
In Review

The Smart Philosopher vs. the People

REVIEWED BY PIERRE LEMIEUX

What Money Can't Buy: The Moral Limits of Markets

By Michael J. Sandel

256 pages; Farrar, Strauss, and Giroux, 2012

The title of Michael Sandel's book *What Money Can't Buy* is a misnomer: it should have been "What Money Shouldn't Buy." There are, of course, things that money can't buy—love and friendship, for example (though a little money does help to get useful introductions). If you try to purchase love or friendship, what you will get will be corrupted by the very process of buying it, so what you get is not the real thing. But these are not what Sandel, a Harvard University philosopher and professor of government, has in mind. What he really argues is that attempting to buy and sell certain goods may be possible, but is immoral and (I suspect) should be illegal. In arguing this, he raises interesting questions but falls far short of his agenda.

Filthy lucre | It is clear from the book that Sandel does not like money. But, paradoxically, he gives money too much importance. He seems to assume that all voluntary exchanges must be for money. In reality, money is just a means of exchange, and some things that cannot be purchased with money can be exchanged through

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long-term barter sorts of relationships. You can't buy love with ad hoc money transfers, but you can buy it—or at least buy its maintenance—with a long-term package deal. You give me love, and I return love in exchange, for an indefinite period of time. The same goes for friendship. No lover or friend would continue to give if he did not get back in exchange something at least as good. Exchange is the master key of social interaction.

The issue on which Sandel focuses is that some things can be exchanged for money but they shouldn't be. One reason is "fairness," to which Sandel duly pays his respects (like to other politically correct causes), but he is too smart to rely on this fleeting concept for his main argument. He does suggest that introducing money in some transactions—say, exchanging a kidney for transplant—exerts "coercion" on the poorest party, but he also admits that queues are not necessarily fair either. He may not fully realize how the fairness argument can be turned on its head to support market transactions. For example, he argues against buying and selling the right to raise children, yet this would redistribute income from rich adopters to the poor who don't want to raise their offspring—and to the adopted children themselves.

Tainting and corruption | Sandel's main argument is about moral degradation: the very act of exchanging certain goods or services for money, he claims, changes

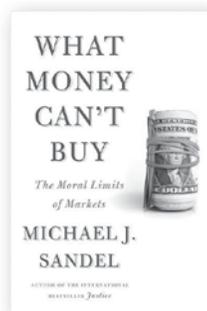
the way they are perceived, taints and corrupts them, negates their "socially useful purpose," degrades their "social utility," and demeans people who trade them. He contends that the last few decades have produced "the commodification of everything" and that these market values crowd out moral values. An example is the viatical market, where investors purchase life insurance policies from individuals and thus benefit from their deaths. An institution that was designed to provide for the deceased's family has branched into a bet on his death. Similarly, the virtue of organ donation is destroyed by trade in organs. Sandel gives several other examples.

One problem with Sandel's thesis is that the purpose of something is generally in the eye of the beholder. For Sandel, "the purpose of public schools is to cultivate citizens"; for others it is to teach children to read and count, and prepare them to be free and self-reliant individuals.

For some people, the virtue of life insurance is, or becomes, to sell their policies if they need the money before their deaths. The presumed moral virtue of organ donation is not worth much for somebody who can't have the organ he needs donated to him.

And are not voluntary transactions on the market the very embodiment of morality? By definition, commercialization responds to a market demand. As a baseball fan, Sandel is distressed by the commercialization of his sport. When he was a kid, he could easily hunt his idols and get free autographs from them. Today's idols very democratically sell them to anybody.

There exist private ways to avoid tainting and corruption. Some institutions have evolved for this task. Marriage helps in the raising of children and douses the temptation of trying to buy with money what money can't buy. Religion, especially monastic religion, provides a means of avoiding the temptations of the greedy



and sensual life. Nonprofit organizations and cooperatives skirt commercialization. Private academic standards prevent the buying and selling of credible diplomas. And if commercialization really depreciates baseball in a way that most fans dislike, an entrepreneur would make a bundle of money by creating a “Non-Tainted Non-Corruptive Major Baseball League.” Advertising can often be avoided altogether if you are willing to pay for the products yourself, instead of letting advertisers pay for what you consume; for example, you can purchase software and apps with no advertising.

Even if one does not agree with these critiques, the question remains of who makes the valuation baselines from which things should not be degraded. What is “the proper way of valuing” things, Sandel asks? His theory “requires that we make a moral assessment”: “we have to decide what values should govern the various domains of social and civic life.” Sandel is apparently unaware that the political “we” has no ascertainable meaning or, if it does, implies either inconsistency (voting cycles) or authoritarianism. This implication of the Arrow Theorem and social choice theory still has not sunk into popular or philosophical culture, as Sandel’s book illustrates.

Confused economics and politics | Sandel’s understanding of economics, although better than other philosophers’, shows many big holes. For example, he does not see that the expressive, sentimental aspect of gift-giving can by itself generate what economists call “utility” both for the recipient and the giver. He believes that baseball tickets are expensive because players draw high salaries, while the causality works the other way: the demand for baseball players is a derived demand—what club owners are willing to pay for inputs is derived from the price that tickets and advertisements can fetch on the market. He believes that economics is about maximizing “social welfare” “as the sum of people’s preferences.” This slippery notion of social welfare has been debunked by welfare economists, while others like Friedrich Hayek and Robert Sugden have convincingly argued that social coordination, not welfare, is the goal.

Sandel’s understanding of politics is worse. It is not “we as a society,” but the state—that is, politicians and bureaucrats—who will make the valuations he calls for. Like many philosophers, Sandel just assumes an ideal state. He ignores that the morals of the state, as it is and not as it should be, are generally worse than the morals of the market. Consider the current case of the Benedictine monks who have been prevented by the Louisiana Board of Embalmers and Funeral Directors from selling the caskets they make because they do not submit to the requirements of licensed funeral directors. Where is the compassion for the monks and for

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the poor consumers who want to buy less expensive caskets? Who profits obscenely from death? To paraphrase the author of *What Money Can’t Buy*, there are virtues that coercive power cannot buy.

On Capitol Hill, line-standing companies employ “standers” to spend hours moving along the queues to enter congressional hearings until, when they get close to the relevant hearing rooms, they cede their places to the well-heeled lobbyists who have purchased the service from the line-standing companies. The problem with this practice is not, as Sandel argues, the bypassing of queues, but rather the nearly unlimited power of Congress to give or take back favors and privileges, and the need for lobbyists to play Congress’s political games.

The trouble with trading | If Sandel proves anything, he proves too much. He criticizes the unequal access to health care, but does not mention the parallel case of food. The comparison is even more striking if we borrow a thought experiment from Auberger Herbert and imagine that

the state has accustomed us to free food. Philosophers would argue that the very fact of buying food for money would taint it, as it is transmogrified from a life-sustaining gift and a perpetuator of “society” to a greedy tool for farmers to make a buck. In Sandel’s terms, the commercialization of food would also crowd out the civic virtue of farmers and grocers who previously worked for free, and teach the wrong moral lesson to food consumers.

Sandel’s thesis is also undermined by an empirical problem. Is it really true, as he argues, that the last three decades have witnessed “market triumphalism” and “a world in which everything is for sale”?

In fact, fewer and fewer things have become free to trade without special conditions, permits, and licenses. Data from the Mercatus Center and the Weidenbaum Center show that

between 1960 and 2007—that is, even before the proliferation of post-recession regulations—the budget of the main federal regulatory agencies had multiplied 11 times in constant dollars, excluding Homeland Security—and 14 times if we do include state security.

Paradoxically, the less markets were allowed to function unimpeded, the more people tried to reinstate them in the interstices of the regulated society. The more laws and bans were imposed, the more the subjects of those restrictions came to see them as simply a cost of doing business or of living. The more rarified genuine market incentives became, the more the authorities tried to “incentivize” people, a word that Sandel understandably does not like. He cleverly notes that President Obama used the word 29 times during his first three years in office. An extreme case of incentivizing from the top was attempted in communist countries during a large part of the 20th century.

