate of 22.9 percent, the average tax rate on the critical top 1 percent of the income distribution, where Steve Forbes resides, is estimated to be 14.3 percent (compared with 22.4 percent under current law). Perhaps I am missing something, but I do not understand how applying economic depreciation instead of expensing to business capital outlays, thereby postponing the deduction by a bit, would raise the tax rate on the rich to the roughly 22.9 percent it would have to reach in that case. That is because at very high incomes, the average and marginal rates converge. If I am right in thinking that the top 1 percent of the income distribution is dominated by people reaping exceptional payoffs from entrepreneurship and innovation, a more plausible estimate for their rate under the illustrative flat tax would be just a bit under 22.9 percent.

Those distributional data are probably the main explanation for the authors' muted preference (they are admirably evenhanded in their presentation) for tinkering with the income tax, rather than taking what they describe as the radical step of converting it to a consumption base. They also appear to be influenced by their conclusion that a transition is likely to involve massive gains and losses and to extract a high price in complexity. In that regard, while they are correct in their analysis of the particular alternatives that they examine, I think they could have done more to lay out the possibilities for an orderly transition.

The problem with any transition is the change in the timing of deductions, rather than the consumption base per se. As my colleague, Dan Shaviro has pointed out, the same problem would arise under the existing income tax if one proposed to shift to a first-year deduction of the present value of an economic depreciation allowance, at the same time canceling all business claims for depreciation on past investments. After all, it is generally believed that the 1981 tax reform reduced the effective rate of tax on capital income to zero, while the 1986 reform took it back to some reasonably high level. The mas-

sive transition effects seem to have been lost in the noise.

In short, the authors' conclusion that shifting from our present, hybrid system to one based on a consistent consumption approach would necessarily be a radical change seems to me misplaced. It could be, but it need not be. The really radical part of proposals like the Hall-Rabushka flat tax is their extreme "cleanness" in the authors' terms. The flat tax would toss out the exclusion of health care and the deductions of charitable contributions, mortgage interest, state and local taxes, and a host of other objects of conventional tax reform tinkering. That is what makes adoption of such schemes unlikely to attract majority support.

There are things that the authors should think about for the next edition. We do not yet have a very satisfactory system for describing fiscal systems. For example, consider the second chapter's description of the existing tax system, in which the authors give the impression that over half of "personal income" is not included in the income tax base, "taxable income." But personal exemptions and standard deductions account for a good chunk, 12.5 percent of personal income. Should not those elements be thought of as part of the rate structure? If so, we are up to 58 percent in the tax base. Some itemized deductions probably also deserve to be counted as appropriate adjustments to reach income in the sense usually used in tax policy discussions. The exclusion of untaxed transfers and the income of "nontaxable persons" accounts for some more. Probably a good deal of that amount should also be thought of as, in effect, part of the rate structure. Untaxed transfers account for another chunk. Should not a transfer be thought of as a kind of negative tax, and therefore not part of the base at all?

The problem of characterizing fiscal aggregates extends to the description of the distributive impacts of the tax system as well. Since it is, presumably, the net effect of all fiscal institutions that interests us, we need to find a way to capture the impact both "income" and "price" or marginal incentive effects of all tax and transfer programs at once.

Lastly, taking seriously the authors' observation that it is "welfare", not income as usually measured, that is the appropriate concern of incidence analysis, the ideal future edition will be developed more consistently in those terms. That means that something other than income, some measure of the pre-tax trade off between leisure and consumption, analogous to a wage rate per unit time worked will be needed to classify people for purposes of describing the vertical distributive effect of tax-transfer systems, which will be expressed in terms of changes in taxpayers' utility (like consumers' surplus). General equilibrium model simulation results are typically presented in those terms now, so the thought is not as speculative as it might seem.

Those criticisms and suggestions should, however, not distract from my message on the jacket of the book. Loaded with useful information and subtle analysis, but lively and approachable nonetheless, *Taxing Ourselves* deserves to be widely read.

