Most of the Devils Are Here

REVIEWED BY DAVID R. HENDERSON

All the Devils Are Here: The Hidden History of the Financial Crisis
By Bethany McLean and Joe Nocera
380 pages; Portfolio Penguin, 2010

All the Devils Are Here is one of the best books yet on the recent U.S. financial crisis. Written by Bethany McLean, co-author of the Enron exposé The Smartest Guys in the Room, and New York Times columnist Joe Nocera, it tells the story of the most important private-sector players and some of the government-sector players in the financial meltdown. It is a fascinating look at a number of factors that came together to create a perfect financial storm: subprime mortgages, “liar loans,” hybrid loans, etc. The players range from Ameriquest and Countrywide Financial to Fannie Mae and Freddie Mac.

The book is must reading for those who want to know which government and private institutions contributed to the financial mess. The authors, to this reader’s eye at least, have thoroughly researched the story they report, even getting most small facts right, while weaving a page-turning thriller.

There are two main weaknesses, though. First, the reader has no easy way to verify the facts the authors present because they provide no references. Second, the authors tend to accept uncritically the views of various government officials. Along the same lines, they give Barney Frank (D, Mass.) two short mentions and zero blame, even though he had resisted attempts to rein in Fannie and Freddie.

Other people’s money | Some free-market economists, including me, have argued that Fannie Mae and Freddie Mac were major contributors to the financial crisis. And they were. But McLean and Nocera show that, while Fannie and Freddie definitely added fuel to the fire — in 2008, they guaranteed or owned a whopping $5.3 trillion in mortgages — they came to the subprime game late in the crisis, essentially imitating what the most irresponsible players in the private sector were doing. What comes across in episode after episode is a story of unjustifiably self-assured men (almost all the devils were men) making huge bets with other people’s money.

These men often had little understanding of the underlying risks. One assumption many of them made, for instance, was that house prices nationwide could never fall — or, at least, not fall by much. Of course, as we now know, that was false.

Even though Fannie Mae came late to the meltdown party, it was one of the initiators of securitized mortgages, one of the culprits in the crisis. In 1999, Treasury Secretary Larry Summers expressed mild concern about the large potential risk to taxpayers if Fannie Mae got in trouble. Fannie’s allies, on both the Democratic and Republican sides, came down hard on him. How did Fannie Mae get such political clout? This is one of the best-told stories in the book. McLean and Nocera tell how a well-connected Democrat named Jim Johnson made Fannie Mae almost invulnerable politically. Johnson, who had been Vice President Walter Mondale’s executive assistant during Jimmy Carter’s presidency and had run Mondale’s failed presidential campaign in 1984, was the chairman and chief executive officer of Fannie Mae from 1991 to 1998. During that time, he turned Fannie Mae into one of the most powerful lobbies in Washington, using that lobbying power to defend its government-granted privileges. The most important privilege was government backing. While the U.S. government did not explicitly back Fannie Mae — a government-sponsored enterprise rather than a government enterprise — everyone assumed, it turns out correctly, that it did.

To get powerful congressmen on board, Johnson set up “partnership offices” in their congressional districts. The first such office was in San Antonio, in the district of Henry Gonzalez (D, Texas), then-chairman of the House Banking Committee. These offices were staffed, the authors write, “by someone close to power — the son of a senator, a governor’s assistant, a former congressional staffer.” Expenditures on such offices don’t even count as lobbying. But Fannie Mae also lobbied, spending $170 million between 1997 and 2006.

Interestingly, the George W. Bush administration in the mid-2000s demanded that the GSEs expand their affordable housing goals — that is, increase lending to borrowers who otherwise were unable to secure the loans they wanted. Of course, this just added more air to the subprime bubble.

Evaluating the unknown | What of the private sector? There were a lot of devils
there too, and, in fact, McLean and Nocera devote most of the book to them. One such devil is Stan O’Neal, who took over as CEO of Merrill Lynch in 2002 and shifted its emphasis from that of providing stockbroking services for middle Americans to dealing in collateralized debt obligations, which McLean and Nocera refer to as “asset-backed securities on steroids.” A CDO, they explain, “is a collection of just about anything that generates yield—bank loans, junk bonds, emerging market debt, you name it.” CDOs are not a problem per se if their risk is understood, but the ratings agencies generally gave a large percentage of them a AAA rating, the highest possible. Wall Street firms would buy risky mortgage-backed bonds and reassemble them into CDOs with a lower risk rating. Wall Street players called this “risk arbitrage.” By 2007, Merrill Lynch “held an astonishing $55 billion in subprime exposure on its balance sheet,” mainly in the form of AAA tranches of subprime CDOs. This was up from “only” $5–8 billion in July 2006, when O’Neal had fired Jeff Kronthal for his more-conservative approach to mortgage risk.

But why would ratings agencies rate CDOs as so low-risk? Aren’t they paid to assess risk wisely? Wouldn’t they lose business if they consistently understated the risk of various bonds? You would think so. But in 1975, the Securities and Exchange Commission “decreed that [only] Moody’s, S&P, and Fitch were nationally recognized statistical rating organizations.” With this legal monopoly, they had less incentive than otherwise to do a good job. You might think that competition among the three ratings agencies would still give them a strong incentive to be right. But, although the authors do not mention this, it was not just that competition was limited to three firms; it was also that the government legally required, from the 1930s on, pension funds and other financial institutions to get ratings. That blocked other ways of disciplining financial management firms, ways that we cannot know because they did not happen. Also, as financial economist Charles Calomiris has pointed out, in many cases, the buyers of the assets, not just the sellers, wanted the rating agencies to give artificially high ratings.

McLean and Nocera name Brian Clarkson of Moody’s as one of the devils. Clarkson joined Moody’s as an executive in 1991, having never worked as a credit analyst. One of his first jobs was to rate mortgage-backed securities issued by Guardian, another of the authors’ designated devils. How well did Clarkson do? They write: “The bonds, needless to say, eventually blew up, but if there was a lesson in that, it was lost on Clarkson and his bosses. By 1995, he had become the co-head of the asset-backed finance group.”

After Clarkson took over, if Moody’s missed out on a deal, which, presumably, would happen if its standards were too demanding, “the credit analyst involved would be asked to explain why.” Market share became the mantra. Needless to say, that kind of pressure did not lead to accurate ratings of lousy bonds.