Sandel has a point when he criticizes the sale of commercial advertising in public schools or the sale of naming rights for public places, like the renaming of the Pattison

Station on Philadelphia's subway system as the AT&T Station. But look carefully at what is really happening there. Virtually bankrupt governments, which have tried to impose the good life with high taxes and borrowed money, are now selling their subjects' public wares in order to maintain the aristocracy of reigning politicians and bureaucrats. And these are the organizations to which Sandel would grant more power to fight tainting and corruption!

Sandel is right to claim that economics cannot ultimately be disentangled from value judgments, a point that welfare economists have made ad nauseam. However, this entanglement does not imply that any act of exchange must be judged on its own merits and approved or banned by someone in authority. With tradable permits—whether on pollution, hunting, or conceivably on immigration or (why not?) free speech—Sandel sees the problem in the “tradable,” while it actually lies in the “permit.” And Sandel dismisses too easily the idea that we must economize on ethics by imposing as few constraints as possible on individual preferences and choices. Otherwise, the only solution to diversity and disagreement is to fight it out.

I, and most libertarians, believe that some things should not be traded. Examples include murder contracts and favors between government and rent-seeking lobbyists. The set of Aristotelian good-life taboos is not empty, but it should be defined more by Hayekian rules and spontaneous conventions à la Sugden than imposed from the top. Unfortunately, Sandel ignores this modern strand of analysis. Only a very limited set of banned exchanges can prevent politics from becoming the largest and most systemically corrupt market.

And am I imagining things, or does the author of *What Money Can't Buy* question commercialization only when it doesn't fit his own values or interests? Nowhere does he criticize the conception of marriage as a contract, probably because he rightfully agrees with this evolution. Nowhere does he argue against copyrights and commercial publishing, in favor of dispensing philosophical wisdom freely to the masses, at safe distance from the tainting

of his own commercial publisher. And why would talking and writing about bad events like terrorist attacks be acceptable while, as Sandel argues, prediction markets for such events (proposed a decade ago by Robin Hanson and the Defense Advanced Research Projects Agency) would have corruptive effects?

The charitable interpretation of *What Money Can't Buy* is to see it as the interesting work of a philosopher recommending the best values to freely choose in our lives. But when the chips are down, after discarding the empty “we” and the angel-manned state, Sandel's effort resembles the proverbial Philosopher King intent on imposing his moral values on others. “[T]he kind of society in which we want to live” is the one

the Harvard political philosopher likes. The good life, or else! R

READINGS

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Not Quite Breaking the Ice

REVIEWED BY JOHN HASNAS

Free Market Fairness

By John Tomasi

368 pages; Princeton University Press, 2012

In *Free Market Fairness*, Brown University political philosopher John Tomasi describes himself as setting off on a quest to thaw the frozen intellectual sea that separates libertarians and classical liberals from Rawlsian liberals. He half succeeds. Tomasi shatters the ice encasing the Rawlsian liberals, setting them free to drift toward the libertarian shore. However, his ice breaker does not have the power to reach the opposite coast and runs aground on the icy shores surrounding the libertarians.

The fact that I attribute only partial success to Tomasi's efforts should not be regarded as a negative evaluation of his book. *Free Market Fairness* is both an excellent book and an important one. What makes a work of philosophy valuable is not

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that it arrives at all the right conclusions, but that it asks the right questions, makes us think, and causes us to re-examine our assumptions. *Free Market Fairness* does all of those things. For this reason, it is appropriate to describe the book as seminal.

Rawls and liberty | It is unfortunate that Princeton University Press chose to place Tyler Cowen's description of the book as “One of the very best philosophical treatments of libertarian thought, ever” on the front cover. This isn't because the book is not an excellent work of political philosophy, but because it isn't a treatment of libertarian thought. If the word “libertarian” were replaced with the word “Rawlsian,” the description may well be accurate.

Free Market Fairness contains a brilliant imminent critique of Rawlsian political philosophy, what Tomasi labels “high liberalism.” An imminent critique accepts the values and premises of one's opponent as correct and shows that they lead not to the opponent's conclusion, but to one's own. Tomasi is meticulous in accepting every aspect of the Rawlsian philosophical project. He subscribes to the high liberals' definitions of terms, fundamental value

judgments, basic premises, and restriction of political philosophy to “ideal theory,” and then proceeds to demonstrate that a correct understanding of high liberalism leads not to the Rawlsian welfare state, but to the classical liberal state of John Locke and Adam Smith.

I am old enough to have read John Rawls’ *A Theory of Justice* for the first time without antecedent knowledge of its conclusion. I still remember undergoing the dismaying transition from “This is really cool” to “How did this go so wrong?” Consider that *A Theory of Justice* begins by arguing that a just political system must guarantee individuals the liberty to lead personally meaningful lives.

Social welfare concerns come into play only after this has been secured. Further, the value of personal liberty is recognized to be different in kind from that of material welfare such that it must be given priority in a lexical ordering that forbids trading liberty for welfare gains. This appears to be a political philosophy that even Hayek could (and apparently did) love. So how did Rawls go from this promising beginning to the liberal welfare state?

Tomasi explains that it is primarily due to Rawls’ and his disciples’ impoverished conception of liberty. Rawls does not view liberty as monolithic, but as an assemblage of specific liberties: the right to vote and be eligible for public office, freedom of speech and assembly, liberty of conscience and freedom of thought, freedom of the person and the right to hold personal property, and freedom from arbitrary arrest and seizure. Those liberties are what Rawls and Rawlsians believe are necessary for individuals to lead meaningful lives—to be responsible self-authors. Tomasi argues effectively that this list is woefully underpopulated. As important as these political liberties may be, Tomasi points out that we live most of our lives in the private sector, that our work gives our lives meaning, and that the freedom to vote pales in comparison to the freedom to start a family business that will provide a better life for our children. In short, he demonstrates that a thick conception of economic liberty must

be on the list of basic liberties for citizens to truly be responsible self-authors.

In addition, Tomasi draws on Hayek’s concept of spontaneous order to show that, to the extent that high liberals are truly serious about promoting the welfare of the least advantaged, they must accept a high degree of individualized economic decisionmaking. In essence, Tomasi shows that Rawls’ Difference Principle—the proposition that inequalities are permissible only to the extent that they benefit the worst-off—requires the mobilization of market forces to a much greater degree than is envisioned by the Rawlsians.

What Tomasi is doing in this part of the book is showing the high liberals what their own paradigm requires. He is essentially telling them how to get Rawls right. The great value of the book is that it requires all those operating within the Rawlsian framework to take the commitment to liberty—specifically economic liberty—seriously.

For the last 40 years, the high liberals’ main strategy for dealing with the insights of classical liberalism has been to either ignore or mischaracterize them. By accepting the Rawlsian framework in every detail and arguing from within it—by bringing classical liberal insights into the high liberal framework—Tomasi has made it impossible for high liberals to continue to pursue this strategy. For high liberals to ignore his argument in *Free Market Fairness* would be to admit the bankruptcy of their own framework. The great value of Tomasi’s book is that it forces the high liberals to engage with classical liberals. In this respect, he has been successful in shattering the ice around the high liberal bastion.

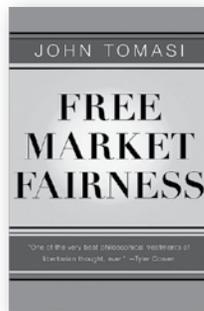
Libertarian thought? | However, in *Free Market Fairness*, Tomasi claims to be addressing not merely high liberals, but libertarians as well. Part of his project is to convince libertarians to embrace social justice when it is properly understood. In this, for both semantic and substantive reasons, he is less successful.

A considerable part of Tomasi’s difficulty in reaching the libertarian shore is due

to semantics. What is likely to be the most effective way to alienate serious libertarian scholars? That would be to mischaracterize their position and then destroy the straw man that one has erected in its place. On the occasions when the academic left has been unable to ignore libertarian thought, this has been its main tactic against it. Libertarian scholars have endured decades of having their well-reasoned, carefully crafted positions identified with the most unreasonable interpretations of the work of Robert Nozick or Ayn Rand and summarily dismissed. Nothing could be more infuriating to them.

