

In Review

Constitutional Quandary

Reviewed by Michael C. Munger

THE STRATEGIC CONSTITUTION

By Robert D. Cooter

412 pp., Princeton, N.J.: Princeton University Press, 2000

God forbid we should ever be 20 years without such a rebellion. The people cannot be all, & always well informed. The part which is wrong will be discontented in proportion to the importance of the facts they misconceive. If they remain quiet under such misconceptions it is a lethargy, the forerunner of death to the public liberty. We have had 13 states independent 11 years. There has been one rebellion. That comes to one rebellion in a century & a half for each state. What country before ever existed a century & a half without a rebellion? & what country can preserve its liberties if their rulers are not warned from time to time that their people preserve the spirit of resistance? Let them take arms. The remedy is to set them right as to facts, pardon & pacify them. What signify a few lives lost in a century or two? The tree of liberty must be refreshed from time to time with the blood of patriots & tyrants. It is its natural manure.

—Letter from Thomas Jefferson to William Smith, November 13, 1787

It is proper you should understand what I deem the essential principles of our Government, and consequently those which ought to shape its Administration[:] ...a jealous care of the right of election by the people — a mild and safe corrective of abuses which are lopped by the sword of revolution where peaceable remedies are unprovided; absolute acquiescence in the decisions of the majority, the vital principle of republics, from which is no appeal but to force, the vital principle and immediate parent of despotism.

—Thomas Jefferson's First Inaugural Address, March 4, 1801

The above two passages, Jefferson's famous "tree of liberty" letter and his equally well-known appeal to a reliance

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on elections, seem in conflict. The most obvious difference is that the "tree of liberty" excerpt was written before we had a working constitution. By contrast, the elections as "mild and safe corrective" idea was written after the U.S. Constitution was established, and Jefferson himself had become president under its rules.

There is more at work here than simply a change in Jefferson's status from observer to ruler. Something surprising had happened, something that may have changed Jefferson's mind: An election had had the same effect as a revolution, throwing out one group and replacing it with another. What a miracle!

Why would anyone expect the people who have power to give it up, just because of an election? The current rulers control the armed forces and have a claim on the loyalties of thousands of government employees who run the nation, all of whom lose their jobs if the current rulers leave office. Why in the world would they hand over the power just because they lost some election?

REVOLUTION, ELECTION, AND LEGITIMACY

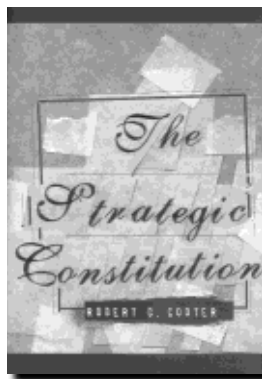
At the time of the 1800 election, it was far from clear that there could be an orderly transition of power, because that had hardly ever happened. Previous attempts at transition had usually been quite disorderly: They were either revolutions (in which people get killed and power changes hands) or civil wars (in which people get killed and

power does not change hands).

But what about peaceful transitions of power? What makes them possible? It is important to understand that the group in power is only going to give up its power willingly if two conditions are met. First, the event (election, plebiscite, etc.) precipitating the change in government has to be perceived as taking place within the framework of rules that the citizens have agreed upon, or accepted, as legitimate. Second, the loser/current rulers have to believe the winner/new rulers will continue to abide by the rules once they take office.

Consider the possibilities if either of those expectations is not met:

- If the first condition (fair election) is not met, but there is a transition nonetheless, then the "takeover" is a revolution by fraud. It is simply a form of coup, though a bloodless one.
- If the second condition (new regime committed to rules) is not met, then the current rulers will almost certainly nullify the election (even if the election itself was fair) and declare martial law. That, too, is a coup, though it is a retention rather than displacement of authority. Nonetheless, the group that "should" rule is prevented from doing so.
- Power may also change hands peacefully, but against the will of the current rulers, if neither of the conditions is met. The transition would require that the new "rulers" have communicated threats that the current rulers find credible enough to make them abdicate. In that case, though there is no violence, there is still a revolution.



In 1800, neither of the two conditions was obviously met, yet there was a peaceful transition of power anyway. The people had reason to believe the change in power was not decided according to the rules: The election was decided (after 36 ballots) in the House of Representatives, and Jefferson's eventual selection had less to do with support for him than with distrust of opponent Aaron Burr.

