
In Review

Threats Everywhere

REVIEWED BY JOHN MUELLER

Permanent Emergency: Inside the TSA and the Fight for the Future of American Security

By Kip Hawley and Nathan Means

260 pages; Palgrave Macmillan, 2012

It was during Kip Hawley's tenure as director of the U.S. Transportation Security Administration that a special committee of the National Academy of Sciences set out to evaluate the approach to risk analysis being taken by the TSA and the Department of Homeland Security more generally. The committee's conclusions were pretty grim: not only could the committee find no risk analysis capabilities in the agencies that were adequate to support the decisions that the agencies had made, but it couldn't even figure out how the DHS was defining "risk."

Hawley's new memoir of his time in office, *Permanent Emergency*, written with Nathan Means, substantially corroborates the NAS committee's findings. Although the book repeatedly declares that "risk management" is a central concern, it is never clear what that means. Insofar as one can begin to grasp a possible meaning, it appears to justify the committee's observation that little attention has been paid "to the features of the risk problem that are fundamental."

High among those neglected features is a consideration of probabilities. For example, at no point does Hawley, in his laudable desire to make airlines safer from ter-

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rorism, suggest that he has tried to answer the fundamental question, how safe are we? At present rates, a passenger's chance of boarding an airliner that is subsequently attacked by terrorists is one in something like 20 or 30 million. (See "Screening Tests for Terrorism," p. 26.) Maybe for some that's not safe enough, but it's where the conversation should start.

There is also an amazing neglect of costs, except very occasionally to note that one security measure was more expensive than another. But the key issue in risk analysis is not simply to compare costs, but to determine whether a security measure reduces risk—the likelihood and/or the consequences of an attack—enough to justify its cost. The book is innocent of such analyses, which would, of course, require a coherent definition and assessment of risk.

In addition, Hawley constantly and tendentiously exaggerates the likely consequences of planned, but foiled, terrorist attacks. Like earlier irresponsible alarmists, he proclaims without explanation that our "survival" is at stake, insists without supplying coherent evidence that al-Qaeda networks currently exist in the United States, and engages in the familiar ploy in which an "al-Qaeda-inspired" terrorist group in one sentence becomes an "al-Qaeda-linked" group in the next.

He also consistently exaggerates the capacities of the terrorists, never finding them to be less than "innovative," "adaptive," and "quick moving." These qualities, he says, require the TSA to be "lightning-fast" in connecting thought to action (lots of luck on that one). And all terrorist bomb

makers seem to be "masterminds," even though the underwear bomb deployed to blow up a U.S.-bound airliner in 2009 suffered from a couple of rather unmasterly design flaws according to Hawley: it could not be detonated and was too small to destroy the aircraft.

He is also alarmed at the danger presented by terrorist bombs using hydrogen peroxide. He does, however, note in passing that even world-class laboratories are able to get this explosive mixture right only one time in three. This difficulty might help explain why no terrorist (however innovative, adaptive, masterly, and quick moving) has been able successfully to detonate even a simple bomb in the United States since 2001 and why, except for the four bombs set off in London in 2005, neither has any in the United Kingdom.

Bureaucracy and security

| The book provides a glimpse of the chaos that attended the hasty scramble to set up the TSA in the years immediately after 2001. Hawley seems to be less impressed by the agency's obscene waste of taxpayer money than by the success of the frantic efforts to meet absurd deadlines. In the process, what was created, he admits, was merely "an amped-up version of the previous system, one in which government employees simply replaced private contractors."

The book does have quite a bit of detail. We learn, for example, what Hawley had for breakfast on the day he was asked to become TSA chief. And there are a number of little personal vignettes along with discussions of bureaucratic infighting. He also proudly says he applied "network theory" and "complexity theory" to the workings of the TSA. This apparently means he worked to give screeners more "autonomy and improvisatory ability" at their "chokepoint"—qualities that, however, do not seem to be in great



evidence in the lines I've stood in.