Yet, unfortunately, this is precisely what Tomasi does. In order to craft an effective imminent critique of Rawlsian political philosophy, he is forced to accept and apply all the definitions of the academic left, including its definition of libertarianism. Thus he depicts libertarians as dogmatic by definition. He defines libertarianism as “a doctrine that grounds unyielding rights of property in a moral ideal of persons as self-owners,” (p. 51) and asserts that “[l]ibertarians employ foundationalist or ‘naturalistic’ forms of argument.... In its paradigmatic formulation, libertarianism is founded on an ideal of persons as *self-owners*” (pp. 53–4). But, under this definition, there would seem to be no libertarian scholars—certainly no living ones. Although under this definition there may be libertarian teenagers, I know of no working libertarian scholar whom it describes. Admittedly, this is purely a matter of semantics, but defining libertarianism as an unreasonable position that no one actually holds is certainly a poor way to make inroads among libertarian thinkers.

Further, under Tomasi’s definition of political philosophy, there are apparently no libertarian political philosophers. Forced by his pursuit of the imminent critique to adopt the Rawlsians’ definitions, Tomasi limits political philosophy to the realm of “ideal theory.” In this realm, no objections based on practical problems of a regime’s feasibility are permitted. Thus, “the choice political philosophers must make ... is not in any sense a practical one. The choice is instead strictly *moral*: which conception of fairness, the social



democratic one or the free market one, offers us the more inspiring ideal?” (p. 265). Hence, any thinker who bases his or her arguments on assertions about the limitations on human knowledge or skepticism regarding the motivations of public officials is not a political philosopher. But I am aware of no working libertarian scholar (other than Tomasi) who does not base his or her arguments on such considerations to some extent. Although this is again semantics, adopting a definition of political philosophy that eliminates all libertarian thinkers from the field is not likely to make them receptive to one’s arguments.

Liberty and social justice | However, the most serious semantic problem Tomasi faces in addressing libertarians is his use of the term “social justice.” He wants to persuade libertarians that a just society is one whose basic structure contains strong protections for individual liberty—including economic liberty—and whose institutions are designed to “maximize the holdings of the least well-off citizens” to the extent that doing so is consistent with respect for this liberty. That is, he wants to convince libertarians to sign on to a corrected version of Rawls’ theory of justice. This is a proposition libertarians could and should consider. But instead of stating the proposition directly, Tomasi insists upon describing himself as presenting an argument for social justice.

This is a major impediment to effective communication. Although he uses the term “social justice” to refer to the philosophical standard by which the basic structure of society should be evaluated, the term is guaranteed to be misinterpreted by libertarians (and others) as referring to the type of redistributive social policies that were excoriated by Hayek. As a result, he is forced to spend an entire chapter of his book—Chapter 5: “Social Justicitis”—attempting to distinguish social justice as political philosophy from social justice as public policy, something that he does with only limited effectiveness.

Not all the flaws in Tomasi’s attempt to break the ice around the libertarian camp are semantic, however. Libertarians will, of course, sign on to the importance

of economic liberty, but Tomasi wants to persuade them to accept what he calls the distributional adequacy condition as well. This condition requires that “a defense of any version of liberalism is adequate *only if* it includes the claim that the institutions being endorsed are deemed likely to bring about some desired distribution of material and social goods” (p. 126, emphasis added), or more specifically that “institutional regimes should be evaluated in terms of how those systems are expected to affect the interests of the working poor” (p. 141). Try as I might, however, I am unable to find an argument leading to this conclusion in *Free Market Fairness*.

In lieu of such an argument, Tomasi reviews the work of all leading libertarian and classical liberal thinkers to show that they either explicitly or implicitly recognize that the material condition of the poor is an important consideration (pp. 127–42). Indeed, he establishes that virtually all of them regard the material condition of the poorest to be a morally relevant factor in evaluating a political regime. However, showing that the material condition of the poorest is a morally relevant factor does not show that it is the essential determinative factor. It does not show that “social justice [is] the ultimate standard of political evaluation” (p. xv).

Tomasi also supplies a careful and quite useful analysis of Hayek’s work to show that, despite his famous condemnation of the idea of social justice, Hayek’s thought is actually not incompatible with social justice correctly understood (pp. 142–61). But, once again, showing that Hayek’s thought is not incompatible with social justice does not show that social justice is the ultimate standard of political evaluation.

After reading *Free Market Fairness*, I remain skeptical that “maximizing the holdings of the least well-off citizens” (p. 193) is the ultimate purpose of a liberal political system. This is because I am convinced that the way the poor obtain their holdings is just as important—if not more important—than how great their holdings are.

This conviction is not necessarily based on reasoned argument and may simply be the residue of stories my uncle told me about life as an impoverished immigrant.

These often concerned the rejection of charitable help from those outside the family’s fraternal society on the grounds that there was nothing shameful about being poor, that poverty was a condition to be overcome by one’s own cooperative efforts, and that what *was* shameful was asking outsiders for alms. The stories demonstrated that what made life meaningful for the poor—what made them capable of being “responsible self-authors”—was not merely how much material wealth they had, but how they got it.

I believe that many, if not most, libertarians would share my skepticism. To see why, consider the following three illustrative statements:

The first is Tomasi’s claim that “[t]he institutions of a free society must be justifiable to all classes of citizens, including the most poor. This requires that the basic political and economic structures be designed so as to ensure that all groups benefit” (p. 172). I believe that it is clear that the second sentence does not follow from the first. It might, if the words “have the opportunity to” were inserted before the word “benefit,” but that would require a major revision to Tomasi’s thesis.

The second illustrative statement asserts that “[l]ibertarians and classical liberals ... justify those economic freedoms in a way that makes them incapable of responding officially to the great ills that sometimes befall persons, or whole classes of persons, through no fault of their own” (p. 268). In many cases, libertarians and classical liberals do indeed oppose responding officially to ills that befall persons through no fault of their own. But the reasons for this have nothing to do with the way they justify the importance of economic freedom. The reasons for such opposition are usually that libertarians and classical liberals have read their Bastiat and understand the concept of Pareto optimality. Bastiat instructs us to consider both the immediate (the seen) and the remote (the unseen) consequences of our decisions when deciding on a course of action. Libertarians take this to heart and resist official action to relieve the plight of those who can be seen if it would mean creating greater hardship for those who

cannot be seen. Libertarians also understand that utopia is not the state of society in which all social ills have been cured, but one in which no additional ills can be cured without making things worse in some other respect. This suggests that our ability to identify unfortunate hardships does not imply that we should undertake official actions to relieve them.

Finally, Tomasi sums up the essence of his theory of social justice with the assertion that “[a]ccording to free market fairness, ... a fair share is the largest possible bundle of real wealth that might be procured for (by!) the least fortunate, consistent with respecting the rights of other citi-

zens” (p. 269). Whether the word “for” or “by” is used in this sentence is not a trivial matter for a parenthetical, but the difference between night and day. For reasons abstracted from my uncle’s stories, I would not support free market fairness when it contains the word “for” in its definition. I might if it contained the word “by.”

I suspect that many other libertarians will share my doubts on these points. Until Tomasi can provide a better argument to show why they are ill-founded, his ice breaker will fail to reach the libertarian shore. Hence, for now, libertarians are likely to remain encased in our icy resistance to Tomasi’s siren song of social justice. **R**

again and again throughout the book, much of health care is priceless in a narrower sense: When we buy health care, we usually don’t know the price until after we buy it. Moreover, someone else—the government, say, or an insurance company—pays a large part of the price. Those two facts mean that we can’t let the prices of health care guide us in our use of this scarce resource the way we can use the price of, say, ground beef or airline flights to guide our purchases of hamburgers and seats on airplanes. Specifically, we overuse artificially low-priced health care. One of Goodman’s main goals is to introduce prices into the health care system in a meaningful way and to do so mainly by deregulating and getting rid of the many regulatory distortions that distort the health care system.

Strong evidence for Goodman’s view that there are good effects from having consumers face real prices for health care comes from the area of cosmetic surgery. Such surgery, he notes, is rarely covered by insurance. He points out that, unlike in most areas covered by insurance, patients can typically find a package price that includes all services and facilities and compare prices prior to surgery. Moreover, he notes, prices adjusted for inflation have fallen over time as technology has improved. He notes that for the kinds of surgery covered by insurance, improvements in technology are blamed for rising prices.