I am skeptical of “important-person” theories, which claim that a major event would not have happened if not for the work of some specific person. So, although I think that Clarkson was important, possibly more important was the fact that the bonds being rated were new kinds of financial instruments and, therefore, it was likely that some firms would do a bad job of rating them. A set of regulations designed in the 1930s is unlikely to work well for financial instruments produced five and six decades later.

Still, employees do matter. Clarkson’s co-head of Moody’s asset-backed group was Mark Adelson, who was much more skeptical of asset-backed securities. While Clarkson was rapidly promoted, Adelson was “moved out” of that line of business. In 2001, he quit and became head of structured-finance research at Nomura Securities. The authors sum up beautifully the problem with having people rate bonds when they know little about them: “At securitization conferences, [Adelson] would look around at the audience and think to himself, ‘No one in that room had ever loaned or collected back one red cent. Any schmuck can lend it out. The trick is getting it back!’”

Not to be missed in the rogues gallery is the firm Ameriquest, whose “core product” was the “2/28” loan. The interest rate was artificially low and fixed for two years, and then reset to an adjustable rate for the next 28 years. Ameriquest made a huge amount of money by charging points up front. The lender may have even broken the law; one discharged Ameriquest employee claimed that she had seen her coworkers copying borrowers’ signatures onto blank documents. When ACORN picketed 20 Ameriquest offices for deceptive lending practices, Ameriquest bought peace by committing to fund $360 million in ACORN-originated loans.

That is not a complete listing of the authors’ private-sector devils—they devote substantial space, for example, to Angelo Mozilo, the CEO of Countrywide—but you get the idea.

Greenspan | One government “devil” the authors point to is Alan Greenspan, chairman of the Federal Reserve Board from 1987 to 2006. I do not think they make their case. I do grant that, in retrospect, he was much too blasé about the brewing financial storm. But then, almost everyone was.

The authors make three specific charges: First, in 1998, Greenspan huddled with a bunch of Wall Street players to bail out Long Term Capital Management. The authors never come out and say it, but I will: he shouldn’t have done that, especially since legendary investor Warren Buffett was waiting in the wings with a low-ball offer for LTCM—something that, shockingly, the authors do not mention. Second, they point out correctly that Greenspan opposed regulation of derivatives. Yet the authors do not even try to make the case that regulating derivatives would have improved matters; they simply quote government officials’ assertions on the issue. Finally, they blame Greenspan, as do many people, for low interest rates, which supposedly created the housing bubble. They never consider the idea that low interest rates were due to a savings glut from China and the Middle East oil-exporting countries, something that Jeff Hummel and I have argued elsewhere. (See our “Greenspan’s Monetary Policy in Perspective,” Cato Institute Briefing Paper No. 109, November 3, 2008.)
**Clearing Up the Murkiness**

**REVIEWED BY GEORGE LEEF**

Fair Trade Without the Froth: A Dispassionate Economic Analysis of Fair Trade
By Sushil Mohan
135 pages; Institute of Economic Affairs, 2010

Go into any upscale grocery store and you will find a variety of goods offered for sale with the assurance that they have been produced and marketed in accordance with “fair trade” principles. Shoppers who want to purchase such products — especially coffee, but also bananas and other crops grown in “third world” countries — pay a premium over the prices charged for non–fair trade goods. The higher price is supposed to help ensure a better life for poor farmers and their families.

The fair trade movement is more than 50 years old, but has only become prominent in the last 15 years or so. Now there is a vigorous campaign in the United States, Britain, and other affluent nations to encourage individuals and governments to convert to fair trade for the benefit of poor people who produce goods they consume. But does fair trade actually do much to help struggling farmers, or is it just another marketing gimmick to manipulate wealthy consumers into parting with somewhat more of their money?

In Fair Trade Without the Froth, economist Sushil Mohan has written exactly what his subtitle promises, namely a dispassionate examination of the fair trade movement. After analyzing the arguments and evidence, Mohan concludes that while fair trade has some beneficial effects for farmers, they are rather small and are accompanied by some offsetting costs. On the other hand, he does not regard fair trade as an assault on the free market — currently at least. While some fair trade advocates resort to anti-market rhetoric, as long as it remains voluntary, it is merely a niche sales strategy no different from other strategies like “buy green” or “buy union.” As we will see, however, there are reasons to worry that fair trade’s proponents will not remain content with a purely voluntary approach.

**Principles**
The key features of fair trade certification include the following:

- Traders must pay farmers a minimum price that covers their living costs and permits “sustainable” production, but if the free market price for the crop rises above that floor, then it prevails.
- Traders must also pay a “social premium” of 5–10 percent to the growers for technical assistance and development.
- Producers must abide by stated social and environmental criteria, such as refraining from the use of child labor, not growing genetically modified crops, and employing only “organic” methods.

To ensure compliance, fair trade organizations (there are several) have established monitoring systems. The cost of those systems and of pro–fair trade advocacy consumes much of the higher prices paid by consumers, leading Mohan to state, “Fair Trade’s proponents try to convey the impression that almost all of the premium they are paying for fair trade products is passed on to the producer, while the reality is far different.” He contends that the producers actually receive just a small cut of the premium, citing research by Tim Harford of the Financial Times showing that, at the large British coffee seller Costa, only 10 percent of the premium went to the growers. The rest fattened Costa’s bottom line.

Mohan is also skeptical about the claim that fair trade does much to protect poor growers against market price fluctuations.
He explains: “The guaranteed price can guarantee income only if there is also a guarantee of quantities that traders will buy from them. It is not possible for Fair Trade to guarantee the quantities that will be bought at the guaranteed price.” And when market demand falls, Mohan notes, fair trade buyers can easily escape their purchasing commitments without suffering any retaliation.

The unseen | As Regulation readers are well aware, programs meant to benefit some people usually have hidden, unintended costs and repercussions, either on the presumed beneficiaries, other people, or both. Mohan argues that fair trade is one of those programs.

One reason for this is that by increasing the production of coffee and other crops in the relatively affluent countries where fair trade currently operates (such as Central America), it may depress the market for poorer farmers in regions (especially sub-Saharan Africa) where it has yet to take hold and for farmers who are too poor to afford the cost of fair trade certification. Mohan says that there is no evidence that this is currently a significant problem, but suggests that if fair trade grows into a larger segment of the market, the adverse impact on those who remain outside the system could become important. In other words, fair trade is a zero-sum game with slight (but visible) benefits to some, offset by slight (but invisible) harms to others.

A second harmful effect of fair trade is that it substitutes decisions that are pleasing to wealthy consumers for decisions that the producers themselves would otherwise make — a sort of nanny-state cultural imperialism. Mohan gives several examples.