Although the operations of the massive intelligence system that has burgeoned since 9/11 have been extensively discussed in a far more important book, *Top Secret America* by Dana Priest and William Arkin, Hawley does provide some arresting insights into its workings. He talks of the lengthy and frequent briefings in which barrages of intelligence, relayed in "story-time" fashion, only "rarely result in action."

On the morning of his last day in office, shortly before Barack Obama's inauguration, he dutifully waded through intelligence reports in quest of possible "threat streams." At the time, intelligence "had already highlighted threats to mass transit"—although, of course, none of those ever materialized. One of the reports particularly caught his eye: the corpses of four young men recently found at a small, remote "training camp" in Algeria, possibly killed by poison or by "some sort of biochemical accident." This set Haw-

ley to wondering, "had they maybe been practicing for today on the [M]all?" This creative, if rather extravagant, exercise in dot-connecting is, says Hawley, a "perfect metaphor for how I had spent nearly the last four years of my life." That would be, of course, at taxpayers' expense.

The 9/11 Commission, as Hawley points out repeatedly, blames the 2001 disaster on a "failure of imagination." The problem now seems to be a surfeit.

As it happens, the Algerian corpse "threat" (a word that seems to have become a synonym for "lead") was only one of hundreds that Hawley examined on his last morning at the TSA, and the FBI reportedly sifts through over 5,000 of them each day. With the swelling intelligence apparatus pitchforking ever more "threats" onto the haystack to be pawed through by people paid to be imaginative, we will always be in an "emergency." The title of Hawley's book, then, is not—as might at first appear—an oxymoron. **R**

industrial policy with a smarter, leaner one.

Atkinson is the president and founder of the Information Technology and Innovation Foundation, where Ezell is a senior scholar, so their interest lies first and foremost in figuring out how the government can leverage the gains from the information technology (IT) revolution. They argue—with plenty of data supporting them—that massive productivity gains in the U.S. economy in the 1990s were primarily the result of firms finally adopting IT en masse and using it to generate massive gains in productivity, driven primarily by Wal-Mart and its retail-sector competitors. Today, these gains have diminished and there's ample evidence (that Atkinson cites elsewhere) that even the diminished productivity growth of late may be overstating the little growth that is actually occurring.

The current plight of the economy means that economic growth may be more important now than ever, given the pressing need for economic growth to generate sufficient tax revenues to get us out of our fiscal hole.

If we're going to do industrial policy (and make no mistake about it, we are—as anyone who's spent even a smidgeon of time in the favor factory that is the U.S. Senate can attest), let's think about doing it so that we get the most bang for the buck.

A key way to do this is to tilt our tax code in favor of those industries that face the most competition from foreign entities. The vast bulk of those foreign firms receive their own share of subsidies, tax breaks, and favors from their own governments that dwarf the advantages we proffer our own companies.

Unlike the libertarian ideal, Atkinson and Edzell's proposal may be achievable. But how can a card-carrying libertarian not shout "*J'accuse!*" at the top of his lungs at such a thought? Because Atkinson and Ezell have a point—and because their reforms would represent a system markedly superior to the travesty currently in place.

Rates vs. breaks | Among other things, Atkinson and Ezell's book serves as an

The Pitfalls of Reforming a Broken System

REVIEWED BY IKE BRANNON

Innovation Economics: The Race for Global Advantage

By Robert D. Atkinson and Stephen J. Ezell
440 pages; Yale University Press, 2012

The phrase "industrial policy" comes with a lot of baggage, at least for those who can hearken back to Walter Mondale. Today, it connotes an activist government that shunts capital into favored industries, uses the tax code to reward friends, and generally gets involved in decisions that should not be made by government.

Anyone paying attention would say that is a spot-on description of our current government's *modus operandi*, but no one who has helped create the levia-

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than devouring our taxes and freedom today (both sides of the political spectrum are to blame, incidentally) would admit to having been a party to the creation of anything as nefarious as an industrial policy. Like boiling a frog, it has occurred quite gradually, although the water in the pot has always been quite warm.