WELFARE IN THE WORKPLACE

Rewarding Work: How To Restore Participation and Support to Free Enterprise

by Edmund S. Phelps

(Harvard University Press, 1997) 198 pages

Reviewed by Walter E. Williams

Early in Chapter Two, one gets a good idea where Edmund Phelps is heading when he laments, “The premise of this doctrine [laissez faire]—the value of self-realization and independence—receives a more sympathetic hearing today than it once did.” He spices up that assessment with a dash of today’s politics of envy by saying, “Antipathy toward the rich or super-rich, as if they were hereditary barons owning all the land (and land was everything), is no longer intense.” Continuing, he instructs us, “What the rosy view taken by laissez faire advocates leaves out is the problem of meager wages. Laissez faire doctrine assumes each person is either amply productive and hence capable of self support or wholly unproductive and hence incapable of self-help.” Thus, the problem for which Phelps will offer a solution is the “class of workers whose employment and wage prospects are too poor to support a lifestyle remotely approaching that of the middle class.”

Phelps tells us that a seven dollar per hour wage—much less minimum wage—does not allow a worker the same purchases of a worker earning a higher wage. That is a silly observation: at any wage, a worker cannot make purchases that people earning a higher wage can make. But he backtracks a little bit when acknowledging that today’s poor workers enjoy a range of goods that would have been the envy of the majority of workers a mere half century ago. He is right about that; by any absolute comparison, intertemporally or globally, what was traditionally known as poverty, at least in the United States, has all but been eliminated. Moreover, two minimum wage jobs would give a married couple, both working full time, an annual income of twenty-one thousand dollars per year, an amount well-above the poverty level for a family of four. There are those who might rejoice that a husband cannot support a family of four at a minimum wage (\$10,500) job. I agree but advise that getting married and having children is not an act of God; one has to take affirmative steps in both cases. Therefore, prudence suggests that a man (or for that matter, a woman) who is financially incapable of supporting a family postpone making that decision.

According to a 21 September 1990 Heritage Foundation report by Robert Rector et al., “How ‘Poor’ Are America’s Poor?”, 38 percent of poor people own homes with a median value of \$39,200. Sixty-two percent of poor households own a car; 14 percent own two or more cars. Nearly half of poor households have air conditioning; almost one-third of poor

households own microwave ovens; and finally, nationwide, twenty-two thousand poor households have heated swimming pools or Jacuzzis. For many “poor” people to have what not long ago were considered luxuries beyond the reach of middle class families is not only phenomenal, it is one of the best testimonials for laissez faire. Additionally, there is a real question about just how poor the poor are. Survey data in the Bureau of the Census’s American Housing Survey for the United States in 1987, published in 1989, show that for each dollar of officially reported income the poor spend \$1.95.

Phelps argues that since the 1970s, a widening gap has opened between low income and middle class workers. (Most who make that claim ignore mandated nonmoney wage compensation or benefits that workers receive today but did not receive in 1970 such as OSHA and EPM mandates, worker compensation, Social Security, and health benefits. Some estimate that those mandates add up to a third or more of a worker’s hourly wage. With the supposed decline in the rewards from work, at least according to Phelps, job attachment has weakened among low-wage workers. Coupled with welfare state incentives, increasing numbers of low paid workers opt out of the workforce. The increased unemployment stimulates criminal activity, drug abuse, and other social pathologies that are costly for everyone.

As a young person, I was lectured that any work is preferable to stealing and begging and I think Phelps agrees, he adds that work creates a livelihood, learning experiences, and the psychological benefits associated with feelings of belonging and responsibility. But Phelps says that those benefits are disappearing due to the growing gap between wages paid on the low end of the skills spectrum and wages paid at the middle or higher end of the spectrum. Therefore, society must do something.