For one thing, growers wishing to obtain fair trade certification must agree not to use any child labor. Coffee drinkers in the United States, Britain, and other advanced countries probably think that they are rescuing children from lives of drudgery and helping them go to school by purchasing fair trade goods. Mohan replies: “Poor families do not send their children to work to be cruel to them, but to help provide a basic income for the family. A prohibition on child labor may be damaging for the families and also for children who may be forced into other dangerous occupations.”

Another instance of fair trade devotees imposing their values on the people they think they are helping is the ban on genetically modified crops. It has become an article of faith among well-to-do westerners that genetically modified crops “tamper with Mother Nature” and will backfire on us with the creation of “Frankenfoods.” Especially with regard to bananas, however, genetic modification may be a good choice for farmers because “normal” bananas are sterile and prone to disease, Mohan notes. The benefits of slightly higher prices could be easily negated by crop reductions or failures that might have been avoided.

Third, fair trade requires that growers join a cooperative if they want to be eligible for certification. Again, that sounds progressive to the target consumers, but cooperatives entail new costs and difficulties for growers, including a mandated middleman that many would rather not deal with. Mohan cites the experience of the largest fair trade cooperative in Guatemala, where an official admitted that after paying all of the co-op’s expenses, nothing of the fair trade premium was left to be distributed to growers. Also, since monitoring is haphazard, it is possible for co-op officials to put their own interests ahead of the farmers’. Mohan writes that they have been known to buy non-fair trade coffee on the open market and then sell it as the output of “their farmers.”

Coercion | Mohan’s case is persuasive that fair trade is far less advantageous to the world’s poor than its advocates would have us believe. Still, why be concerned about it? Fair trade is voluntary. Growers do not have to participate and consumers are free to buy non-fair trade goods. Fair trade may be little more than a marketing gimmick, but the commercial world is full of those.

What worries Mohan, and ought to worry the rest of us, is the possibility that fair trade zealots will turn to coercion to speed up the success of their movement. He points to efforts by fair trade proponents in the United Kingdom to exclude non-fair trade products from schools and churches. In Britain an organization called Fairtrade Foundation has managed to get some schools to embrace fair trade by agreeing to use fair trade goods whenever possible, to insinuate fair trade ideas into the curriculum, and to require students to engage in pro–fair trade actions in the community.

It is on the issue of the prospect for fair trade zealots turning to political activism that the book could have used some additional work. In the United States, the fair trade movement is widespread and energetic. Last May, the Chicago City Council voted to become a “fair trade town,” joining scores of other American and European cities. Its resolution states that the city will “encourage the purchase of fair trade certified products by city agencies, use of fair trade products by catering contractors, and publicize fair trade policy through the media.” Moreover, the mayor and city council will “promote awareness of fair trade issues” and “promote fair trade practices among local businesses and organizations.”

With Rahm Emanuel and friends doing all that encouraging and promoting, will any business or organization have the nerve to say “no”? And just as organized labor has used political influence to lock in place policies it favors (prevailing wage laws, for example), is it not likely that the fair trade movement will eventually turn to politics to start mandating or otherwise favoring fair trade goods?

Mohan concludes by making the case that free trade, which is often demonized by fair trade advocates, is a far better development policy for the world’s poor. By extending the market and bringing capital investment to third world nations, free trade increases production, thus leading to higher living standards. Fair trade does little or nothing to speed up economic development; by interfering with the decisions of farmers, it might impede it.

Fair Trade Without the Froth will make consumers think twice before they plunk down extra money for fair trade goods.
Strained Insight

REVIEWED BY RICHARD L. GORDON

Accelerating Energy Innovation: Insights from Multiple Sectors
Edited by Rebecca M. Henderson and Richard G. Newell
274 pages; University of Chicago Press, 2011

The energy hysteria so rampant among American politicians has produced a vast stream of writings. Typically, they reiterate the same points. Thus, this National Bureau of Economic Research anthology’s very different approach is welcome, in principle. As the subtitle suggests, the book examines technological success stories in other sectors in the hope that they will provide better guidance to government energy policy. Unfortunately, the book’s effort fails to deliver on the promise of its approach.

The heart of the book consists of a handful of necessarily terse reviews of five areas of successful innovation: agriculture; chemicals; life sciences; semiconductors, computers, and software; and the Internet. These are preceded by the usual editors’ introduction and a survey of energy technology, and followed by a discussion of venture capital firms. The result is several interesting reviews of developments that unfortunately lack appropriate skepticism about the application of their findings to the energy sector.

Important difference | The book’s critical deficiency is its neglect (let alone explicit recognition) of the gaping difference in potential between energy and the areas covered. Each of the examined technologies was susceptible to massive improvement with the aid of government support. In contrast, much energy technological advancement was privately developed, and the alternatives craved by the contributors have long histories of failed efforts because those options — e.g., solar, wind, biofuels — are depressingly difficult to improve dramatically from their current status. Where the other realms involved problems with solutions that were readily developed, energy is an area in which difficulties are periodically perceived when a supply shock occurs, and proposed answers fail when the shock dissipates.

The synfuels fiasco, noted in the book, is a clear example. On paper, synfuels looked so promising to optimists in the 1970s that it seemed a sure bet. However, when development efforts became intensive, the hopes were quickly dashed. Basically, government energy efforts faltered because they failed to produce fruitful results. The big oil companies are quite capable of developing and employing economically viable technologies such as improved exploration and drilling practices and the commercialization of a radically new way to produce natural gas. Electric-equipment makers had similar successes. Efforts in alternative energy could not produce similar results.

Another problem is that the contributors are overly enthusiastic about the interventions made, overly optimistic about regulation, and weak on energy experience. The book’s failure to provide discussants who could have introduced some helpful skepticism, therefore, is particularly troubling.

Success stories | The five technological success stories involve three models of government involvement. Agriculture and life sciences were nurtured by government support of university research efforts. The computer-related cases involve support at the start by national defense programs. As the chapter by Ashish Arora of Duke University and Alfonso Gambardella of Bocconi University shows, chemical developments were predominantly private, though the chapter stretches to conjecture that the 1911 government breakup of Standard Oil speeded the development of catalytic cracking by making independent the component (Standard Oil of Indiana) where the process was invented. The chapter eventually moves to two examples of government involvement in chemicals technology: the successful World War II development of economically viable synthetic rubber technologies and Jimmy Carter’s synfuels failure.