On the second condition, the fearful Federalists had real questions about what Jefferson's Democratic-Republicans would do once they took office. Consider this hysterical, but not unusual, excerpt from the Federalist-leaning *Hartford Courant* in 1800: "There is scarcely a possibility that we shall escape a Civil War. Murder, robbery, rape, adultery, and incest will be openly taught and practiced."

Now, that prediction is clearly an exaggeration (one that some would say was not fully borne out until the Clinton administration). But it does illustrate how hard it is to trust your opponent enough to let him take power. That brings us back to our question: Why do some sets of rules take hold and become accepted, while other sets — equally plausible on their face — fail miserably or become the worm-eaten targets of reforms and rearrangements?

STABILITY AND STRATEGY

Robert Cooter's book, *The Strategic Constitution*, addresses a lot of topics, but it does not address the fundamental question of why some constitutions take root. That surprised me, because it seems to me that the question "Why would anyone obey the constitution?" is the starting point for any discussion of the "strategy" of constitutions. I do not want to dwell on this point, but there is some very good work on that question, including Barry Weingast's 1997 paper on the rule of law and Peter Ordeshook's 1992 piece on constitutional stability. I am mystified as to why Cooter does not finish his analysis and review of the literature by at least trying to say what the literature should be about.

The reason this is disappointing is Cooter's start is really excellent, as far as it goes. The beginning is promising enough:

A state commits to a constitution by arranging institutions so that each official or political faction expects to lose from violating the constitution.... Once established, a constitution creates incentives for officials and citizens to do things or refrain from doing them. Although the tumult of politics and the particularities of history obscure these incentive effects, I try to uncover them using economics and political science (pp. 3-4).

The problem is the "once established" bit. The author begs all of the important questions by saying that a constitution has the claimed effects and creates a set of incentives once it is "established."

As a number of people in the inter-

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national relations literature have shown, comparing the stability of democracies and non-democracies over time is dicey. It appears that democracies that have "established" constitutions are more stable, but that new democracies are much more likely to collapse. In fact, new democracies are dangerous and unstable until their constitutions become "established."

Why? Why do people at first tend to disobey the rules, and then start to obey them? Is it the content of the rules themselves, as Cooter suggests (but does not really argue), or is it something else — like luck or equilibrium in a game that we still do not understand — that makes a constitution established?

Taken as a whole, Cooter's argument is much more about evolution than the avoidance of revolution. It reminds me of the debates among legal scholars about the "efficiency" of the

common law. The idea is that the common law tends over time to advantage as precedents those rules that decide disputes in the way that minimizes transactions costs. That places liability in accordance not with justice, but with the agents who have the information and ability to avoid the occurrence of damage in the first place.

Further, as Gerald Scully has argued, it is clear that the common law is more certain than statutes because common law binds future judges through precedent. No legislature can bind future legislatures in anything like the same way. One way out is the constitution, because the constitution comes before the legislature, both in terms of time and precedent. But no one can unilaterally create a binding constitution, even if it says that we "ordain and establish this Constitution."

COMMITMENT, NOT EFFICIENCY

Perhaps the explanation for the greater success of some constitutions compared to others is that incentive-compatible constitutions survive, and that constitutions with internal, if unintended, conflicts collapse. But that would mean that there might be no general rules of constitutional quality, at least not of the abstract sort that Cooter is looking for. Success simply means survival, and survival depends on the (possibly arbitrary) distribution of rights and powers at the time the constitution is implemented. A constitution that survives in one setting may collapse in another.

Transactions costs Consider the case of Chile in the late 1980s. The military dictatorship led by Auguste Pinochet appeared genuinely to want to return power to a democratically elected government, perhaps to avoid continued sanctions and perhaps because the Chilean military considered the democratic constitution of 1925 to be "established" and valuable. But both the military and the democrats faced a problem: The military wanted guarantees that there would be no reprisals by civil authorities once power changed

hands, while the pro-democracy forces had no mechanisms for making such a guarantee, at least not in the context of a traditional constitution.

How did they solve the stalemate? Did they design a good constitution, according to abstract principles? No, they came up with a crazy quilt of veto set-asides for Pinochet and his military henchmen in the Chilean senate and the high court. Those provisions meant that the pro-democracy groups could not break the amnesty for the military and its leaders, even if the new government wanted to.

The Chilean constitution is hardly a model for other nations wishing to devise a set of rules of governance. But it has resulted in a stable and (mostly) democratic system of government, and Chile has once again been able to take its place among democratic nations.