A dominant theme in health care reform is what Goodman calls “the engineering approach.” This is the idea that all we need to do is figure out what works in health care and then have everyone do it.

That engineering approach is an example of Hayek’s “fatal conceit,” the idea that government officials can design a plan better than the various plans that the market spontaneously creates. The ACA is chock full of such conceit. One instance in the new law is Accountable Care Organizations (ACOs) in which, as Goodman puts it, “a federal bureaucracy will virtually dictate the way medicine is practiced.” He lays out the ways in which the ACA will muscle doctors into this federal straitjacket.

The Price Is Wrong

REVIEWED BY DAVID R. HENDERSON

Priceless: Curing the Healthcare Crisis

By John C. Goodman

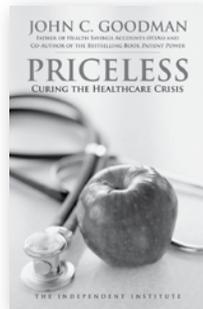
370 pages; Independent Institute, 2012

Whether Mitt Romney wins the presidency or President Obama is re-elected, they and Congress would be well advised to read and digest John Goodman’s book *Priceless*. The reason is that whoever is president will soon find himself facing unintended, but often predictable, consequences of the new health care law and also of previous laws. Goodman, a health economist and president of the National Center for Policy Analysis, has a lot to say about the Patient Protection and Affordable Care Act (often called “ACA” or “Obamacare”) and about many other pressing issues in the economics of health care and health insurance.

Goodman has been studying health economics for over 30 years, and it shows in the wide range of issues he addresses in the book. Whether the issue is Medicare or

Medicaid, health savings accounts, the tax treatment of health insurance, the costs and effects of preventive health care, the wastefulness of “single payer” health care systems, or the perverse effects of Obamacare, Goodman brings an encyclopedic knowledge to the issue. A reader who is skeptical of his claims can check one of the literally hundreds of studies and government documents that he footnotes. Goodman alternates between being an idealist who wants to get government out of health care, and being a policy analyst who takes certain goals as given—such as having government give health care aid to low-income people—and considers more efficient ways of achieving them. So, whether you want to make a case for complete separation of health care and state (as I do), or you’re a legislator who wants to make incremental improvements away from current dysfunctional health care policy, much in this book will inform and help you.

Engineering vs. prices | The book’s title, *Priceless*, is a play on words. On the one hand, we often use the word “priceless” to suggest that something is very valuable. On the other hand, as Goodman shows



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Goodman uses his understanding of how actual markets work to point out the flaws in the engineering approach. The basic flaw is that there's no single, specific solution to each problem in health care. He even gives a name to his critique: Goodman's Nonreplicability Theorem. He writes:

Scholars associated with the Brookings Institution identified ten of the best hospital regions in the country and then tried to identify common characteristics that could be replicated. There were almost none. Some regions had doctors on staff. Others paid fee-for-service. Some had electronic medical records. Others did not. A separate study of physicians' practices found the same thing.

Much positive change in the rest of the economy happens because of entrepreneurship, notes Goodman. Why should medical care be any different?

Because both governments and insurers keep the prices of health care artificially low, writes Goodman, we use too much of it. We were already doing that before the ACA. The U.S. tax code gives employers an incentive to provide overly generous health insurance, with low deductibles and low co-payments, as a way of paying tax-free compensation to their employees. This fact, which virtually every American economist who studies health care is aware of, is not given as much prominence in Goodman's book as I had expected. Possibly that's because he and co-author Gerald L. Musgrave dealt with the tax law at great length in their 1992 book *Patient Power*. Obamacare will make the overuse problem worse. Goodman points out that under the new law, insurers will not be able to charge their customers specific fees for a number of "preventive care" services such as annual prostate cancer tests for men and annual mammograms for women in their 40s—tests whose medical value is now questioned.

Goodman's solution on the tax side is to make employers' contributions to their employees' health insurance taxable, but then to have the government give a \$2,000 tax credit per person to be used toward health insurance. Families with many children would get huge tax credits. His plan has some additional complexities. For instance,

if people in a geographical area don't claim the whole tax credit, then the local government in that area would get the unused part of the credit as a block grant from the federal government to be used for indigent care. I'm skeptical about how well this would work. First, the local government doesn't have a strong incentive under Goodman's scheme to use the money well. Second, one can imagine a city government fighting a county government over who gets how much of the block grant. My own view is that a better way to end the distortion is simply to make all employer contributions to employees' health insurance taxable, but then make the change revenue-neutral by dropping marginal tax rates by a few percentage points.

Goodman's other solution to the overuse problem is Health Savings Accounts (HSAs). In fact, he is often called the "father" of HSAs. The idea is that an employer gets to deposit up to a few thousand dollars per year in an employee's HSA, modeled on a Roth IRA, and the employee can use that money for various health care expenditures. Any unused funds in a year would simply accrue and employees would have an incentive to economize on health expenditures in order to amass funds for future expenditures.

Right to health care? | One nonstarter that Goodman does an excellent job of criticizing is single-payer health care. He notes that there are only three countries in the world with single payer: Canada, Cuba, and North Korea. It is literally illegal in those countries for an individual to pay for health care. (There are some exceptions in Canada, mainly for services that Canada's single-payer system does not cover.) Under single payer, the government sets a zero price to the patient and then pays the providers. With a zero price, he notes, there is rationing by waiting. Goodman constructs a plausible example to show that such rationing by waiting can add dramatically to the cost. People pay twice: patients with their time and taxpayers with their money.

Goodman also has some striking tables showing that, for some services, uninsured people in the United States get the same or more health care than people in single-

payer Canada. For example, 65 percent of uninsured American women aged 40 to 64 have had a mammogram within five years; in Canada, it's the same percent. Some 31 percent of uninsured American men have been tested for prostate cancer versus only 16 percent of Canadian men. Moreover, in Canada only 5 percent of women and 5 percent of men have ever had a colonoscopy, versus 30 percent of American women and 29 percent of American men.

These data, plus the fact that Canadians wait so long to see a doctor and to get surgery, help to make another point that Goodman discusses: the supposed "right to health care." When I hear people say that people have a right to health care, I take on the moral issue with moral reasoning, questioning whether health care is something that a person can truly have a moral right to. Goodman does it differently—and effectively. He points out that Canadians don't have a right to health care. How can you say it's a right if people aren't guaranteed to actually receive the health care service they need? The right to get in line for care, which is really all that Canadians are guaranteed, is not much of a right. And nothing in the Obamacare legislation makes health care into a right for Americans. Goodman writes, "[A] lot of knowledgeable people (not just conservative critics) predict that access to care is going to be more difficult for our most vulnerable populations." He argues that under the Massachusetts health care law adopted under then-governor Mitt Romney, which served as a template for the ACA, that has happened. "The waiting time to see a new family practice doctor in Boston," he writes, "is longer than in any other major U.S. city."

We often hear that one way to judge a health care system is to look at life expectancy, and that by that standard the U.S. system does substantially worse than other systems that cost less. But Goodman has a table showing that if you take out fatalities due to injury, which presumably are not much affected by health care, the U.S. life expectancy is the highest in the world. One troubling fact, though, is that in his table showing various countries' life expectancies, taking out fatal injuries actually reduces life expectancy in Japan, Canada,

Sweden, and a few other countries. It seems implausible that stripping out fatal injuries for any country *reduces* life expectancy.

Health care spending | Goodman has always been a critic of managed-care organizations and scores a number of points against them. Interestingly, though, he does not mention health economist David Dranove's finding, in his book *The Economic Evolution of American Health Care*, that managed care "bent the curve" on health care spending for most of the 1990s. In 1990, health expenditures were 12.5 percent of GDP and grew to 13.8 percent of GDP by 1993. In 2000, they were still "only" 13.8 percent of GDP. Part of this was due, of course, to strong economic growth during that period, making the denominator, GDP, grow. But it's also true, as Dranove shows, that managed care restrained the growth of the numerator, health care expenditures.

What should be done about Medicare and Medicaid, two programs whose growth, if unchecked, would likely drive federal spending as a percent of GDP close to European levels by the middle of this century? Goodman considers various proposals too numerous to mention here, many of which seem promising. They range from health care "stamps," similar to food stamps, to Health Insurance Retirement Accounts (HIRAs).