Blowing up the current arrangement would disappoint few economists. However, there is little unanimity on what should replace our current, convoluted industrial policy. While the natural conclusion of the libertarian-minded would be for government to drop corporate tax rates, tax expenditures, and anything resembling an explicit subsidy into the dust-bin and be done with it, Rob Atkinson and Steven Ezell argue—at times quite convincingly—to replace the current



INNOVATION ECONOMICS
THE RACE FOR GLOBAL ADVANTAGE
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Rates vs. breaks | Among other things, Atkinson and Ezell's book serves as an

opening salvo in the upcoming battle over corporate tax reform. Most people on the left and right now agree such reform should be a high priority for the next Congress, even if they disagree over how it should be done.

An oft-overlooked truism in economics is that the entity that writes the check to the government is not necessarily the one that bears the burden of the tax. For instance, the notion that employers and employees equally share the burden of the Social Security tax is an accounting fiction. In the tax's absence, the incomes of workers could go up by the entire amount of the tax (depending on the labor supply), meaning that workers bear the full burden of the tax.

Similarly, the corporate income tax is not borne solely by the evil, faceless corporations or even their shareholders. To wit, the corporate income tax decreases the returns to investment in plants, equipment, and machinery. As a result, less investment is undertaken and workers are less productive than they otherwise would be. Hence, wages are lower, the company produces less (and earns fewer profits), and prices for whatever they produce are higher as well. Therefore, workers and consumers bear the burden of a corporate income tax along with the owners of the company, and the relevant question for policymakers is how the burden is split among the three. That answer is important regardless of whether the concern is to maximize economic growth or redistribute income: if the burden primarily falls on workers, then the corporate tax code isn't going to be very effective at either one.

The bulk of research of the last decade suggests that labor bears the brunt of the corporate tax burden, making the tax an especially bad way to redistribute income—even the lefty citadels at the Tax Policy Center have accepted this. Therefore, a lower corporate tax rate would increase wages and ameliorate income inequality more than other tax changes.

But Atkinson and Ezell have other concerns. What worries them is that the U.S. corporate tax code stands out not only because of its high statutory rate (highest among the nations in the Organization for Economic Cooperation and Development), but also because it does a lousy job

of incentivizing investment. Our corporate tax code ostensibly encourages investment via two “tax expenditures”: the research and experimentation (R&E) tax credit (which gives a tax break to companies that increase their spending on activities that fall under those labels) and “bonus” depreciation, which allows companies to deduct spending on equipment more rapidly than it actually depreciates in value. But the bonus depreciation isn't especially generous, and neither is the R&E credit—and the latter is not designed particularly well to begin with.

While we know what tax reform generally does (trades the loss of various preferences for a lower tax rate), the question on the corporate side is how far can Congress take this process. Specifically, would it make sense to jettison the investment incentives for new plants and equipment (via the bonus depreciation) as well as the research and experimentation tax credit, in a quest to get the rate as low as possible, assuming the best we can do is a revenue-neutral reform?

The answer that a company pleading to Congress would give to that question depends on how much it benefits from these incentives, of course. A capital-intensive business that spends a lot of money on research and development perceives that the lower rates won't make up for the lost incentives, so it is not particularly anxious to make that deal. Companies that undertake little R&D or capital investment are keen on such a tradeoff and have been diligent in letting the tax-writing committees know. Which firms do we disappoint?

The temptation is to choose the low rates and insist that the market can sort it out more efficiently than the tax code can. Atkinson and Ezell argue that this is a cop-out: to quote Geddy Lee, if you choose not to decide, you still make a choice—in this case, in favor of banks and financial companies, and against manufacturers. Atkinson and Ezell wouldn't pass judgment for tilting the tax code this way because of its increase in inequality (although others would), but they would object to making U.S. businesses that compete against foreign entities operate under a tax code that renders them even less competitive. And make no mistake, the current U.S. tax code does them few favors.

Taxing tradable goods differently | This brings us to the second point of their book: We need a tax code that treats companies that compete globally, in the traded sector of the economy, differently than companies that have no international competition. Haircuts can't be outsourced to India, but there is no tax on this service. Tractors can—and are—produced all over the world, and the tax environment for tractors is worse in the United States than almost anywhere else. It's equally bad for U.S. companies operating abroad, for reasons that make absolutely no sense.