My point is this: A “good” constitution may be one that solves the particular transactions costs (including, but not limited to, the problem of credible commitments) that stand in the way of changing political property rights from the status quo system to a different system governed by that constitution. A constitution that is otherwise good in terms of the abstract principles that Cooter discusses would likely have resulted in a military coup, or might have never even been adopted, in Chile.

Beyond efficiency More simply, our notion of constitutions and their value as a solution to transactions cost problems has to be divorced, as Douglass North has argued, from the abstract idea of efficiency or even evolution toward efficiency. Transactions costs may force nations to bump along on the floor of their achievable range of prosperity, even though there are Pareto superior rule systems available. The reason is that even bad systems create long-run rent streams enjoyed by those privileged under the current rules. There may be no credible mechanism for guaranteeing a distribution of the rents under the new system that leaves those with vested inter-

ests in the current, Pareto inferior, system at least as well off.

A promise is no good, even if it will not be broken. It takes a commitment that literally *cannot* be broken. As soon as Lincoln was elected in 1860, even though he promised not to touch the right to own slaves in any state that already allowed slavery, the United States no longer had a constitution. The reason I say this is that the southern states were not assured that the government under Lincoln would follow the formula of one new slave state for each new free state. All the words in the Constitution were the same as they had been in 1859, but those words no longer constituted a credible commitment. The government collapsed, and only through civil war was the Constitution restored.

CONCLUSION

Cooter has written a very useful book, one that makes a great contribution by summarizing and elucidating a wide variety of different literatures and perspectives. It is important to identify the general principles – the engineering principles if you like – that underlie the structure of effective constitutions. And that is just what the author has done.

If Cooter had titled the book *The Efficient Constitution*, I think I would have liked it better. But it is a terrific, if incomplete, book just as it stands. **R**

READINGS

- “Constitutional Stability,” by Peter Ordeshook. *Constitutional Political Economy*, Vol. 3 (1992).
- “The Institutional Framework and Economic Development,” by Gerald Scully. *The Journal of Political Economy*, Vol. 96, No. 3 (June 1988).
- “Institutions and Credible Commitment,” by Douglass North. *Journal of Institutional and Theoretical Economics*, Vol. 149 (1993).
- “The Political Foundations of Democracy and the Rule of Law,” by Barry Weingast. *American Political Science Review*, Vol. 91 (1997).

Quick Looks

By Peter VanDoren

POLICY REFORM IN AMERICAN AGRICULTURE

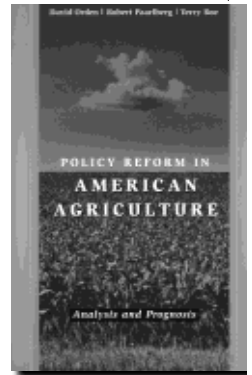
By David Orden, Robert Paarlberg, and Terry Roe
270 pp., Chicago, Ill.: The University of Chicago Press, 1999

Policy Reform in American Agriculture provides an excellent history and evaluation of U.S. policy interventions in farm commodity markets from the New Deal to the present. The authors, two economists and a political scientist, provide a political economy taxonomy of crops: import-competing crops like sugar, peanuts, dairy, and tobacco, which received cartel-like protection from the government; export crops like feed grains, wheat, cotton, and rice, which received price supports; and crops that never received New Deal assistance, such as hay, oilseeds, fruits, vegetables, and livestock products.

The latter received very little government help because supply-restricting controls could not be implemented easily – animals cannot be inventoried at low cost, and fruits and vegetables are perishable.

Reform has gradually occurred in those programs that affect exportable crops because the programs’ resulting high prices hurt U.S. exports in world markets. Programs that affect import-competing programs have remained largely unaltered because the costs do not show up on the federal budget, do not limit exports, and raise prices to consumers in ways that the consumers do not understand.

The Federal Agricultural Improvement and Reform (FAIR) Act of 1996 gave export-crop farmers a fixed and declining seven-year schedule of payments. But in 2002, policy will revert



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to the traditional price support program at 1948 levels if Congress does not act. Optimistic policy analysts see the FAIR Act's payments as a transitional measure leading to a permanent reduction or even elimination of commodity support programs after 2002. Such a transition is more likely if farm prices are high in 2002.