Unfortunately, Goodman recommends that to fund the HIRAs, the federal government require employers and employees each to cough up 2 percent of pay annually. This is essentially a 4 percentage point tax increase, with the difference between this tax and the usual tax being that the employee gets to keep it. One problem with that policy is that, if implemented, it would cause Medicare to last longer. A better solution is for the government, and for free-market economists like Goodman, to start telling people under age 45 that Medicare is unlikely to be around in 20 years and that they had better plan for that fact. The result, if I'm right about the future of Medicare, would likely be a renaissance in health care for the elderly—one that, as Goodman shows throughout his book, is bursting to break out. The price would then be right. **R**

A Feeble Call for Unionism

REVIEWED BY GEORGE LEEF

Why Labor Organizing Should Be a Civil Right

By Richard D. Kahlenberg and Moshe Z. Marvit
147 pages; Century Foundation Press, 2012

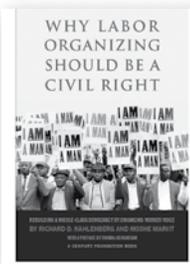
In June 2012, the U.S. Senate voted down a bill that would have changed the federal law covering labor relations so as to permit employers to give individual employees merit raises where there is a union collective bargaining contract in place. Current law protects the supposed need for worker solidarity by preventing employers from unilaterally granting raises or bonuses. The union establishment lobbied for the bill's defeat and afterward the Service Employees International Union cheered that by killing it, they had upheld the "fundamental rights" of workers.

It is worth keeping that incident in mind when reading *Why Labor Organizing Should Be a Civil Right*. Authors Richard Kahlenberg (a senior fellow at the Century Foundation) and Moshe Marvit (an attorney who practices labor and employment discrimination law) see labor unions as great champions of workers and their interests, which happen to dovetail with the authors' belief in the redistribution of income and "social justice" legislation. They argue that the union movement would be greatly energized if the Civil Rights Act of 1964 were amended to prohibit employers from acting in ways that penalize or inhibit workers from union-organizing activities. That course is necessary, they contend, because the National Labor Relations Act (NLRA) and its slow-moving enforcer, the National Labor Relations Board, are not adequate to the task of protecting workers who advocate unionization.

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I do not find the authors' case persuasive.

Wealth gap justification? | Let's start with the cornerstone of their argument, namely that the country would benefit if there were a union resurgence to the levels of the 1950s, when unionization peaked at about 36 percent of the private sector labor force. Kahlenberg and Marvit take a page from the Occupy Wall Street playbook and attempt to link their cause to the increasing wealth gap between the



"haves" and the "have-nots." At the same time unionization has been declining, they write, "economic inequality has skyrocketed to the point that the top one percent of Americans own more than the bottom 90 percent and income from productivity gains have gone exclusively to the top 10 percent."

Many Americans have been taken in by the overwrought "wealth gap" argument, but the increase in income inequality has nothing to do with unionization. The United States has become much more wealthy over the last half century because of technological breakthroughs and improved efficiency in the use of resources, both of which unions tend to hinder. As Americans have become wealthier across the entire income range, it has become increasingly possible for those few individuals who are exceptionally good at providing broadly desired goods and services to earn huge fortunes. The decline of unionization had nothing to do with the stratospheric earnings of entrepreneurs like Bill Gates, entertainers like Oprah Winfrey, or athletes like New Orleans Saints' quarterback Drew Brees. (For comparison purposes in sports, Terry Bradshaw, one of the top quarterbacks in the 1970s, earned only \$400,000 per year, while Brees just signed a contract under which he'll be paid \$20 million annually for his efforts. That isn't because Brees is better, but simply because of the far greater inflow of dollars

into professional football now.) A greater dispersion of incomes is natural when consumers have more disposable income; if we could somehow go back to the days of high union “density,” that wouldn’t put the slightest dent in “the wealth gap.”

Unions and rents | Is it not true, however, that union-represented workers earn more than non-union workers? Kahlenberg and Marvit point to statistics showing that, on average, unionized workers receive higher pay and benefits than do non-union workers, implying that similar gains await non-union workers if only they could vote in a union. In fact, the authors go so far as to make the inaccurate claim that union workers *always* make more.

That line of argument is badly flawed. It is not the case that unionization necessarily leads to higher compensation. If, for example, you compare worker earnings at unionized United Parcel Service and non-union Federal Express, there is little difference. In some job categories, UPS workers are paid slightly more, but in others Fed Ex workers are paid slightly more.

More to the point, unions long ago established themselves in those industries where there was little or no competition and managed to extract all the advantages they could. For instance, electricians in New York’s entertainment industry are unionized and the story recently surfaced that the top electrician employed by the Metropolitan Opera earns over \$516,000 per year. That remarkable compensation is possible because his union is in a position to squeeze lots of money from wealthy opera lovers for whom the Met is essentially a monopoly supplier. It does not, however, follow that unions can achieve high, or even any, gains for workers in industries where competition is intense and increased costs cannot be passed along to consumers.

One of the most egregious errors of omission in the authors’ rosy depiction of unions is their failure to admit that unions can and do cost workers jobs by making the employer uncompetitive. A good current example is Hostess Brands, the maker of Twinkies, Wonder Bread, and Drake’s coffee cakes. Hostess is in bankruptcy and trying

to stave off liquidation. Unfortunately, the Teamsters Union, representing Hostess’s drivers, has refused to renegotiate its collective bargaining agreement. If Hostess goes bust and the employees lose their jobs, union intransigence will be largely to blame.

Why would union officials do this? Because they don’t always have the best interests of workers in mind. Sometimes officials’ own interests are best advanced by their demonstrating “toughness” and refusing to accept any “givebacks.”

The entire book is marred by the authors’ magnification of the benefits of unions while ignoring their costs.

Unionism today | Kahlenberg and Marvit are eager to blame the sharp decline of private sector unionism on increasing management hostility and nefarious consultants who specialize in defeating union organizing drives. But they fail to acknowledge more obvious reasons for that decline. One crucial reason is that unions have sparked the growth of non-union competitors through the inefficient work rules that unions often insist upon.

In that respect, the construction industry is an especially good illustration. During Big Labor’s heyday, unionized construction was predominant. Today it clings to just a few urban strongholds where non-union firms fear to enter, and to government projects where special interest legislation handicaps non-union competition. In most of the private sector, unionized construction firms find it difficult to compete because of their notorious work rules that impede the efficient use of labor.

Another reason for unions’ decline that doesn’t fit the authors’ story is the improvements that many firms have made in human relations. The old, authoritarian management style that gave rise to much justified worker antagonism is largely gone, replaced by a style that focuses on worker satisfaction.

The authors’ blindness to the undesirable effects of unions is particularly risible when they discuss public sector unions. In recent years, it has become obvious that those unions have taken advantage of their position of controlling both sides of the bargaining table—they use their politi-

cal clout to elect public officials who are beholden to the unions and thus malleable to their demands—to extract extremely high compensation for their members. Public sector workers receive significantly higher pay and benefits than do comparable private sector workers. Some cities have already been driven to bankruptcy by the cost of their public union contracts and more are on the brink.

And yet the authors lament the efforts by politicians such as Wisconsin governor Scott Walker to rein in the power of the unions. Instead of worrying about lowering the cost of public sector compensation, they say, we should work toward increasing private sector compensation to match it—which is what the authors think their proposed change in the law would help bring about. But if government units that have the power to tax are going bankrupt because of the high cost of unionization, how will newly unionized firms that have to compete for scarce consumer dollars fare? That is another of the problems Kahlenberg and Marvit never contemplate.

What should be done | While the underlying rationale for their proposal to make labor organizing a “civil right” is very weak, there actually is something to be said for changing the law, although not in the manner the authors have in mind.

Under the NLRA, it is an unfair labor practice for an employer to retaliate against an employee who exercises his statutory right to seek unionization. The problem, Kahlenberg and Marvit argue, is that the current avenue for redress of violations is so slow and uncertain that employers who decide to fire pro-union workers usually escape with little cost. Comparing the high immediate benefit from deterring unionization with the low cost of battling the NLRB and possibly incurring some penalty years in the future, some employers choose to terminate pro-union workers. Those workers may have thought that union activism was legally protected—union organizers would most likely reassure them of that—only to find themselves unemployed with only the possibility of some compensation in the future.