It raises an important philosophical question: Is tilting a country's tax code so as to make it more favorable toward exporters akin to managing trade? Or how about funding an agency that makes loans to potential customers of major exporters? To some degree it undeniably is. Consider the complaint of Delta Air Lines, which argues that U.S. Export-Import Bank loans to foreign air carriers to purchase jets from Boeing put Delta at a competitive disadvantage, since it isn't privy to the same cut-rate financing if it bought Boeing jets.

Atkinson and Ezell argue that unilateral disarmament in the high-tech jobs race, which is our current *modus operandi*, is a path to the eventual disappearance of the high-tech, high-value-added jobs in building aircraft, construction equipment, farm equipment, automobiles, and a host of other industries that China and Europe have been aggressively courting with their fiscal tools. The Chinese ex-im bank is 10 times the size of the U.S. bank, and direct government subsidies to their fledgling aircraft and construction equipment dwarf anything we do for our own companies. That does not even count the rampant theft of intellectual property that the Chinese government is (at best) ignoring or (at worst) abetting. A corporate tax reform that jettisons the R&E tax credit and bonus depreciation would exacerbate an already perilous environment for our manufacturers, they declare.

Economic growth rather than neutrality | The problem with the U.S. Ex-Im Bank (which I've litigated on these pages previously, ultimately concluding it is an

unfortunate necessity; see “Reforming the Export-Import Bank,” Summer 2012) lies largely in the micro-managing that Congress exerts over it: while the current mandate is for Ex-Im to make loans to overseas customers of U.S. businesses, it must make sure that a proportion of those loans go to support small businesses, women-owned businesses, and minority-owned businesses. No doubt, a congressional staffer is working hard this very minute to identify other aggrieved groups who deserve a loan support quota as well.

Our government tries to do too many things for too many groups. Telling it to do less is always a safe directive. But that may not be an option here: if we are going to fundamentally reform the tax code and have our government fund an export-import bank, we need to come to some sort of agreement on the goals of these efforts. Atkinson and Ezell argue—convincingly—that the goal of both should be economic growth, and the way to achieve that is to create a system that gives U.S. companies that compete in a global market as much of a competitive edge as we can, even if that means that companies that face no such international competition see their relative burden for funding government go up. The competing message, namely that we worship the vague totem of simplicity for its own sake, can respond only by labeling this reform as interventionist.

Simplicity should not be the goal of tax reform; economic growth is the metric that really matters. Atkinson and Ezell argue that a tax code that favors investment, research, and development produces more economic growth. Those who want a tax reform that merely simplifies the corporate code by jettisoning these incentives have to either explain why such a reform would produce higher economic growth than keeping pro-growth incentives, or else why simplicity is worth slower growth.

Simplicity and economic growth may go hand-in-hand when it comes to reforming the personal tax code, but Atkinson and Ezell present a compelling brief for why this is not the case when it comes to corporate tax reform. Here’s hoping we have a reason to pay attention to them soon. **R**

Is It Time for the X-Tax?

REVIEWED BY IKE BRANNON

Progressive Consumption Taxation: The X-Tax Revisited

By Robert Carroll and Alan D. Viard
222 pages; AEI Press, June 2012

What would a tax reform look like that would be acceptable to both political parties? At the moment it’s hard seeing Democrats and Republicans even agreeing on pizza toppings, so positing wholesale changes to the tax code that would be mutually amenable seems like an insurmountable barrier, but let’s give it a shot: Republicans would presumably insist upon a tax code that would have lower marginal rates and more incentives for savings and investment, and generally be more conducive to economic growth. Democrats would insist on greater progressivity as well as more revenue. In theory, a tax code that achieved all of those standards ought to be grist for a deal.

Does such a thing exist? Happily, it does, and economists Bob Carroll and Alan Viard spell it out in great detail in their new book, *Progressive Consumption Taxation*. I predict the book will soon be discussed and pored over on and off Capitol Hill—or at least its first 14 pages, which is all that the typical attention-deprived D.C. denizen can bother to read.