But if the events of the last two years continue, a more likely scenario is increased aid to farmers. Commodity prices remained high enough in 1996 and 1997 that payments would have been quite small if the old program had been continued. In 1998, however, commodity markets weakened, and in 1998 and 1999, Congress approved additional payments to the growers of the so-called export crops: \$6.6 billion in 1999 and \$8.7 billion in 2000.

Those actions of Congress and the Clinton administration signal an increased likelihood that farm commodity programs will not only continue in 2002, but their magnitude will not be significantly cut. The book's authors write:

The 1996 FAIR Act, rather than being viewed in retrospect as an effective buyout of farm programs, would come to be seen as a short-sighted experiment ... In the realm of ideas, the New Deal-era assumption of farm sector entitlement to special government protections would be strengthened rather than weakened, and an agricultural process establishment that continued to depend on that assumption would be strengthened as well (pp. 223-224).

The most probable near-term future outcome for U.S. agriculture policy could be a renewal of the FAIR Act compromise—somewhat weakened perhaps, but not reversed. Decoupled cash payments would continue to be made for export crops, and producers of those crops would be protected against adverse market outcomes in various ways, while import-competing commodity programs would once again escape reform. If this emerges as the new

policy equilibrium, the farm policy reform problem must be considered unresolved (p. 225).

THE FINANCING OF CATASTROPHE RISK

Edited by Kenneth Froot

477 pp., Chicago, Ill.: The University of Chicago Press, 1999

DISASTERS AND DEMOCRACY

By Rutherford H. Platt

320 pp., Washington, D.C.: Island Press, 1999

The *Financing of Catastrophe Risk* includes original papers and referee comments that examine the provision of insurance against large natural disasters by private markets and governments. Regular readers of *Regulation* will be familiar with the general policy issues, in particular the difficulties of the government precommitting not to provide disaster assistance to those who refuse to insure themselves. (See "Rethinking Disaster Policy," *Regulation*, Vol. 23, No. 1.) They may be less familiar with the details that this volume provides. I will describe two chapters that caught my attention.

Rate of return Standard finance theory would suggest that the return demanded by investors to bear catastrophe risk would not be very high as long as the risk of catastrophe was uncorrelated with other returns and the total capital required was small relative to the total supply of capital. Under such circumstances, investments in catastrophe insurance improve returns relative to risk as long as they exceed returns on Treasury bills.

In practice, the observed returns required to induce investment in catastrophe insurance appear to be much larger than would be expected. Kenneth Froot and Paul G. J. O'Connell examine possible explanations for that phenomenon and conclude that capital market imperfections make it expensive

to hold large stocks of capital and raise more when disasters hit. The imperfections are created by the taxation of capital in insurance reserve funds and the difficulties of controlling managerial behavior. Froot and O'Connell write:

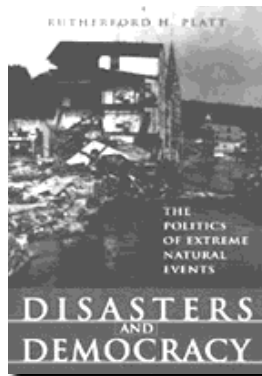
Put simply, in the standard corporate form, where managers have wide discretion over how to spend internal resources, it can be scary to think about setting them up with a multi-billion dollar cushion that is not needed for day-to-day operations. The obvious worry is that the money will find a way to get spent, perhaps on writing negative-net-present-value policies in a misguided effort to grow the business (p. 231).

History In his chapter, David Moss provides the definitive history of federal provision of disaster assistance. Moss chronicles the transformation of American expectations about federal disaster assistance from the exception to the rule. The Disaster Relief Act of 1950 followed the provision of flood-control public works during the New Deal. After 1960, the federal government gradually assumed responsibility for managing the risks associated with natural disasters. Moss writes:

The critical point here is that the rush of new risk-management policies after 1960 reflected a fundamental shift in public expectations about the role of government. Americans increasingly expected protection against an ever-widening array and, at the same time, were becoming more and more comfortable with federal insurance and other forms of public risk management (p. 326).

Subsidies and development

Another source of good analysis into the growth of federal disaster assistance is



Disasters and Democracy. Although one might not think of *Regulation* as the likely vehicle for a favorable review of a book by environmental publisher Island Press, they would be wrong. The main argument of the book—that development has occurred on environmentally sensitive land because of federal subsidies—is absolutely correct.