Kahlenberg and Marvit offer the solution

of allowing such individuals to sue under the more plaintiff-friendly Civil Rights Act. Favorable judgments for workers would come faster and with much more sting for the offending firms, they claim. And once firms discovered that they couldn't deter unionization with such tactics, unions would be established at many more companies and the country would be on its way toward a suitably egalitarian future.

I agree that it is bad when people who believe they have certain legal rights find out that those rights are more theoretical than real. But instead of wading deeper into the swamp of politicized labor relations law by creating a new cause of action under the Civil Rights Act (which is sure to lead to the same sort of harassing litigation we see under other anti-discrimination laws), we ought to move in the opposite direction and depoliticize the field.

Specifically, we should repeal the NLRA in full. Among the consequences of that would be the elimination of the law's prohibition against employers announcing that they will not engage in collective bargaining and making it a condition of employment that workers refrain from union activism. Before the NLRA eviscerated the common law of contract for labor, employers were just as free as anyone else to contract only on agreeable terms. They could say "no" to unionization, and some—but not all—did so.

Wouldn't that leave unions impotent? Not at all. There are means other than legal coercion to counter employers who take a hard line. It is easier than ever to communicate real or perceived abuses to the public. If Acme Company exercises its freedom of contract by declining to hire anyone who won't agree to a no-union pledge, labor and other groups are free to exert pressure on Acme through information campaigns on the internet or other media. Socially minded consumers might be induced to boycott Acme and good workers might be poached by other firms that offer a more employee-friendly environment.

American labor law does need to change. But by encouraging the labor movement to keep relying on the antiquated tactics of coercion, this book's recommendation would make a bad situation worse. **R**

A Fine Update

REVIEWED BY DAVID R. HENDERSON

The Armchair Economist: Economics and Everyday Life

By Steven E. Landsburg
316 pages; Free Press, 2012

Steven Landsburg's *The Armchair Economist* is one of the best economics books ever written. It is insightful, disarmingly simple and yet sophisticated and, at the same time, provocative, passionate, and witty. Were I to detail the many things I like about it and why, I would write much too long a review. So instead I'll highlight a number of the particularly good and important parts of the book, extend one, and criticize another.

Preferences for the unusual | One of the book's most insightful chapters is titled "The Indifference Principle." Landsburg states the principle as follows: Unless you're unusual in some way, nothing can ever make you happier than the next best alternative. You might prefer living in San Francisco to living in Lincoln, Neb., for example, but if everyone shared your preference, people in Lincoln would move to San Francisco. When would the movement stop? When the higher demand for housing in San Francisco has raised housing prices there and the lower demand in Lincoln has dropped prices there—to the point where the two places are equally attractive. The fact that many people in San Francisco are not indifferent but prefer San Francisco to Lincoln is not evidence against Landsburg's thesis; it simply means that not everyone is the same. He notes that most of us are unusual in many ways and points out an important implication of basic economics: "The greatest gains in life come in the areas where we're most unusual." So if you love San Francisco, chances are that you're not the marginal person who is indifferent between San

Francisco and Lincoln, and you get big benefits from living in San Francisco. In short, unusual preferences pay off.

So, notes Landsburg, do unusual talents. Tim Lincecum of the San Francisco Giants makes a lot of money—not because he's a good pitcher, but because he is (or was, when he signed his contract) so much better than almost anybody else.

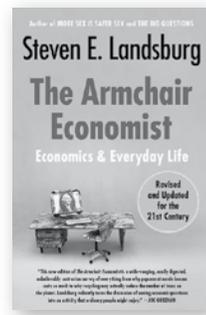
Landsburg uses this Indifference Principle to show that requiring a barber to obtain an expensive license doesn't hurt barbers but does hurt those who want haircuts. By the same token, police crackdowns on drug dealers don't hurt drug dealers but do hurt drug users.

Who, asks Landsburg, can avoid the consequences of the Indifference Principle? Only the owner of a good in fixed supply. An increased demand for actors cannot benefit actors, he notes, because it brings new entrants into the profession. But an

increased demand for Ben Stiller will benefit Ben Stiller because there's only one of him. He is a fixed resource. Landsburg shows a strong implication for public policy: If the EPA is successful in reducing pollution, residents of the less-polluted area don't gain in their role as residents. They gain only to the extent that they

owned land in the less-polluted area before pollution was reduced.

Moreover, reasons Landsburg, if there are no owners, there are no gains. He gives an example in which the government of the fictional town of Springfield spends \$10 million to build an aquarium and decides to let everyone visit the aquarium for free. So people line up to get in. How long do they wait in line? Until the value of their time in line makes them indifferent about going to the aquarium. Thus they get no "consumer surplus" from the aquarium: the expenditure is pure waste. How would you make it less wasteful? By letting someone own it.



Deadweight loss | Landsburg lays out beautifully why economists think taxes are bad. It's not because the government takes money from person A and gives it to person B. As economists, we can't say whether that's good or bad. But what economists do bring to the discussion is the concept of deadweight loss—that is, a loss to the taxed person that's not a gain to anyone else. Taxes cause deadweight loss by motivating taxpayers to avoid the tax. So the deadweight cost of taxation, paradoxically, comes about because of people's efforts to *avoid* taxation.

And here's where I can extend Landsburg's thinking in a way that I think he would approve of. This next thought is not original to me but came from Jim Black, a smart undergrad I taught at Santa Clara University over 30 years ago. Black, who is now a successful lawyer in San Francisco, pointed out that the big objection to taxes is how the government *spends* the taxes. If, he explained, the government took \$10,000 in taxes from you and spent it exactly the way you would have spent it, and if collection costs were zero, taxes wouldn't matter. Also, you wouldn't try to avoid them. So the big deadweight loss from taxes is spending.

Correcting conventional thinking | Virtually all economists are in favor of free trade. One of the main reasons is that it allows people to buy things of a given quality at a lower price. Landsburg makes this point well with a true story. When George H.W. Bush relaxed import restrictions on Japanese trucks, Bill Clinton complained that the United States got nothing in return. Bush answered that what he had gotten was the Japanese government to open its market to U.S. goods. Landsburg's comment: "Apparently both failed to notice that what Americans gain when they buy Japanese pickup trucks is: Japanese pickup trucks."

Elizabeth Kolbert, in a 2010 *New Yorker* essay, claimed that income doesn't matter for happiness. She pointed to surveys showing that despite rising incomes, the average level of self-reported happiness is the same now as it was in the much poorer 1950s. She approvingly quoted former Harvard president Derek Bok's question: "[W]hat is

the point of working such long hours and risking environmental disaster in order to keep on doubling and redoubling our Gross Domestic Product?" Landsburg lays all this out and then points out that since 1965, the average American has gained, besides more income, "about six hours a week of leisure." If happiness hasn't increased, he asks impishly, "why aren't Bok and Colbert asking why we bother to come home from the office" and take vacations? He then goes on to point out a common-sense reason why the surveys would show constant happiness: People who are asked how happy they are will tend to answer a different question. They will tend to answer based on whether they are happier than normal or happier than their friends. He drives home his point by noting that American men today are about two inches taller than American men 100 years ago. But in response to the question, "Are you tall?" a 5 ft., 9 in. American man would probably have answered yes a century ago and would probably answer no today.

Chances are that you, like me, are not a smoker. Landsburg shows that if we're buying life insurance, we gain from the fact that others smoke. Why? Because insurance companies want to price for our risk and have limited information about how much risky behavior we engage in. One activity positively correlated with risky behavior is smoking. Smokers self-select into the high-risk category by smoking, and we non-smokers select into the low-risk category by not smoking. Similarly, he argues, if there are no laws requiring motorcyclists to wear helmets, those who use them are probably lower-risk than those who don't. So if the government requires helmets, that law distorts the information that insurance companies get on you: they don't know if you're the kind of person who would voluntarily use helmets or the kind who does so only because of the law. For that reason, concludes Landsburg, a helmet law could actually raise insurance rates for those who would wear them anyway.