But skimming it would be a pity because Carroll and Viard lay out a comprehensive tax code that may represent the only way to thread the needle and come up with a full-fledged tax reform just as “Taxmageddon”—the legislated return to 1998 tax rates—begins to rear its ugly head. And in Washington, D.C., timing matters.

Taxing consumption | The authors (Carroll is a former treasury official and is currently a partner in the tax practice

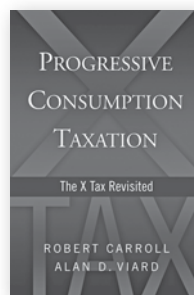
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at Ernst and Young; Viard is a former academic and Federal Reserve Bank economist currently at the American Enterprise Institute) are apostles for the “X-tax,” which forms the basis of their plan. The plan was first spelled out by the late David Bradford, who created a code that taxes consumption. Nothing is especially unique about that: nearly every country in the developed world, save for the United States, has some sort of consumption tax in the form of a value-added tax (VAT). In general, economists would prefer taxing consumption rather than income because any tax produces less of whatever is taxed, and our economy does better if we deter consumption rather than income and the concomitant work that creates it. The problem for the political left is

that the VAT is not progressive, and the right hates the VAT because of the perceived ease with which it could be raised without the citizenry being aware.

However, an X-tax is less stealthy than the VAT. Under such a plan, people would still pay a tax on their labor income, but any income received from interest, capital gains, or dividends would not be taxed. There would be no deductions for IRAs or health savings accounts, although any money set aside for retirement or saved for any other purpose would be treated the same as a Roth savings account, with no further taxes being extracted. Exempting capital income from taxation makes economic sense because each dollar extracted from taxing capital income deters saving, investment, and economic growth more than does a dollar collected from labor income. Nobel economics laureate Robert Lucas called ending capital taxation “the closest thing to a free lunch that exists in the economy.”

Recent history has demonstrated that sustained economic growth can do wonders to a country’s revenue. For instance,



when the economy grew at roughly 3 percent per annum between 2004 and 2007, tax revenue grew nearly 40 percent. Between 1995 and 2000, when economic growth averaged 4 percent per annum, revenue went up by fully 50 percent.

Since upper income households receive most of the non-labor income, exempting it from taxation means that progressivity—as well as the foregone revenue—has to come from somewhere else. The authors re-introduce progressivity in part by discarding most deductions currently in the code—such as the mortgage interest deduction—that go predominantly to upper-income households. Their version of the X-tax also has graduated tax rates on wages, which could be tweaked to achieve the level of progressivity desired by any Congress.

On the business side, the X-tax basically ditches the current corporate income tax structure and instead imposes a business cash flow tax. The difference is that instead of a corporation coming up with a measure of net income, this tax simply looks at the difference between spending and revenue. Carroll and Viard would extend this to all businesses, not just C corporations, which no doubt gives S corporations and partnerships some heartburn. Consistent with their desire to move to a full consumption tax, they would allow companies to immediately and fully expense all capital investment. A much broader base also means that much lower tax rates are possible.

Political calculus | Is America—or Congress—ready for a reform of the tax code that makes the 1986 tax reform seem like small potatoes? America is, I would argue; people don't much like paying taxes, but what really angers them is when they think others (especially the wealthy) aren't paying their fair share. The X-tax would greatly reduce the ability of individuals and corporations to creatively use various deductions and credits to hammer down their tax bill.

What will be difficult is for each side to acknowledge that the X-tax really does give them what they want. It is easy to see Democrats railing about the unfairness of not taxing dividends and capital gains even if the new code results in higher progressivity,

or certain Republicans being angry about valuable deductions being removed even if tax rates on the personal and corporate sides are brought down. And members of the tax-writing committees on both sides of the aisle might be hesitant to vote for something that takes away their ability to do favors for their friends, although the cynic might note that clearing the deck opens the door down the road for a whole new round of tax preferences and influence-seeking.