Edmund Phelps calls for a “market-based solution” where government subsidizes the wages of low wage workers. The subsidy would work as follows: a firm would pay the worker according to what Phelps calls his “private productivity.” That private productivity might be four dollars per hour. But, according to Phelps, society benefits from low skilled people working—less crime and less dependency—therefore, the worker should also be rewarded for the social productivity that society reaps from his employment. That is where Phelps’ wage subsidy comes in. He proposes adding a subsidy of, say, three dollars to the worker’s hourly compensation. That is, we should be taxed so the government can make a three dollar payment to the employer, thereby enabling the employer to pay the worker a gross hourly wage of seven dollars. That way, the worker is compensated for both his private and social productivity. The subsidy, Phelps contends, would create a greater attachment to the world of work. The subsidy would be graduated; viz., it would decline as worker wages rise. The specific example in the book has the subsidy declining by small decrements as wages rise to twelve dollars per hour where the worker’s hourly wage subsidy would only be six cents; once the worker’s wage rises to thirteen dollars per hour, the subsidy would be eliminated. Phelps argues that

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society would gain from his subsidy program through lower crime costs and welfare dependency.

There are some particulars about Phelps's "market-based" scheme that warrant attention. Early in the book, he decries the fact that a seven dollar an hour wage will not permit the worker to purchase items available to the middle class. Thus, according to Phelps' reasoning, his subsidy scheme would make for no improvement in work attachment. That question is even more germane in light of the findings by Michael Tanner, Stephen Moore, and David Hartman in a 19 September 1995 Cato Institute Policy Analysis entitled, "The Work vs. Welfare Trade-Off." In that report, the authors show that the hourly wage equivalent of welfare ranges from a high of \$17.50 an hour in Hawaii to a low of \$5.53 in Mississippi. The poor are not stupid; they respond to incentives just like everybody else. So the question arises: Why would a Washington, D.C. welfare recipient give up a welfare equivalent of \$13.99 (after taxes) an hour in exchange for Phelps' wage subsidy scheme of seven dollars (before taxes) an hour? How much work attachment would that generate? Nonetheless, Phelps sees his subsidy scheme as superior to other approaches that have been tried such as increases in the minimum wage, public sector jobs, and job-training programs.

Phelps acknowledges studies such as Charles Murray's 1984 classic, *Losing Ground*, that point to the work disincentives of various welfare programs. The most comprehensive study, the Seattle/Denver Income Maintenance Experiment, finds that for each dollar increase in welfare payment, low-income persons reduced labor earnings by eighty cents. And using a 1970 National Longitudinal Survey of Youth data, Dr. M. Anne Hill and Dr. June O'Neill found that a 50 percent increase in the monthly value of welfare benefits led to a 43 percent increase in the number of out-of-wedlock births.

However, Phelps dismisses such studies, "My thesis is quite different: that a proemployment policy that draws upon and builds up the low-wage workers' capacity for self-help is better for everybody and, if instituted, would cause welfare to wither away." For an economist to take that position is indeed strange. Regardless of political persuasion, I believe most economists—at least most academic economists—would agree that if something is taxed we will get less of it and if something is subsidized we will get more of it and, indeed, surpluses of it. Phelps gives the wrong causal direction when he suggests that a "proemployment policy . . . would cause welfare to wither away." The causal direction might be exactly the opposite: elimination of welfare would create greater work attachment. In other words, I conjecture, and I know of no evidence to the contrary, that people will not choose starvation over working forty hours a week at five dollars an hour. History tends to confirm my conjecture. Workers spent lifetimes employed at "menial, dead end" jobs at low wages before the advent of the welfare state.

In his Prologue, Phelps acknowledges that for most of its history, America "was an earthly paradise in which people, through their work, supported themselves, developed their tal-

ents, and took part in the community." But, "In its third century, then, the American experiment has ceased to deliver the inclusion it did in the past. . . . This social breakdown and unrest, I argue, can be traced to economic forces that have deprived a great many less advantaged workers of much of the power of their labor." That description of today's America does not fit the experiences of immigrant groups who arrive on our shores poor, in fact some are poorer than our resident poor, and often do not speak our language. However, in the space of a generation or two, they manage to melt into the economic mainstream of American society. Unlike resident poor, immigrant poor tend to work at any job for long hours, and they save a large portion of their earnings. The tools they use to move up the economic ladder are available to our resident poor but are rarely used.