The agriculture chapter by graduate student Tiffany Shih and professor Brian Wright, both of the University of California, Berkeley, is the most problematic in the entire book. It too hastily deals with too many issues without any discrimination about their relevance to energy. The chapter’s subtext that biofuels are another application of agriculture and might thrive as did other crop research efforts is left tacit. The chapter begins by citing implausibly high estimates of the return on investment to public expenditures on agricultural research, hastily summarizes the data on worldwide expenditures in the area, and then reviews the history. Much space is devoted to an unsatisfactory discussion of intellectual property issues and then to a naïve discussion of regulatory problems.

Iain Cockburn of Boston University, Scott Stern of MIT, and Jack Zausner of McKinsey and Co. provide a coherent review of the status of life-science research with its mix of the National Institutes of Health, university, and private-sector participation. The main problem is neglect of the debate over the medical care system and particularly the thread that attacks the intellectual property rules for drugs that the chapter praises. As typical of the book, the comparison with climate change technology stresses organization over opportunities.

David C. Mowery of the University of California, Berkeley similarly well indicates that the development of semiconductors, computers, and computer software was speeded because of substantial national
The book’s critical deficiency is its neglect of the gaping difference in potential between energy and the areas covered.

Energy innovation | The survey of energy innovation by Richard G. Newell careers among many points. (At the time of the conference when these papers were first presented, Newell was a professor at Duke; he has since become director of the U.S. Energy Information Administration.) The chapter first gives an overview of the familiar points that energy has greatly increased in use and that government had little to do with this. He next surveys developments in five areas of energy and turns to examination of public policy.

The fossil fuel portion of Newell’s chapter is particularly peculiar. He starts by recognizing the substantial advances made in oil and gas exploration and development, without noting that they were made by the private sector. He characterizes the current situation in energy technology development as “mixed” because one expected technological advancement, thermal efficiency in conventional steam generation of electricity, has not improved; another technology called “fluidized beds” has not succeeded (probably because, as not noted, it was too costly); but gas-fired combined-cycle power plants have been a major advancement. In transportation technology, he praises efforts to improve automobile mileage and to promote ethanol — an effort that now even many environmentalists admit was ill-advised. The nuclear section is fuzzy. The treatment of renewables predictably advocates federal support. Similarly, the thermal efficiency subsection steps on its initial message that federal mandates were desirable by noting independent private response to higher energy costs. His view of pollution control observes that regulatory pressures were sufficient to induce innovation.

Newell’s policy sections are similarly problematic. The initial one observes the fluctuations in effort to bring about innovation without noting the panic over short-term conditions that typically sparked increased effort. He notes the lower percent of sales devoted to research and development in energy compared to other industries without mentioning the obvious point that the other industries examined in the book have better innovation prospects. He eventually gets to his most germane point, that clear, credible policy development will inspire technological development. Newell then turns to a survey of government efforts in energy research and development. Here review of the failures is followed by report of some small-scale successes.

Harvard’s Josh Lerner provided the last and best chapter, on the entirely different issue of venture capital firms. He nicely summarizes the history with examination of efforts in alternative energy. Unfortunately, he tarnishes his effort by gratuitously inserting a call for government support through precisely the procurement preferences, efficiency standards, and adoption mandates widely and properly decried in the energy literature.

A Fumbled Handbook

REVIEWED BY RICHARD L. GORDON

The Oxford Handbook of Regulation
Edited by Robert Baldwin, Martin Cave, and Martin Lodge
688 pages; Oxford University Press, 2010

For several decades, commercial publishers such as Elsevier and Edward Elgar have produced handbooks on various subfields of economics, often drafting leaders in those subfields to produce outstanding surveys of the then-prevailing state of knowledge. Thus, when the distinguished publisher Oxford University Press decided to join the action, I expected the results to be even better than the other publishers’. Sadly, the opposite is the case for Oxford’s Handbook of Regulation. The book is inexcusably ill conceived and ill executed.

Given the recognition by the book’s contributors that the United States has by far the richest experience with regulation, the book’s heavy reliance on British contributors proves even more unwise in practice than in theory. Familiar issues are treated with little regard for American experience. Another serious problem is the dominance of lawyers among the contributors. Neither is an irreparable defect; non-American lawyers can have knowledge of economics and the American experience. However, the book is dominated by failures of such expertise.

At a minimum, the dominance of British lawyers produces a disgraceful deficiency in literature review. In particular, the attention given to devastating criticisms...
of regulation from the Chicago school and many others is perfunctory. Almost no attention is given to the obvious question of what, if anything, needs to be regulated. Too many efforts are made at vacuous general principles for evaluating and improving regulation. All of the contributors ignore the fact that the drawbacks of regulation are inherent and immune to meaningful reform. The chapters, including several of those purportedly devoted to specific issues, are largely devoted to inane, failed efforts to develop overriding principles of regulation. The excessively limited space devoted to experience in specific realms is too narrow and in most cases ineptly executed.

The book also suffers from a timing problem. The contents apparently were set by early 2009. Thus, much attention is given the prospects that reaction to the 2008 financial crisis might revive government interventionism, but the disastrous actual responses occurred after the book went to the publisher.

Overview chapters | As is standard, the anthology begins and ends with chapters by co-editors Robert Baldwin, Martin Cave, and Martin Lodge, all of the London School of Economics and Political Science, where they teach law, economics, and political science, respectively. More unusually, the description of the chapters comes in the end chapter of the book; placing that information in the introduction, as is customary, would have helped the reader grasp the essence of the book.

The co-editors’ brief introduction is the first of four introductory chapters. It is followed by an uncharacteristically effective survey of the economics of regulation by London-based attorney Centro Veljanovski. That chapter is then followed by an uncharacteristically effective survey of the economics of regulation, as is customary, would have helped placing that information in the introduction chapters that only affect.

Strategy chapters | Part II starts with an unimpressive effort of Veljanovski to discuss what information is available to regulators and the regulated. The next three chapters are excessively overlapping discussions of approaches to regulation. The first, by Dublin University’s Colin Scott, distinguishes between regulations that set a desired outcome and those that mandate how the goal is to be achieved. Then Neil Gunningham, an Australian specialist in health and safety regulation, dashes through a discussion of whether to punish or persuade the regulated, two prior efforts to design systems of adaptive regulation, and then the possibility of setting goals and delegating compliance to a private body. Gary Cogliano, a professor of law and political science at the University of Pennsylvania, and Evan Mendelson, a Washington, D.C. lawyer, explore the distinction between regulation delegated by government and that voluntarily adopted. The problems of each are explored.