But splitting a shrinking pie makes for painful politics, and a step toward higher long-run economic growth would make the politician's lot much easier. The baby boom generation is careening toward retirement without any assurance at all

that our country can afford to make good on what they've been promised in retirement. Congress will soon have to choose whether to shortchange the boomers on what they've been promised, or offend some entrenched interests and embrace a tax reform that has the potential for goosing economic growth.

Virtually no one (save for the Obama administration, which apparently sees no need to work on tax reform) is happy with the current state of the tax code. With Taxmageddon on the horizon, the timing may be propitious to create a tax code that, in the words of a former treasury secretary, looks like someone designed it on purpose. R

Beyond Madoff's Wildest Dreams

REVIEWED BY PIERRE LEMIEUX

The Clash of Generations: Saving Ourselves, Our Kids, and Our Economy
By Laurence J. Kotlikoff and Scott Burns
275 pages; MIT Press, 2012

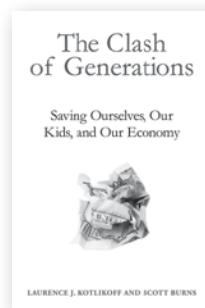
The *Clash of Generations* would be interesting if only because one of the co-authors, Laurence Kotlikoff, is a creative and eccentric economist. A professor at Boston University, he is well known for his iconoclastic research on government insolvency. In 2006, he published an article in (of all places) the journal of the Federal Reserve Bank of St. Louis entitled, "Is the United States Bankrupt?" He answered yes. He ran a third-party campaign for president in 2012. Co-author Scott Burns is a personal financial planner who has written with Kotlikoff before.

In this book, the authors defend with

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brio the thesis that "[t]he United States is bankrupt" (italics in original). Their light style and flashy formulas have all the advantages and drawbacks of the genre: they make for engaging and easy reading, but with shortcuts that sometimes make the point more, not less, difficult to understand.

Fiscal gap | The problem, they explain, is not the annual deficits. The annual deficit is not a significant figure: it can be misleading as it changes depending on how the government labels expenditures and revenues—what the authors call "the labeling problem." Accounting manipulations hide expenditures by shifting them into the future and disguise future taxes by leaving inflation to increase them stealthily. Instead of taxation without representation, we now have "taxation without cognition" (emphasis in original). The result is that most of the liabilities "have been carefully kept off the government's books in a system of duplicitous accounting that goes far beyond Enron's and Bernie Madoff's wildest dreams."



The authors argue that what matters is the “fiscal gap,” that is, the difference between the government’s promises and future obligations on the one hand, and all its expected revenues on the other hand. Calculated in discounted dollars over an infinite horizon, the fiscal gap cannot hide expenditures nor lie on revenues. It is the only true measure of whether a government is financially sound or bankrupt.

Kotlikoff has done much academic work to quantify this statistical and actuarial construct. His latest estimates (as of June 2011), reported in *The Clash of Generations*, show the federal fiscal gap at \$211 trillion dollars, about 20 times the amount of the official debt. It is equivalent to 14 times current gross domestic product. “[O]n a fiscal gap basis,” the authors write, “the United States is in worse fiscal shape than Greece.”

In order to close that gap, the government would have to immediately and permanently increase all federal taxes by 64 percent. Alternatively, the government could immediately and permanently cut primary federal expenditures (all expenditures excluding reimbursement of the interest and principal on the official debt) by 40 percent. If action is delayed, even more dramatic tax increases and/or budget cuts would be needed. We are close to the point where nothing could realistically prevent a federal bankruptcy.

The main culprits for the fiscal gap are Social Security and Medicare. Created by Franklin D. Roosevelt in 1935 (and complemented by Medicare since 1965), Social Security is “a six-decade-and-counting Ponzi scheme.” The system is based on the obligation of current workers to pay for current retirees’ retirement, with the promise that the former will get similar subsidies when they grow old. This promise has become impossible to honor because the old are taking too much and the young are not able to pay.