Amazingly, Phelps asks, "After two centuries of economic advance, how can there be extensive poverty, and more poverty than a half century ago?" That question is amazing for the following reasons: (1) it ignores the actual wealth of the poor, which I discussed earlier; (2) it contradicts census data that poverty has declined since 1950; and (3) it fails to consider that today's poverty is not poverty in the material sense but behavioral poverty.

For the most part, people who are poor today have chosen a lifestyle that produced that result. Lawrence Mead points out in his 1992 book, *The New Politics of Poverty: The Nonworking Poor in America*,

Today's poor are mainly found among female-headed families and single adults. . . . Between 1959 and 1989, the total number of poor Americans dropped from thirty-nine million to thirty-two million, but the number of poor living in female-headed families grew from seven million to twelve million and the number of poor single people grew from five million to seven million. Together, the two groups comprised 30 percent of the poor in 1959, but 58 percent by 1989.

Married-couple families comprise 94 percent of the top income quintile while single-headed families are over half the lowest quintile. Forty-three percent of family heads without a high school diploma are in the lowest earnings quintile.

Another point that Phelps misses is that poverty is often transient. A June, 1992 study of tax returns by the Joint Economic Committee of the U.S. Congress, entitled *Income Mobility and Economic Opportunity*, showed that four-fifths of those in the bottom 20 percent who filed tax returns in 1979 were no longer there in 1988. And a University of Michigan study by Greg J. Duncan, et al., entitled *Years of Poverty, Years of Plenty: The Changing Economic Fortunes of American Workers and Families*, found that less than half of families surveyed from 1971 to 1978 remained in the same quintile of income distribution through that period.

Phelps spends considerable time discussing the dysfunction of inner cities (read black neighborhoods). For most of black history, "dead end" and low-wage jobs have been standard fare.

During earlier periods, when there were fewer opportunities, less mobility and much greater discrimination, poor black communities had little of the social pathology we see today. For starters: most blacks worked. During the Post-Reconstruction era, black labor force participation rates were equal to, or higher, than that of whites. Census data show that in 1910, for example, 71 percent of blacks over nine years of age were employed compared with 51 percent for whites. Black labor force participation rates were higher than that of whites until the mid-1960s. Thomas Sowell reports in his 1995 book, *The Vision of the Anointed*, “Going back a hundred years, when blacks were just one generation out of slavery, we find that census data of that era showed that a slightly higher percentage of black adults had married than white adults. That fact remained true in every census from 1890 to 1940.” Today, family stability among blacks is a mere skeleton of its past. Census data show that as recently as 1960, only 21 percent of black children grew up in female-headed households. By 1991, only 37 percent of black children lived in two-parent households; the figure for whites was 77 percent. The dramatic family breakdown has coupled with astonishing growth in the rate of illegitimacy. The black illegitimacy rate in 1940 was 19 percent; by 1965, it had grown to 28 percent. Beginning in the late 1960’s black illegitimacy skyrocketed, reaching 49 percent in 1975. Today, black illegitimacy stands around 65 percent and if present trends continue, it will be 75 percent at the turn of the century. The dysfunction in black communities is not a result of low wages. It is more likely to be the other way around: low wages are a result of the dysfunction.

Whenever a proposal is advanced calling for government intervention, one should ask: is that really a problem that lies within the scope of government? Is it amenable to government solutions? Do the proposed solutions have a record of past success?

Phelps argues that weak attachment to work resulting from low wages leads to dependency, crime, and other antisocial behaviors. Unfortunately, there is no evidence for Phelps’ causal connection. Historical labor force participation rates suggest that those rates were much greater when wages, living standards, and potential for upward mobility were much lower than they are today. The alleged effects of weak work attachment—dependency, crime and antisocial behavior—may be the result of something other than weak work attachment. The welfare system, along with lax law enforcement, and reduced social sanctions against irresponsible behavior have reduced the cost of irresponsible behavior.