Oddly, none of the chapters mentions emissions taxation or tradable pollution rights. Equally curiously, the first two are unwisely devoted exclusively to the sub-area of the regulation of ordinary business practices such as product design and professional ethics. As Cogliano and Mendelson implicitly show by their stress on conventional environmental problems, the concentration on lesser issues was unnecessary.

Issues chapters | Part III deals with another set of issues. Six chapters attempt to provide alternative, unrealistic views of the design and appraisal of regulations. The section starts with Syracuse University environmental law professor David Driesen’s inept discussion of the use of taxes and tradable emissions, curiously labeled as “alternatives to regulation.”

City University of London economist Jon Stern covers evaluating regulatory performance. Co-editor Baldwin treats direct participants. Thus, his and other devastating criticisms of government involvement and skepticism over regulation by the industry are ignored and the discussion is fatally flawed. Readers are simply told the best ways to regulate, illustrated by problems that mostly should not be regulated.

The attention given to devastating criticisms of regulation from the Chicago school and many others is perfunctory.
the search for better regulation. Claudio Radaelli, a political science professor at the University of Exeter, and Fabrizio de Francesco, a research fellow at Exeter, then treat regulatory impact statements as a special approach to evaluation. Julia Black, a law professor at the London School, reviews risk assessment. Black reaches the unsurprising conclusion that concentrating on risks is inferior to a full economic evaluation of the benefits as well as the drawbacks. Again, the basic analytic formulation is mushy and the literature review stresses the obscure over the germane. Co-editor Lodge and Lindsay Stirton, lecturer in law at the University of Sheffield, treat accountability. Antonio Estache, an economics professor at Université Libre de Bruxelles, and Liam Wren-Lewis, an economics doctoral student at Oxford, cover regulation of “network industries” in developing countries. Mathias Koenig-Archibugi, a political scientist at the London School, treats global issues.

Driesen manages to botch completely the simple subject of market-based environmental controls. Among his faults are continued gratuitous condescending comments about what he calls the “neoliberal” (i.e., libertarian) position. In discussing alternatives, he suggests that often the controls give flexibility. As an example, he cites the United States’ use of new-source performance standards that can be met in whatever way the regulated firm determines is best. This ignores the analytic point that stressing new sources already distorts choice toward preserving old plants and the factual point that the 1977 amendments to the U.S. Clean Air Act added both the requirement to use best-available control technology and (ultimately) ineffectual provisions to favor “local” coal (to keep western coal from displacing Illinois-basin coal). However, what puts him beyond the pale is his assertion that nothing in economic theory allows not regulating pollution. In writing this, he ignores Ronald Coase’s 1960 warning in “The Problem of Social Costs” that action is justified only if (1) the costs of regulation as well as compliance are less than the benefits, and (2) the imperfect implementation characteristic of government actually is better than private response.

The six chapters in this section, and another at the end of Part IV dealing with evaluating and improving regulation, manage to treat different aspects of the problem. The basic issue of the barriers to efficient regulation is treated by co-editor Lodge and Christopher Hood in Part IV. They set up and slay the straw men that regulatory review is new and that, in the United Kingdom, fresh initiation and privatization facilitate better implementation. They trace the criticism that the latter argument has received. The Stern chapter dispassionately discusses the formal structure of regulatory assessments, with stress on the World Bank guide of which he was a co-author. Black careers through an appraisal of what such reviews should accomplish. Radaelli and de Francesco rush through discussion of the goals of appraisal, the problems of attaining them, and a short review of surveys of implementation.

Baldwin’s effort is another embarrassment. The problems start with another unsatisfactory effort to suggest broadening the goals. He seems to believe that “better” is synonymous with “more complex,” so that simplification conflicts with improvement. A British effort to provide improvements is made central to the discussion, as if the U.S. literature did not exist. Lodge and Stirton provide more superficiality by treating the privatization-driven British case as archetypical.

Estache and Wren-Lewis roam too tersely over many issues. The title of their chapter, “On the Theory and Evidence on Regulation of Network Industries in Developing Countries,” is misleading because the points apply to all regulation and the literature review is nearly nonexistent. Basically, the chapter takes too seriously half-baked theoretic ideas about how to work around the inherent inefficiency of such countries. Koennig-Archibugi similarly roams aimlessly through the information interchange, world-trade competition, and coordination aspects of international relations.

Domains chapters | The rest of Part IV is similarly disappointing in the choice of topics and implementation. Niamh Moloney, a London School law professor, leads off with a superficial treatment of financial regulation that deals weakly only with conceptual issues. This is startling given the cries of inadequate practice prevailing at the time of publication. Janice Hauge and David Sappington, American economists, cover too briefly pricing in “network” industries (actually, just electricity and telecommunications). Curiously, no attention is given marginal-cost pricing, and the cell phone revolution is ignored. (To make matters worse, the endnote for a comment that telecommunications competition has increased cites as a cause the widely reviled Telecommunications Act of 1996.) The chapter also manages to speak approvingly of using policy to redistribute income, provide universal service, and electricity demand management.

Lawyer Peter Alexiadis and co-editor Cave then cover similar ground and make the same mistakes of exaggerating the extent of monopoly and approving tinkering with universal service and similar goals. Two researchers at the Max Plank Institute, Jürgen Feick and Raymund Werle, career through the Internet. The ill-developed message conveyed is that private management has worked well and the calls for intervention come from governments that dislike openness. Adrian Towse, a British health regulator, and Patricia Danzon, a U.S. professor of health care, turn to regulation of pharmaceuticals. The treatment is fine as far as it goes; the standard criticism of the delays in U.S. regulatory approval is treated cursorily.

The next chapter, by geographers Catherine Mitchell and Bridget Woodman of Exeter University, is another drop in the endless stream of bad energy prognoses. Indeed, the authors may be worse than most because they reject price-based incentives. They start unwisely by embracing the goal of “sustainability,” defined as encompassing climate change and amorphous other goals such as poverty alleviation. They develop the argument that even a properly designed emission cap or tax will not efficiently secure sustainability. They drag in the concepts of Brian Arthur and Paul David that bad past decisions lock in inefficient technological choices. In the
process, Mitchell and Woodman manage an error that is all too typical of this book. Recognition of the devastating criticism of lock-in by Stan Liebowitz and Stephen E. Margolis is limited to an endnote claiming Liebowitz and Margolis’ debunking of the claim that the QWERTY keyboard was not inferior to the Dvorak keyboard only showed a smaller inferiority of QWERTY. (See “Debunking Path Dependence,” Summer 2000.) The remainder of the chapter muddles through recognition of the deficiencies of regulation to the hope that good technological guidance would be provided.