There has been a lot of controversy in recent years over whether and by how much Americans' real income has increased over the last few decades. The usual method for finding the answer has been to measure median inflation-adjusted household income, which, notes Landsburg, rose

only 5.3 percent between 1996 and 2005. But, he notes, a crucial problem with that measure is that household size has fallen. He explains that correcting the data for changes in household size shows that the increase in real income over those years was a whopping 24.4 percent.

Garbled green thinking | Possibly my favorite part of the book is the chapter "Why I Am Not an Environmentalist." There's much good, passionate reasoning in that one chapter. He tells how his daughter was subjected to shoddy propaganda in preschool. The recurring mantra at the ceremony to celebrate her graduation from preschool—that such a celebration was even held is itself a worrisome sign—was "With privilege comes responsibility" for the earth's resources. Landsburg's biting response: "Thomas Jefferson thought that life on this planet was more an inalienable right than a privilege, but then he had never been to preschool."

He goes after many of the environmentalists' claims, pointing out important inconsistencies. Consider the choice between building a parking lot and leaving the land as wilderness. Environmentalists argue that the decision to pave is irrevocable. Landsburg grants that point but points out that the decision *not* to pave is also irrevocable in an important way: people's opportunity to park there today, if the parking lot isn't built, is lost. "The ability to park in a more distant future," he notes, "might be a quite inadequate substitute for that lost opportunity."

Moreover, notes Landsburg, if environmentalists were as concerned about saving resources for future generations as they claim to be, more of them should oppose taxes on capital income and the Social Security system, both of which "encourage overconsumption in the present."

A criticism | In a chapter titled "Choosing Sides in the Drug War," Landsburg offers a beautiful critique of a November 1990 article in *The Atlantic* by Richard J. Dennis, who opposes the drug war. I'm virtually positive that Landsburg opposes the drug war also, but he also opposes bad arguments. Dennis has many such

arguments and Landsburg does a good job of taking them apart.

Unfortunately, Landsburg adds his own bad argument: he incorrectly evaluates the benefit of lower drug prices that would result from legalizing currently illegal drugs. Landsburg believes there would be no net benefit from lower prices on the amount of drugs that people are already

using. He analogizes lower drug prices to a lowering of the price of pizza and concludes that the amount consumers gain from the lower price on the number of pizzas they would have bought at the high price is just offset by the amount that pizza producers would lose. But that ignores *why* legalization of drugs would cause their prices to fall. It's because legalization

reduces the risk of dealing in drugs, and therefore drug dealers would no longer be compensated for that risk. Landsburg's Indifference Principle should have led him to that conclusion. So the gain to consumers of a lower price has no offsetting loss to producers and is a pure gain to society.

Still, to make only one mistake in a 316-page book is an impressive achievement. **R**

IN REVIEW | WORKING PAPERS

Below is a summary of some recent papers that may be of interest to *Regulation's* readers.

BY PETER VAN DOREN

Housing Markets

- "Did Affordable Housing Legislation Contribute to the Subprime Securities Boom?" by Ruben Hernandez-Murillo, Andrea C. Ghent, and Michael T. Owyang. March 2012. SSRN #2022461.
- "Predatory Lending and the Subprime Crisis," by Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, and Douglas D. Evanoff. April 2012. SSRN #2055889.
- "Why Did So Many People Make So Many Ex Post Bad Decisions? The Causes of the Foreclosure Crisis," by Christopher L. Foote, Kristopher S. Gerardi, and Paul S. Willen. May 2012. NBER #18082.

When a public crisis occurs, popular commentary usually converges fairly quickly on an "explanation" of how the crisis came about. Subsequent scholarship often undermines those explanations, but too late to dislodge the conventional wisdom and the policies that result. The housing bubble and subsequent financial crisis are becoming a case in point.

In my "Working Papers" column in the last issue, I discussed how many commentators, including former Federal Reserve chairman Paul Volcker, have blamed the 2008 financial crisis and subsequent recession on the 1999 Gramm-Leach-Bliley Act, which eliminated the 1933 Glass-Steagall banking act's legal barriers between investment and commercial (i.e., traditional deposits and loans) banking and insurance. As part of the column, I reviewed a paper by New York University economist Lawrence White that argued that the high-leveraged lending to the housing sector that fueled the financial crisis would not have been prohibited by either Glass-Steagall or its proposed present-day reincarnation, the Volcker rule. Despite the fact that Gramm-Leach-Bliley had no role in the financial crisis, the need to reimpose Glass-Steagall-like regulation through the so-called Volcker rule is now conventional wisdom, especially since the trading losses of JP Morgan Chase were announced in May of this year and former Citigroup chief executive Sanford Weill announced in July that the separation of investment and commercial banking should be reinstated.

Another prominent component of the conventional wisdom

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about the housing bubble, particularly for conservatives, is that affordable housing goals imposed by Congress on banks by the Community Reinvestment Act enacted in 1977 and imposed on Fannie Mae and Freddie Mac in 1992 led to the increase in high-risk mortgages offered and their subsequent default. Those goals mandated mortgage lending in census tracts with large minority or low-income populations and to minority and low-income people regardless of their residential location.

Hernandez-Murillo, Ghent, and Owyang do not dispute the role played by private label mortgage-backed securities (PLMBS) in the downfall of Fannie and Freddie. The two mortgage giants bought PLMBS heavily at the height of the housing boom, believing they would yield large long-term profits. Instead, though PLMBS accounted for only one-third of Fannie Mae's business, they produced more than 70 percent of its losses through 2010. Rather, the authors' goal is to test whether borrowers and census tracts that fulfilled affordability goals disproportionately received loans that then subsequently defaulted. They do this using the arbitrary legal divisions that distinguish loans that achieve affordability goals from loans that do not. Loans that "just" qualify as achieving affordability goals are compared to loans that "just fail" to qualify. If affordability goals affected the behavior of the agencies and loan suppliers, then the population of loans that just qualify should be larger than the population of loans that just fail to qualify.

The authors identify two CRA and five Fannie and Freddie goals:

- Loans to borrowers living in census tracts with a median income of 80 percent or less than median Metropolitan Statistical Area (MSA) income.
- Loans to borrowers with incomes of 80 percent or less of the median MSA income.
- Loans to borrowers living in census tracts with a minority population of 30 percent or more and median income of 120 percent or less than MSA median income.
- Loans to borrowers living in census tracts with a median income 90 percent or less than MSA median income.
- Loans to borrowers with incomes of 60 percent or less than the median MSA income.

- Loans to borrowers with incomes of 80 percent or less than the median MSA income and who live in census tracts with a median income 80 percent less than MSA median income.
- Loans to borrowers with incomes of 100 percent or less than the median MSA income.

If any of the affordable housing goals affected loan decisions, we would expect to see discontinuities in originations, interest rates, or default rates related to the median income of the census tract relative to the MSA median, the minority population in the census tract, or the ratio of individual borrower income to median MSA income. For each of the goals, the authors conduct several tests: Are there more loans per capita in census tracts that just qualify relative to tracts that just fail to qualify? Is there a discontinuity in interest rates in census tracts that just qualify relative to tracts that just do not? Is there a discontinuity in the default rates in census tracts that just qualify relative to tracts that just fail?

The data for the tests consist of all 722,000 subprime securitized mortgages in metropolitan California and Florida in 2004–2006. Seventy percent of the loans satisfy some affordable housing goal. The average loan amount was \$296,000. The average borrower had 173 percent of median MSA income and lived in a 47 percent minority census tract of below-average income.

The authors could find no statistically significant discontinuities. This result is robust to those loans with full documentation and different bandwidths—i.e., 1 percent, 2 percent, and 5 percent above and below the relevant cutoffs. Affordable housing goals appear not to be responsible for the PLMBS that Fannie and Freddie purchased.

For those on the political left, the conventional wisdom is that the housing bubble was the result of “predatory lending”—mortgages issued on terms that seemed attractive but ultimately were unfair and financially crippling to borrowers. Agarwal et al. analyze the effects of such predatory lending in Chicago. In 2005, the Illinois legislature enacted legislation to curtail those lending practices. The program was initially conceived as a four-year pilot program primarily for the South Side neighborhoods of Chicago, and it mandated counseling for all those borrowers with FICO scores (a measure of creditworthiness) less than 621 and those between 621 and 650 if they chose high-risk products. The law also mandated counseling regardless of FICO score if the mortgage product included negative amortization, prepayment penalties, or closing costs higher than 5 percent.