No evidence supports Phelps’s proposal that wage subsidies can account for Americans having the world’s highest standard of living. Keep in mind that two hundred years ago, we were, by today’s standards, a Third World nation. As Phelps points out in his Epilogue, transfer payments now equal nearly 30 percent of earnings. In 1960, transfers equaled 10.5 percent of earnings; in 1929 they equaled 3 percent and from the inception of the nation, until World War I, transfers were negligible. Acknowledging the insignificance of transfers, Phelps makes the remarkable statement, “The system of subsidies to private employers of low-wage workers for which I have

argued in this book fit the founders’ conception of our government.” That is unmitigated balderdash. Had Phelps bothered reading Article I, Section 8 of the United States Constitution—which specifically enumerates the functions of the federal government—he could not have reached such a conclusion; there is nothing listed among the powers of Congress that even remotely authorizes worker subsidies.

Phelps might invoke the general welfare clause. But the acknowledged father of the Constitution, James Madison said, “I cannot undertake to lay my finger on that article of the Constitution which granted a right to Congress of expending, on the objects of benevolence, the money of their constituents.” Specifically addressing the general welfare clause, Madison said, “With respect to the words *general welfare*, I have always regarded them as qualified by the detail of powers connected with them. To take them in a literal and unlimited sense would be a metamorphosis of the Constitution into a character which there is a host of proofs was not contemplated by its creators.”

In the next to the last paragraph in the book, Phelps gives me pause to be a bit more optimistic about a man I have long admired as a well-trained economist. He tells us that his proposal is really a first step toward “revitalizing the conception of government on which the country was founded.” That is, when people work to take care of themselves:

[T]here will be no case for injecting the government into decisions on family formation and child raising. Crusades are not wanted in this country, only a limited government conducive to our private pursuits. And with the less productive back on their feet, there will be hope of a reassessment of the government as an insurance company and equalizer of incomes.

In other words, Phelps sees his subsidy scheme as a means to a libertarian end and thus, I guess I should not condemn him too much for his “good” intentions. But by no means should his strategy be implemented.

WHY (AND WHY NOT) GOVERNMENT? Free Markets and Social Justice

by Cass R. Sunstein

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Reviewed by Irwin L. Morris

Nothing is more certain than the indispensable necessity of government; and it is equally undeniable that whenever and however it is instituted, the people must cede to it some of their natural rights, in order to vest it with requisite powers. (Federalist 2).

No one but ardent anarchists would dispute Jay’s claim. The world we know would not exist without government. We must

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trade our “natural rights,” for the benefits of good government. The central question is “How do we, as a community, identify the appropriate balance between individual rights and government authority?” Though the search for the “ideal” government is almost certainly an endless odyssey, we bear the responsibility for choosing the type of government we want. So we seek answers to the following questions: (1) What should governments do? and (2) What should government not do?

How do those questions relate to the book, *Free Markets and Social Justice*? If the title is any indication, they don’t. But this is a peculiar book. A collection of previously published essays, the book has little to do with free markets or social justice. First, the book is not about “free markets.” As far as Sunstein is concerned, markets are not “free.” And Sunstein never explicitly defines “social justice,” the term is even omitted from the index. The title notwithstanding, it is quickly apparent that the author’s main focus is the role of government, and implicitly coercion, in the “good” state. As he argues, “[t]he real question is what kinds of regulations (emphatically including those that make markets possible) promote human well-being in different contexts.” In his treatment of that issue, Sunstein reacts to a half-century of research on market failure and welfare economics that was intended to demarcate the proper sphere of government authority, a sphere circumscribed by the extent to which “free” markets fail. Given the connection to a vast body of previous work, the book must be understood in the context of that literature.

Traditional defenses of markets focus on the interactions that form markets and the outcomes those interactions generate. In markets, individuals voluntarily participate in mutually beneficial transactions. In fact, the free, individually oriented transactions of buyers and sellers produce outcomes that are individually and collectively superior to the previous state of affairs. As Adam Smith, the philosopher of market forces, wrote:

[t]he natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operations.