Final notes | A bizarre, but apparently not unique, quirk of the book is that UK spelling practice is imposed so vigorously that often spelling is inexcusably changed in citations (e.g., the several journals with “Organization” in their name are rendered “Organisation”; try googling that and all you’ll get are referrals to other writings with similarly altered spellings.) This combination of repetitious material, much unsatisfactory development, and the general neglect of the inherent drawbacks of regulation make this a book for readers to avoid.

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**No Big Deal**

**REVIEWED BY DAVID R. HENDERSON**

**Peddling Protectionism: Smoot-Hawley and the Great Depression**

By Douglas A. Irwin

244 pages; Princeton University Press, 2011

I hear many people, including some economists, say that a major cause of the U.S. Great Depression was the Smoot-Hawley tariff of 1930. I think their view of its cause is strongly affected by their justifiable hatred of trade barriers. In the past, when I’ve heard that, I’ve responded, “No, Smoot-Hawley was one of the causes, but it does not rank in the top three.”

The top three, in my view, are:

- monetary policy, which Milton Friedman and Anna J. Schwartz argued was more important than any other cause;
- Herbert Hoover’s and Franklin D. Roosevelt’s successful attempts to keep nominal wages in various sectors from falling and
- Hoover’s more than doubling of income tax rates.

I used to think that the Smoot-Hawley tariff was the fourth most important cause. But Douglas Irwin’s new book, *Peddling Protectionism*, has convinced me that Smoot-Hawley, though bad, was even less important than I had thought.

Why am I so convinced? Because Irwin, an economics professor at Dartmouth College and one of the world’s leading scholars of international trade, makes a careful, fact-freighted case. He points out that Smoot-Hawley did not raise tariffs to as high a level as is commonly thought. He also shows that international trade, so important to the U.S. economy today, was much less important then. And he shows that evidence presented by the late Jude Wanniski on the stock market’s reaction to Smoot-Hawley is quite weak. The one part of the commonly accepted view of Smoot-Hawley that holds up is the idea that it led to retaliation against U.S. exports by other countries’ governments.

**Tariffs, considered** Consider tariff rates. Although the late Gottfried Haberler claimed in the 1970s that Smoot-Hawley had pushed tariffs to “skyscraper” heights, that is an exaggeration. It is hard to generalize about a bill that raised tariff rates on literally hundreds of separate items, but Irwin estimates that Smoot-Hawley raised the average tariff on imports subject to the tariff by 15–18 percent, an increase of about 6 percentage points. Irwin contrasts this increase with that caused by the Fordney-McCumber tariff bill of 1922, which raised the average tariff rate by a whopping 64 percent, or 13 percentage points. Of course, we had a boom in the 1920s, which is further evidence against the idea that tariff increases per se had much to do with economic decline.

We know that tariffs hurt an economy by reducing specialization and diverting domestic factors of production to high-cost items that we can get cheaper from other countries. Irwin does not argue that the tariff increases did not hurt the U.S. economy. But he claims that the damage was less than commonly thought — not only because the tariff increases were less than commonly thought, but also because there was not much trade on which to impose the tariffs. In 1929, imports were only 4.2 percent of gross domestic product. And that 4.2 percent substantially overstates the amount of imports subject to the tariff increases because, notes Irwin, only a third of imports, or 1.4 percent of GDP, were subject to tariffs to begin with. Smoot-Hawley raised tariff rates almost solely on goods already subject to tariffs. It is hard to believe that the 1.4 percent tail could wag the 98.6 percent rest of the dog.

Irwin notes that international trade did shrink after Smoot-Hawley. But if Smoot-Hawley was the main factor behind this shrinkage, reasons Irwin, then imports subject to the tariffs should have declined a lot, and duty-free imports should not have declined much. In fact, he finds, between the three months prior to Smoot-Hawley taking effect and the three months after, the value of “dutiable” imports fell by 34 percent, but the value of duty-free imports
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n this crisply written paper, Mark Ramseyer describes what happened in Fukushima, Japan on March 11, 2011. On that day, a 9.0 magnitude (Richter scale) earthquake produced a devastating 14–15 meter tsunami that crashed against four Japanese nuclear plants outside the city and set off a national radiation emergency. (Elsewhere along the Japanese coast, the tsunami reached heights of 38 meters.) The water flooded the plants’ backup diesel generators, resulting in loss of coolant to the reactors. Given that tsunamis of equivalent height have hit Japan three times since 1896, the 2011 disaster was predictable. So why were the plants built in such a dangerous area?

Ramseyer argues that nuclear power is fairly unique in its ability to generate damages that easily exceed the net worth of its owners. In this case, a company with a net worth of around $32 billion has caused damages on the order of $60–70 billion. This occurs because all risks created that exceed the net worth of the company are “free” from the perspective of its owners because they suffer no loss beyond the destruction of the value of their shares.

In theory, regulation of private plants can internalize the

Broader effects The late Jude Wanniski, in his 1978 book The Way the World Works, argued, on the basis of stock-market declines, that Smoot-Hawley had a large negative effect on the U.S. economy. Wanniski wrote that the stock market declined by large percentages whenever the probability of passage of Smoot-Hawley increased. But Irwin carefully examines the evidence and finds Wanniski’s implausible. He notes that the Dow Jones Industrial Average fell by 6 percent on October 23, 1929, but that “the only tariff news that day was the failure of the coalition [in favor of Smoot-Hawley] to reduce the duty on carbide.” The Dow fell a whopping 23 percent on Monday and Tuesday, October 28 and 29, “but the only tariff news from Sunday was the statement by Sen. Reed that the tariff bill was dead and the response by Sen. Smoot that it was not.”

Irwin, moreover, quotes economist Scott Sumner’s research finding that while the stock market was plunging in October and November 1929, the widespread view at the time was that the protectionist wing of the Republican Party — the people pushing for Smoot-Hawley — was losing.

Irwin shows that critics of Smoot-Hawley are on firmer ground when they claim that other countries’ governments retaliated against U.S. exports. America’s largest trading partner then, as now, was Canada, and Canada’s government responded by reducing tariffs on British goods and raising tariffs on 16 products that, in total, accounted for 30 percent of the value of U.S. exports to Canada. He notes that after Canada’s government raised its tariff on eggs from 3 to 10 cents a dozen, American exports of eggs to Canada fell from 919,543 dozen to 13,662 dozen. After Spain’s government aimed a protectionist provision at American cars, U.S. car exports to Spain fell by 94 percent, while sales to Spaniards of British, Canadian, and German cars surged. Irwin argues that the worldwide depression would have caused many governments to increase trade barriers had Smoot-Hawley never been passed, but that Smoot-Hawley definitely contributed to the rise of protectionism, especially against U.S. goods.