The intervention had large effects on lenders and throughput. Purchase loan applications decreased by 18.6 percent and refinancing applications by 46.6 percent. Actual purchase mortgages declined 29.2 percent and mortgage refinancing declined by 48.5 percent. Of the 49 lenders offering loans in the area before the program, only 25 remained during the program. (Because of the drastic effects on applicants and lenders, community activists and lenders succeeded in suspending the program after only 20 weeks of operation on January 17, 2007.)

But the large effect on throughput had no effect on the subsequent default rate 18 months after origination. Relative to a control area, the default rate on the treated group declined a

statistically insignificant 3.6 percent.

Both of these papers add to the evidence presented in my Spring 2011 “Working Papers” column that neither affordable housing goals nor subprime loans were important explanations of the housing bubble.

Another important component of conventional explanations of the foreclosure crisis involves informed insiders selling overpriced houses and associated financial products to uninformed outsiders. Foote, Gerardi, and Willen present 12 facts that refute this narrative. They argue that the explanation most consistent with the facts is one in which overly optimistic beliefs about ever-climbing housing prices were held by investors, borrowers, and lenders alike. If the insider/outsider story were true, then better regulation and information might prevent future bubbles, but because collective beliefs are the problem, prevention is much more difficult.

The most interesting of their 12 arguments are as follows:

The exploding Adjustable Rate Mortgage (ARM) theory has been central to many narratives, including that given by Shelia Blair of the Federal Deposit Insurance Corporation. But data about various vintages of “2/28” ARMs (loans with an initial low interest rate that “resets” to a market rate two years later) and default rates show no relationship between reset and foreclosure. Only 12 percent of borrowers involved in foreclosures between 2007 and 2010 were making payments higher than the initial rate when they defaulted.

Many argue that “mortgage innovation”—that is, the recent development of “exotic” types of mortgages—was the problem. But these products weren’t all that new or exotic. The option ARM, for example, was invented in 1981 and accounted for one-third of all originations in California by 1996. “NoLos,” in which the borrower had to provide little if any evidence of creditworthiness, were also old-hat; by 1990, 35 percent of loans were no or low documentation. Low down payments mortgages were started long ago by the Veterans Administration and Federal Housing Administration, and accounted for half the market in the 1950s. Mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) that were used to finance mortgages, as well as other complex financial products, had been around for decades.

The originate-to-distribute model of mortgages, in which banks initially make the loan but then promptly sold off the asset to investors, was likewise not new—the authors quote from a 1959 discussion of the model. Its use grew dramatically in the 1970s when unanticipated inflation decimated the traditional originate-and-hold model for fixed-rate mortgages. By the late 1980s, 50 percent of savings-and-loan mortgages were sold rather than held by the originating institution.

It’s difficult to argue that the financial bust was the product of savvy industry insiders taking advantage of gullible and naïve outside investors. Mortgage investors had lots of information about the assets available to purchase. In fact, much of the information we have on loans comes from the disclosures given to investors before they bought. Lehman and UBS prospectuses illustrated the expected performance in a housing price meltdown scenario and have been quite accurate.

Moreover, mortgage market insiders were the biggest losers from the bust. Bear Stearns executives were the major investors in their two hedge funds that went bankrupt. The biggest winners were outsiders who made large bets against mortgages in the credit default swap (CDS) market. Ironically, most analysts at the time were very bullish on subprime mortgages and the negative CDS bets were made on the basis of a regression-to-the-mean trend analysis rather than any insights about underwriting defects.

It should be noted that, in the financial collapse, AAA-rated bonds did not turn out to be toxic. Only 10 percent of those bonds suffered losses. However, AAA-rated CDOs *were* toxic; investors suffered losses on 90 percent of AAA-rated CDO tranches. Both CDOs and MBSs were rated by the same firms, so why the different outcomes? MBSs were rated using structural models to estimate how correlated defaults would be if housing prices changed; CDOs were not. The analysts who studied the CDOs were bond analysts who simply used historical correlations, which for corporate bonds have proved to be excellent predictors of default even today. Thus the information asymmetries were not between outsiders and insiders, but between two different groups of analysts within the investment firms

Many believe that the rising popularity of lower down payment loans last decade stimulated house prices. This belief conflicts with a fundamental theorem of finance: that financial innovation improves risk sharing, decreases precautionary savings, and lowers asset prices. The Achilles heel of all rational financial innovation models is that temporary innovations cannot cause prices to change. Thus the models must assume that permanent changes occur and then have surprising exogenous reversals to account for booms and busts and satisfy their own internal logic.

A recent rational financial innovation model to explain the housing boom and bust assumes a down payment collapse from 25 to 1 percent to generate its results. But down payments have been low for some time, so the applicability of this model is suspect. And housing prices did not collapse because financial innovations were reversed beforehand. Rather, financial innovations ceased to be used because housing prices collapsed.

Oil Markets

- “The Incidence of an Oil Glut: Who Benefits from Cheap Crude Oil in the Midwest?” by Severin Borenstein and Ryan Kellogg. June 2012. NBER #18127.

The unexpected boom in oil production in the Midwest from shale rock has created strains on the oil pipeline transportation system. The long-term decline in domestic production over the last 50 years has resulted in a pipeline system that is designed to transport imported crude oil *from* the Texas Gulf Coast inland to Cushing, Okla., where various pipelines meet and tank farm inventory facilities are available. The same system cannot ship crude oil *to* the Gulf Coast, however. Thus the ironic temporary result of increased domestic production in the shale areas in the United States and the tar sands area in Canada is that once the oil reaches Cushing, it then cannot reach the

world market. It can only be shipped to inland refineries. The result is a mismatch between too much domestic supply and too little domestic refinery demand, and thus a price discount relative to crude oil prices in the rest of the world market.

Even though West Texas Intermediate (WTI) crude oil prices are lower than world prices, Midwestern gasoline prices are not lower because refined product pipelines are not capacity-constrained and the output of Midwestern refineries is not sufficient to meet Midwest product demand. Thus the marginal source of gasoline in Midwestern markets uses crude oil priced at world levels rather than the lower-priced WTI. This means that though crude prices in the Midwest are low because of the Cushing blockage, gas prices are not.

Projects are underway to reverse the flow of crude pipelines so that the excess oil in Cushing can travel to the Gulf Coast and find its way onto world markets. The result will be an increase of WTI prices to world levels, but no change in the price of gasoline, whose price already reflects world crude prices. The refineries that use WTI will see a reduction in their profit margins. The expansion of the Keystone Pipeline from Canada, if it occurs, will result in an analogous increase in the price paid for Canadian crude.

Chrysler Bankruptcy

- “Was the Chrysler Reorganization Different?” by Mark J. Roe and Joo-Hee Chung. July 2012. SSRN #2103276.

In the 2009 federal government-sponsored reorganization of Chrysler, secured creditors of the company received only 29 cents on the dollar while unsecured but government-favored creditors (mostly pension and health benefits) received full payment. Some commentators said this violated the rule of law, but others said that the debtor-in-possession (in this case the government) gets to set the rules and that this case “didn’t turn anything upside down.”

The authors argue that priority mischief among creditors in a bankruptcy proceeding can occur when some debt is carried through the reorganization rather than a straight cash sale for assets with all debts extinguished. Thus the percentage of debt that passes through the reorganization process rather than being extinguished is a measure of the differential treatment of some debtors relative to others. The authors gathered data on this ratio for 63 large (\$100 million or more in assets) bankruptcies prior to Chrysler and compared various descriptive statistics between Chrysler and the others.

In the Chrysler case, more than half of the preexisting liabilities (health and pension funds) were carried through to the new entity. For the 63 other bankruptcies, the modal and median values of debt carried through were zero. In the Chrysler case, the ratio of total debt assumed to purchase price was 90 percent. For the other 63 the mode was 0, the median was 3 percent, and the average was 23 percent. Even among the subset of the 63 cases that involved high pension obligations, Chrysler was different.

So was the Chrysler reorganization different? The answer appears to be an emphatic yes. **R**