Aside from cultivating economic growth and prosperity, markets also promote the advancement of political freedom. Where the structure of government precludes the development of markets, civil liberties are at risk to the extent that they exist at all.

Given all that is good about markets, the question is, “Why government?” What is the rationale for coercion in a liberal society? Government actions are often justified as corrections for “market failures.” Even freshmen economics majors are told that, sometimes, markets function improperly, sometimes they fail. Imperfect competition, externalities, public goods, information asymmetries, and transaction costs prevent markets from achieving optimal outcomes. For example, in the case of alleged imperfect competition, monopolies extract profits beyond a normal return by restricting supply. The eco-

nomie surplus generated by commerce is less than that produced in situations where monopolies do not exist. In perfectly competitive markets, that type of market control never occurs. Similarly, markets tend to underproduce public goods. By definition, once a public good (e.g. clean air) is produced, it cannot be restricted and its enjoyment by one person does not lessen or prevent others’ enjoyment of the good. Given the characteristics of public goods, the incentives to “free ride” on the purchases of others tend to reduce or eliminate the incentives to purchase for oneself. Markets may also produce a nonoptimal amount of a good if producer and consumer do not share the same information. When producers have an informational advantage over consumers, producers may earn an artificially high price for the relevant good or service.

In each case, traditional economic analysis suggests that markets generate suboptimal outcomes. Theoretically, government, through the use of coercive power, can improve upon market outcomes. When markets fail, government can solve the problem. For example, government could eliminate free riders and thus foster a more nearly optimal supply of a public good through coercive taxation. In any case, the market failure literature provides an efficiency rationale for the exercise of government authority and the concomitant restriction of individual liberty. That is the jumping-off point for Sunstein’s arguments.

The initial cluster of chapters is entitled “Foundational Issues,” and in those five chapters (one written with Richard Pildes), Sunstein makes three important claims that bear on the question of the proper roles of government and markets. First, he rejects the traditional distinction between markets and government, arguing that markets are not really free. Second, he contends that citizen preferences are not mere personal desires (exogenous, to use social science language). Rather, they are endogenous, effected by external influences and subject to manipulation. Finally, Sunstein argues that people value different goods, services, and situations differently. People not only value some goods more than others; they actually value different things differently.

Sunstein has serious reservations about restricting government to act only in situations in which markets are said to fail. His most significant objection is the false dichotomy between markets and government presumed by alleged market failure analyses. He believes the classical liberal preference for markets is misguided because governments play an important role in properly functioning markets. For Sunstein, markets are dependent upon the definition and protection of private property, the enforceable contracts, and the legal system all provided by government. Accordingly:

[T]he law that underlies free markets is coercive in the sense that in addition to facilitating individual transactions, it stops people from doing many things that they would like to do. This point is by no means a critique of free markets. But it suggests that markets should be understood as a legal construct, to be evaluated on the basis of whether they promote human interests, rather than as a part of

nature and the natural order, or as a simple way of promoting voluntary interactions.

Since markets are not a remnant of the state of nature, markets actually presuppose government, one cannot justify government solely on the basis of potential market failures. Government precedes markets.

Though an important point, it is not unique to Sunstein. Both Adam Smith and Friedrich Hayek realized that efficient markets required government. Nevertheless, Sunstein's reiteration of that perspective is important. As Sunstein removes, again, the firewall between markets and government, traditional arguments about their proper spheres of influence become less useful. But those arguments do not become irrelevant. Sunstein's point does not necessarily invalidate the "market failure" perspective that would mandate government intervention in economies on a focused and limited basis.

For Sunstein, the minimalist government advocated by those who believe in "market failures" is too narrow and restricted. He sees justification for a much more activist state. To understand why that is the case, one must realize that conventional economic analysis presumes preferences are exogenous meaning they are beyond analysis and manipulation.