And the bitter irony is that Smoot-Hawley did not work even on its own narrow terms and could not have worked. Why? Irwin points out that the bill was conceived by a farmer-dependent Republican Party as a measure to help farmers. But at the time, the United States was a large net exporter of cotton, wheat and other grains, and tobacco. In 1929, the United States exported $771 million of cotton and $286 million of wheat and other grains, but U.S. imports of those commodities were a meagre $53 million and $20 million, respectively. And the areas of the agricultural economy in which the United States was a net importer were relatively small parts of the agricultural economy.

So, although Smoot-Hawley did not do as much damage as is often thought, it did do harm and did not accomplish its goal of helping farmers. Hmmmm — causes damage and does not accomplish its primary goal. Does that sound like a lot of other government programs?
excessive external costs problem, but “good” regulation is itself a public good and the companies will take much more interest in the regulatory process and its results than the public.

Would government ownership of nuclear plants result in safer operation? Ramseyer argues no because unequal taxation, which would be used at least partly to fund nuclear power, leads to most voters receiving the benefits while a small minority of taxpayers pay the bills through the progressive tax system.

Public Sector Pension Underfunding


Public sector employees typically receive a relatively large fraction of their income in the form of deferred defined-benefit compensation. While private employees earn $1 in compensation through employer-provided retirement benefits for every hour of their work, teachers earn $3. This is a particularly worrisome tendency because state pension funds have been underfunded since before the decline in financial markets during the Great Recessions.

Maria Fitzpatrick asks how teachers’ valuation of deferred compensation compares to the cost of providing it. If teachers have a strong preference for current rather than future compensation, then the possibility exists that states can purchase back their future obligations, improve their finances, and make the employees better off.

The literature reports that, in general, retirees are willing to exchange half of their Social Security benefits for a lump-sum payment even if that payment were only 75 percent of the present discounted value (PDI) of the expected benefits. Similarly, in the military drawback program of the early 1990s, most of the separates selected a lump-sum payment over a retirement annuity worth twice as much in present value.

Fitzpatrick uses a change in the Illinois teacher retirement system enacted in 1998 to estimate the value that teachers place on current versus deferred compensation. Illinois teachers were given the opportunity to purchase an upgrade to their pensions after the 1998 law passed. The price was 1 percent of salary as of 1998 per year of service. The benefit for a teacher with 20 years experience would be an 8.2 percent per year increase in retirement pension in each year of retirement. So for a one-time payment of 20 percent and immediate retirement, the payback period would be less than 3 years. Fitzpatrick calculates that 99 percent of teachers would receive a rate of return of more than 7 percent for a pension upgrade.

But even though the returns for this upgrade were generous, the author estimates that teachers were willing to pay only a fraction (less than 20 percent) of its cost. That is, teachers were willing to pay less than $2 for $10 of future benefits in present value. For example, the average price of the enhanced plan offered to employees with 25 years of experience in 1998 was $15,245 while the expected costs of providing them with the extra retirement benefits if they all purchased the upgrade would have been $94,166. Given the data on the upgrade purchases, the author concludes that the typical teacher in Illinois public schools values future compensation at just 17 cents on the dollar. Fitzpatrick suggests that states could dramatically reduce their currently unfunded pension obligations if they offered a future benefits buy-back option at the rate of 20 cents on the dollar, more than the rate (17 cents) at which employees value them.

Hygienists vs. Dentists


One would think that the decline of unions in the private sector (see “The Rise and Decline of Unions,” Summer 2007) implies greater freedom in the labor market. Morris Kleiner, however, has documented that as the labor force has become more educated and white-collar, unions have been replaced by occupational licensure (“A License for Protection,” Fall 2006). For instance, dentists and dental hygienists are both licensed in all 50 U.S. states. Generally, dentists dominate the state licensing boards that, among other duties, advise the legislature on the services hygienists can perform relative to dentists and the kind of supervision of the former by the latter. Some states, however, allow greater autonomy for hygienists. As of 2007 seven states allowed hygienists to be self-employed without the direct oversight of a dentist. What effects does this freedom have on wages and employment?

In the states that allow hygienists to be self-employed and perform relatively broadly defined services, hygienists have about 10 percent higher earnings and 6 percent higher employment growth. Dentists in those states have 16 percent lower hourly earnings and 26 percent slower employment growth. On the other hand, the transfer of income from hygienists to dentists in those states where regulation limits hygienists’ occupational freedom is estimated to be approximately $1.34 billion per year.

The authors are able to estimate the magnitude of the deadweight loss assuming that there is no reduction in the quality of services provided to patients in states with fewer dentistry regulations. The output loss from licensing is found to be between $544 million and $680 million per year, with an additional $80 million per year in losses from the restrictions that allow hygienists to be employed only by dentists. The combined loss estimate is approximately $620–$750 million per year. In other words, there is an approximately 1 percent annual reduction in the
output of dental services for those states that required dentists’ supervision of dental hygienists.

Occupational regulation distorts free-market outcomes. It redistributes wealth from lower-skilled occupations to higher-skilled occupations and imposes efficiency losses on society.

**FTC v. Intel**


On December 16, 2009 the Federal Trade Commission filed a complaint against Intel alleging that its loyalty discounts program violated antitrust law. The FTC argued that the computer chip maker’s loyalty discounts prevent its rivals from achieving minimum efficient scale to compete effectively. Intel’s practices gave computer manufacturers incentive to purchase almost all of their microprocessor and graphic processor units from Intel. Once rival chip producers fail, conjectured the FTC, Intel would raise prices to extract surplus from the captured chip buyers. Intel and the FTC settled the complaint in August 2010 without Intel admitting that it had committed any anticompetitive acts.

Because the predictions of economic theory on the effects of loyalty discounts are inconclusive, government investigations rely on empirical analysis. The case of Intel is unusual in terms of the volume of available data: their discount program had been in place for about 10 years. Wright uses two methods to estimate the competitive effects of Intel’s conduct. First, he follows the conventional approach of looking at the traditional antitrust metrics — market share and profit margins — and second, he uses an alternative approach that is based on financial market information. Neither of the two methods supports the hypothesis that Intel’s behavior harmed consumers.