To be sure, the author would like no development to occur on such land. I, on the other hand, neither oppose nor favor development as long as the owners pay the full costs. But in the real world, taxpayers pay for rebuilding the beaches rather than owners. Given that reality, Platt is correct to oppose such development.

REGULATING FINANCIAL MARKETS: A CRITIQUE AND SOME PROPOSALS

By George J. Benston

137 pp., Washington, D.C.: AEI Press, 1999

Regulating *Financial Markets* summarizes George Benston's work on financial regulation since the receipt of his Ph.D. in 1962. Benston examines the usual rationales for banking regulation and finds that only one passes muster: protecting taxpayers from the cost of bailing out banks covered by government deposit insurance. He advocates requiring banks to have owners' capital that equals 15 to 20 percent of total assets and the use of subordinated debt rather than equity as a substantial part of the capital.

The function of subordinated debt is to eliminate unnecessary risk taking on the part of bank managers. During the savings-and-loan crisis in the early 1980s, banks with zero or negative net worth made very risky loans at high interest rates because of the possibility of large profits for bank-equity holders if the borrowers were to pay off their debts. On average, that strategy failed and the subsequent S&L bailout increased the cost to taxpayers. If more owners' capital were in the form of debt rather than equity, such risk taking behavior would have been severely reduced because bondholders receive no upside gain from such bet-the-bank behavior.

Benston calls for stiff capital requirements and a financial reporting system that allows for what Benston terms "Structured Early Intervention and Resolution" (SEIR). But his strategy

In Calomiris' view, deposit insurance was a public subsidy to the instability created by small banks, rather than a solution to the market failure of bank runs.

is premised on the existence of publicly provided deposit insurance that puts taxpayers at risk from bank manager bet-the-bank mischief.

Do we need to have FDIC insurance? Benston does not give in-depth consideration of that question; instead, he offers a one-sentence answer: "Bailouts cannot be avoided politically — which experience shows is the case" (p. 8). I found his answer to be less than satisfactory given Bob Litan's proposal, more than a decade ago, of a two-tiered banking system in which consumers would receive safety and a low return from institutions that invested in Treasury bills (*What Should Banks Do?* Washington, D.C.: The Brookings Institution, 1987). Under Litan's scenario, all other banks would be uninsured and offer higher returns and risk. An AEI publication should at least discuss why it is less radical than a 14-year-old proposal from Brookings.

U.S. BANKING REGULATION IN HISTORICAL PERSPECTIVE

Charles W. Calomiris

359 pp., New York, N.Y.: Cambridge University Press, 2000

Charles Calomiris' new book is a collection of some of his most important papers, accompanied by a newly written introduction. Calomiris' work examines the history of banking regulation from a political economy perspective. He argues that regulations arise when

concentrated minority interests pass legislation that furthers their distributive goals, but the "specific economic history of a country matters" (p. xviii). Thus deposit insurance, a proposal that had gone nowhere for 50 years, finally passed because of the combined effects of the Depression and the political entrepreneurial skill of Rep. Henry Steagall.

The fragmented U.S. banking system was extremely inefficient and vulnerable to regional economic shocks because banks' loan portfolios were not geographically diversified. The supply of credit to rural areas was particularly negatively affected, but branching restrictions were "a central element of the populist, agrarian platform in the nineteenth and twentieth centuries" (p. xix). Why? Calomiris argues that branching restrictions served the interests of wealthy farmers because banks could not easily divert credit to borrowers located elsewhere, even though agricultural price declines had reduced the net worth of existing agricultural customers.

Publicly provided deposit insurance is usually justified as a response to depositors' inability to differentiate banks whose loans are unlikely to be repaid from banks that have made good lending decisions. Calomiris' most important papers reinterpret the economic history of bank failures by demonstrating that withdrawals during panics varied greatly across banks, and those banks that failed ex post also appeared weak ex ante. Thus depositor withdrawals, in Calomiris' view, played an important role in imposing market discipline on banks rather than being a source of uniform contagion.

In Calomiris' view, deposit insurance was a public subsidy to the instability created by small, undiversified unit (one-branch) banks, rather than a solution to the market failure of bank runs. The fight between small, inefficient banks and large, efficient national banks will continue in struggles



over deposit insurance reform and the use of advances from the Federal Home Loan Bank (FHLB), which increasingly doles out cheap money to weak commercial banks as a political survival strategy.