Sunstein argues that preferences are endogenous; he contends that personal preferences are a function of a variety of different factors including background, personal experience, and the particulars of decisionmaking contexts. If preferences are endogenous, if they are manipulable, then the extent to which individuals should be free to act on those preferences is open to question. As Sunstein writes, "The phenomenon of endogenous preferences casts doubt on the notion that a democratic government ought to respect private desires and beliefs in all or almost all contexts." For example, if individuals' personal circumstances generate the formation of preferences that are obviously antithetical to personal and public well being i.e. the development of an addiction to controlled substances then the results of free exchanges based on those preferences would not be in the public interest and government should intervene. In that case, no market failure has occurred, but Sunstein argues government must nevertheless respond by fostering the development of more socially desirable preferences.

Sunstein also criticizes the assumption that all goods are valued on a single scale, a foundational assumption of market economics. According to Sunstein, "[h]uman beings value goods, events, and relationships in diverse and plural ways." Goods or events valued in qualitatively different ways are "incommensurables." If the single metric assumption is suspect, then that suggests that consumer decisionmaking and citizen decisionmaking are distinct. If citizens and consumers make decisions in qualitatively different ways, the use of a market perspective to identify the proper sphere of government activity is faulty, and evaluating government activities on market-oriented criteria (i.e. improve upon market failures) is likely to produce an inappropriately small public sector.

The second group of articles entitled "Rights" includes a

critique of market solutions to discrimination, an essay on the First Amendment in cyberspace, an analysis of economic rights in new constitutions in Eastern Europe, and a piece on campaign finance reform. Aside from a superficial focus on rights, the articles are seemingly unrelated. If there is a relationship between the chapters, it is Sunstein's preoccupation with the development of what he describes as a "deliberative democracy." For him, rights such as free speech and freedom of the press are prerequisites for the development of the polity to which the founders were committed, "a deliberative democracy among informed citizens who are political equals." Accordingly, without the constitutional protection of civil rights, deliberative democracy would be impossible.

One cannot overemphasize the significance of the modifier "deliberative." In a "deliberative" democracy, discourse is an integral component of decisionmaking. It is not a democracy in which policy is determined by the simple aggregation of fixed preferences; here, policy decisions are a function of the policymaking context, the malleability of preferences, and the process of reason-giving. Sunstein communicates his vision of deliberative democracy in the following passage:

[A] democratic system, at least in America, is not supposed to represent an effort to aggregate preferences at all. Instead, the process is a deliberative one, in which different information and perspectives are brought to bear. In that deliberative process, preferences are supported by reasons, to be transformed into values and judgments.

That passage highlights an important connection between the nature of individual preferences and the practice of deliberative democracy. To the extent that preferences are exogenous, deliberative democracy is nonsensical. In such a case the only necessary institutions of government are: (1) those that aggregate preferences and (2) those that identify the proper sphere of government authority. Where preferences are fixed, rights are simply those prerogatives not subject to the whims of majority rule. However, if preferences are actually a function of the political system, then they take on a somewhat different meaning (Sunstein dislikes the term "preferences" but provides no suitable alternative); they become essential components of the workings of the system. In the former case, rights protect the individual's capacity to behave as an individual. In the latter case, rights insure the capacity to participate fully in the political system.

Unfortunately, the determination of rights in Sunstein's polity is complicated, and it is unclear what rights should be protected or how those rights should be chosen. Clearly, Sunstein has little confidence in traditional "natural rights" arguments, so we cannot deduce rights from first principles. Thus, rights are a function of political decisions that must presuppose certain rights to have legitimacy. This "chicken or egg" problem is far from trivial, and Sunstein provides no solution. But if we are willing to assume away this problem for the time being, the last set of chapters in Sunstein's book provides ideas about the kinds of decisions that deliberative democracy should produce and insight into decisionmaking in

that system.

In the final group of articles, Sunstein focuses on the public regulation of risk and a variety of proposals designed to improve our system of government by fostering the deliberative character of democracy. There are several underlying themes. The first theme is simple: where there are “irrationalities and injustices,” eliminate them. The more subtle second theme is: make policy decisions at the level of particulars. If there is a third theme, it would be that the institutionalization of deliberative democracy will aid in both of those endeavors.