The conventional approach tests the prediction that if Intel’s practices are anticompetitive, then Intel’s market share would increase and the market share of its rivals would decrease. During the period when the Intel discounts were in place, AMD, Intel’s main competitor, did not experience a decline in market share. In addition, AMD’s financial statements showed that the company increased its output and invested heavily in capacity expansion.

Financial market data analysis makes clear that AMD’s stock performed well from 2001–2002 to 2006, a period when Intel was providing its buyers with loyalty discounts. The available evidence is not sufficient to attribute the decline in AMD share performance after 2006 to Intel’s practices. Moreover, when both firms’ performance is tested against the market’s performance starting in 1999, Intel’s cumulative abnormal returns actually trend downward, which is not the case for AMD until around 2007.

The evidence demonstrates that neither Intel’s principal rival nor consumers were harmed by Intel’s pricing behavior. The antitrust action by the FTC had no empirical basis.

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**Effects of Gifted and Talented Educational Tracking**


On March 13, 2010 the Obama administration released its proposal for reauthorization of the No Child Left Behind Act (NCLB). Some criticize NCLB because of its emphasis on students who perform below grade level. But the Elementary and Secondary Education Act (ESEA) (which was renamed NCLB in its reauthorization under President Bush) includes the Jacob Javits Gifted and Talented Students Education Act passed in 1988. The Gifted and Talented program (GT) created by the act counterbalances some of the NCLB attention to low-ability students.

Not much is known about the effectiveness of GT programs. This paper attempts to estimate the effects of these government educational programs on high-ability students.

As with all educational policy studies, the econometric problem is to separate the effects of underlying unobserved student characteristics, such as motivation, from the causal effects of participation in a GT program. The correlation of unobserved characteristics with attendance and achievement likely produces an overestimate of the true impact of a GT program on achievement.

The study takes two principal approaches: First, the authors exploit a regression discontinuity (RD) design to compare the performance of two student groups: those who scored just above the well-defined cutoff of eligibility to the GT program, and those who scored just below the cutoff. Students are selected into the program on the basis of an index score that combines achievement tests, a nonverbal ability test, grades, teacher recommendations, and socioeconomic status. The objective of the regression discontinuity analysis is to estimate the effect of enrollment in a GT program among similarly gifted students, some of whom randomly do not attend a GT program. Second, the authors exploit the randomized nature of the enrollment of talented students into a premier GT magnet school. They compare performance of the students who win the lottery and attend one of these...
schools to the students who lose the lottery and either attend a neighborhood GT program in the district, a magnet school based on a different specialty, or a charter school. This structure allows for estimation of the effect of a premium magnet school on the talented students’ achievement.

The authors obtained the administrative records in a large urban school district in the American Southwest for the 2007–08 to 2009–10 academic years. Their sample for the RD analysis includes approximately 2,600 students in the 7th grade cohort who were evaluated for GT in 5th grade. For the lottery analysis, the sample consists of 542 students who applied for admission in one of the district’s oversubscribed magnet schools. The authors perform numerous robustness tests to ensure that their results are unbiased and consistent. For example, they test for a possibility that teachers manipulate student evaluations to compensate for the low test scores of applicants.

The researchers make two important findings: Regression discontinuity analysis showed that students who were exposed to GT curriculum for 1.5 years in middle school demonstrated no significant improvement in achievement as compared to their peers who just barely missed the cutoff. In fact, their preferred regression specification shows declines in reading, math, and social science scores, although the results were not statistically significant. Other specifications report similar results, so the authors are able to rule out positive effects of the GT programs. Another interesting finding is that although the GT students got better peers, they did not have better teachers assigned to them. The lottery-based study that compared students in the two premier GT magnet schools to other GT students also showed little improvement in overall 7th grade achievement with the exception of science scores, despite such clear advantages as higher-quality teachers and peers.

NCLB does emphasize the results of the least successful students and some have voiced concern about the implications of this emphasis on the progress of the gifted. The presumption behind such concern is that programs for GT students have positive results that would suffer from reduced emphasis and funding. At least in one large urban school district, GT programs do not appear to have any effects at all on student achievement.

In this paper, Edward Zelinsky describes the excise tax on "high cost" health plans, the Medicare tax on investment income, the increase in the Medicare tax rate for high-income earners, the small-employer health insurance and premium-assistance tax credits, and tax-enforced individual and employer mandates. Zelinsky arrives at a conclusion similar to Hyman’s: health care reform increases spending and demand for health care largely within the existing system. The tax provisions are complex, friendly to the status quo, and do not control health care costs.

A central feature of the new federal health care law is the mandate that individuals purchase and employers offer health insurance. If noncompliant, an individual must calculate and pay an excise tax penalty, which is determined through a non-trivial four-step procedure. The process is complicated by a number of exemptions, typically income- or employment-related, that have to be determined through elaborate formulas. In 2014, eligible taxpayers will be able to claim a premium-assistance tax credit. The amount of the credit for individuals whose household income exceeds the poverty level but is below 400 percent of the poverty level is determined monthly through a complex procedure. Together, the individual mandate and subsidies impose significant compliance obligations on taxpayers, primarily those of modest means, and add to the IRS enforcement burden.

The employer mandate has similar effects. It obligates every "large employer" to provide its workers with an affordable plan that offers no less than minimum coverage as established by law. The status of "large employer" is determined yearly while the number of full-time employees is determined monthly. The employer is penalized on a monthly basis if it does not offer affordable medical coverage to all its full-time employees and their dependents. If fined, the employer pays the penalty calculated according to the number of employees, even if only one of the workers’ insurance conditions triggers the penalty. In addition, compliance with the affordability provisions by employers requires the employer to know employee adjusted gross income, which means the employer must know workers’ deductions, not just gross income — which is not possible under the current system.

Besides the compliance requirements, the most important cost a firm will face is the decision to hire its 50th employee. That will trigger recategorization from small to large employer and subject the firm to the mandate.

Ironically, according to Hyman and Zelinsky, health care reform preserves many of the perverse incentives of the current health care system and is more incremental than either its proponents or opponents acknowledge. The tax on “Cadillac” health care insurance plans, for example, is scheduled to take effect in 2014. Why should we expect a future president and Congress to let that tax go into effect?

PPACA and HCERA exacerbate U.S. health care problems through both complexity and incrementalism. The tax provisions postpone politically difficult decisions rather than undertake serious health care cost control.