What does the future hold? Calomiris argues that the future of banking reform will be determined by whether the attempts of publicly created institutions, like FHLB and Fannie Mae and Freddie Mac, to create political constituencies will offset other trends that increase the ability to compete without government assistance. For example, if technology allows banks to develop their own electronic payment system and avoid the Federal Reserve payment system, then banks could renounce their charters with little cost and avoid regulation.

RESTRUCTURING REGULATION AND FINANCIAL INSTITUTIONS

Edited by James R. Barth, R. Dan Brumbaugh Jr., and Glen Yago
484 pp., Santa Monica, Calif.: Milken Institute Press, 2000; and Norwell, Mass.: Kluwer Academic Publishers, 2001

The Milken Institute volume is an edited collection of papers presented at a March 1998 conference. I will discuss four papers that caught my attention.

In light of George Benston's recommendation of owners' capital that equals 15 to 20 percent of total assets (see above), Federal Reserve Bank economists Cara Lowen, Stavros Peristiani, and Kenneth Robinson authored a paper that examines the role of increased capital requirements in the bank-lending crunch of the late 1980s and early 1990s. They conclude that the increased capital requirements reduced the supply of commercial credit and shifted lending toward safer home mortgages. Thus, increased capital requirements are not costless.

Susan Woodward describes how SEC regulation serves to restrict entry, innovation, and competition, rather

than just correct information market failures that hurt investors.

Economists Gordon Alexander, Jonathan Jones, and Peter Nigro, in their paper, tell us that a substantial minority of investors have serious misconceptions about financial markets: 28 percent of those surveyed did not know that bonds could lose money, while nearly 25 percent did not know that stock market returns are higher than Treasury bill returns. The authors call for increased "plain English" requirements from the SEC as more unsophisticated investors invest outside banks.

Ken Scott of the Hoover Institution and Ralph Parsons of Stanford University, in their comments on the paper by Alexander et al., provide a useful corrective. Scott and Parsons argue that most markets work very well even though consumers are uninformed, because sellers compete for marginal customers and markets for intermediaries exist. But what should you do to increase investor literacy? They argue that if the SEC had devoted the last 60 years to educating the public about the positive correlation between risk and return and the reduction of risk through diversification, rather than mandating prospectuses, the public would be much better off. I agree.

Richard Ippolito of George Mason Law School argues in his chapter that the current structure of retirement savings, in which firms offer a limited number of mutual fund investments for employees, would not have arisen unless it were tax-favored relative to individual

investing. In his view, the government ought to encourage competition in savings plans by expanding the IRA contribution limit from \$2,000 per year to 25 percent of wages. Then, employers would provide pension plans only if they truly possessed a comparative advantage in doing so.

THE ECONOMICS OF PRICE DISCRIMINATION

By George Norman
569 pp., Northampton, Mass.: Edward Elgar, 1999

ECONOMIC REGULATION

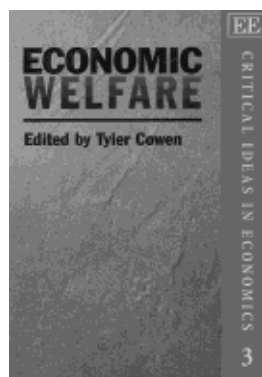
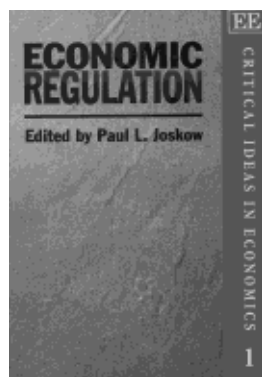
By Paul L. Joskow
709 pp., Northampton, Mass.: Edward Elgar, 2000

ECONOMIC WELFARE

By Tyler Cowen
606 pp., Northampton, Mass.: Edward Elgar, 2000

These massive reference works provide one-stop shopping for the reader who has not subscribed to all economics journals. The books give the reader access to such articles as "A Disneyland Dilemma: Two-Part Tariffs for a Mickey Mouse Monopoly," by Walter Oi, which originally appeared in the *Quarterly Journal of Economics* in 1971, and "Input Choices and Rate-of-Return Regulation: An Overview," by Bill Baumol and Alvin Klevorick, which originally appeared in the *Bell Journal of Economics and Management Science* in 1970.

Each of the volumes contains the articles the editor would include in a greatest-hits overview of the topic. The main benefit of such a collection is the tremendous reduction in transaction costs that results from not having to find the original journal articles or chapters in the library. **R**



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