Sunstein identifies a host of regulatory “irrationalities and injustices.” For example, Sunstein notes that “the United States spent no less than \$632 billion for pollution control between 1972 and 1985, and some studies suggest that alternative strategies could have achieved the same gains at less than one-fifth the cost.” That works out to deadweight losses of half a trillion dollars. Sunstein even goes to great pains to enumerate the “paradoxes” of regulation and the regulatory state. Among those paradoxes are the increase in overall risk levels with the implementation of stringent regulation of new risks, the impeding of technological development by establishing the Best Available Technology (BAT) requirement, and the contribution of disclosure requirements to the inadequacy of available information.

Where “irrationalities and injustices” exist, we should eliminate them. Fine. But it is often difficult to determine whether particular phenomena are manifestations of irrationality or nonconventional preference systems. Rather than valuing risks along a single “more or less” continuum, he argues that people evaluate risks in qualitatively different ways; he argues, in essence, that the valuations of diverse goods are often incommensurable. So spending \$50 million per life to prevent cancer deaths and only \$1 million per life to prevent motorcycle fatalities could be reasonable or unreasonable. If we evaluate risks in different ways because of differences in the character of the risk itself (e.g. voluntary vs. involuntary) then an apparent “irrationality” becomes rational. Unfortunately differences in risk aversion might also be a function of poor information (inadequate access to reliable risk assessments) or outright irrationality (gross misperception of actual risk in the face of countervailing information). In those cases, the fifty to one differential is irrational.

In general, it is difficult, if not impossible, to determine whether a specific regulatory decision is a function of irrationality or an unconventional evaluative scheme. Take into account the fact that in a world of endogenous preferences government must take responsibility for the elimination of “inappropriate” preferences, and the problem becomes more difficult. What are the proper guidelines for government action? Sunstein’s response to that question is one of the most interesting sections of the entire book: we should make decisions about specific circumstances in a deliberative environment. We might call it Sunstein’s “theory of particulars.” He

argues that in many cases, those who have divergent ideological perspectives might still agree about a particular course of action in a specific situation; they might achieve what Sunstein refers to as an “incompletely theorized agreement.” Thus, deliberation about specifics may solve policy problems and foster consensus in a way that ideological discourse will not. According to Sunstein, “debates that seem intractable at the most abstract levels may admit of solutions when the question is narrowed.” To the extent that an analytical focus on particulars will lead to policymaking consensus, well done.

However, augmenting the power of the state even in a deliberative democracy is risky. One of the most significant developments in the study of politics over the past thirty years is the growth of public choice theory. Admittedly, public choice is different things to different people; there are certainly no less than three significantly distinct schools of thought within the literature. Nevertheless, from the methodological starting point of a rational actor in a political context *homo economicus* becomes *Homo politicus* a theory of politics has developed which tells us some very interesting things about the topics with which Sunstein deals.

Though a complete rendering is beyond the pale here, public choice theory suggests that small, organized and interested groups often manipulate governmental power. Public choice theory also suggests that the actual existence of a market failure is not a sufficient condition for government action. Governments also fail, and it is quite possible more than likely for a good number of public choice theorists that government failure will be worse than the original market failure it was designed to rectify. To the extent that deliberative democracy results in an augmentation of government authority, it may increase threats to individual liberty. Effective deliberative democracy requires public information and citizen vigilance and oversight on an unprecedented scale; as the power of government is augmented, the burdens of citizenship increase. Plainly, as citizens, we snooze, we lose.

Finally, Sunstein’s preoccupation with Madison’s vision of “deliberative democracy” does an injustice to Madison’s philosophy. We cannot forget that one of Madison’s most important contributions to constitutional government was his insistence on “limited” government. Though deliberative democracy may produce consensus, that it will actually do so is little more than an article of faith. Deliberation may not produce agreement, and if it does not, what then? For Madison, the answer was clear—in the face of significant conflict, err on the side of freedom. We should always be wary of empowering the state in situations in which significant conflict over policy still exists. Unfortunately, that perspective is often forgotten in the drive to recreate democracy. That Sunstein makes us think about those important issues of “deep” theory is very much to his credit.