In parallel with longer life expectancy, the state “has been turning retirement into a well-paid, long-term occupation.” Retirees get on average more than \$30,000 per year in Social Security, Medicare, and Medicaid benefits, which amounts to three-fourths of annual per capita income, “far beyond our children’s capacity to pay” and “far beyond

our own capacity—and will—to pay.” In 2030—less than 20 years from now—these expenditures would eat two-thirds of federal revenues. According to official figures (which are less pessimistic than Kotlikoff and Scott’s), putting the Social Security system on a sound financial basis would require an immediate and permanent increase of 29 percent in the Social Security tax rate (from 12.4 percent to 16 percent), or an immediate and permanent 22 percent cut in benefits. The welfare state that has been built for the old is “a generational time bomb, which will explode as a terrible clash of generations.”

The old have voted themselves retirement incomes that are not supported by savings. The national savings rate has been decreasing for six decades, from 16 percent of GDP to essentially zero, while consumption, and especially consumption by the old, has increased. In order to pay what has been promised to older Americans, working adults will have to pay enormous taxes, which will depress the economy and make their tax burden even heavier. Until now, people have received more in benefits than they have paid in Social Security and Medicare taxes, but that is ending: young people will have to pay more in taxes than they will get in benefits. This is nothing less than the exploitation of the young by the old, “fiscal child abuse,” and a “war on our children.”

Kotlikoff and Burns argue that Ricardo equivalence (whereby the current generation would save in order to help the future one pay its higher taxes) does not work because, empirically, the old don’t care that much for their children. Either the working young will have to pay twice—once for today’s retirees and a second time for their own old age—or else the system will crumble.

The authors also examine the fiscal policies of state and local governments. To close their own fiscal gaps of \$38 trillion (to be added to the \$211 trillion federal fiscal gap), state and local governments would have to increase their own taxes by 12 percent or reduce expenditures equivalently. “We are, in short, totally screwed,” conclude Kotlikoff and Burns. They fear that “major social strife could occur at any time.”

‘Purple Plan’ | *The Clash of Generations* is three books in one, with the fiscal gap

section being followed by a section outlining the authors’ proposed policy solution and another section offering financial advice for individuals. Unfortunately, the second and third sections are not as interesting as the first one.

The second section explains the authors’ so-called “Purple Plan” to save America from government bankruptcy. They call their plan “purple” “because both Red Republicans and Blue Democrats will like what they see.”

What are the solutions? A repudiation of the federal debt would only solve part of the problem. What is needed is to question the welfare state. But Kotlikoff and Burns don’t want to travel that road.

The first component of their Purple Plan is a big attempt at social engineering of the financial sector. They want banks to be stripped of their limited liability if they don’t become mutual fund companies that simply pass their depositors’ money to mutual funds. This intriguing idea may be an exploitable entrepreneurial idea. Perhaps our authors should continue to build businesses around their ideas and create a Purple Bank (assuming actual regulations do not make the venture too costly). The problem with their proposal is that it would impose a single banking model on everybody. They must be very sure of their idea, to want to impose it on 300 million Americans! Would they be willing to assume personal liability for the results?

The second component of the Purple Plan aims at reengineering health care. The authors of *The Clash of Generations* propose a national health insurance scheme that would subsidize a basic health insurance plan for every American. The private insurance companies that would offer such plans would be prohibited from discriminating against existing conditions. As anybody would be allowed to supplement his basic insurance plan if he wished and could afford it, the proposed system appears to be non-monopolistic, much like Obamacare. Why, then, do the authors claim that their proposal would have “much in common” with the Canadian health care system? I don’t know.

The Purple Health Plan is marred by other problems. This sort of initiative should be left to the states. Indeed, Massa-

chusetts, Vermont, and Maine have similar schemes, and have had them for a long time in the last two cases. People who want some form of public health insurance just have to move to those states. Moreover, Kotlikoff and Burns are quite certainly mistaken to think that their system would reduce the cost of public health care. They do propose liability and malpractice reform, but they fail to mention (and perhaps don't realize) that simply restoring freedom of contract, with the parties assuming the price/risk ratio they want, would do the trick.

A deep tax reform provides the third component of the Purple Plan. The main idea is to replace the personal and corporate income tax system with a consumption tax of 17.5 percent. The authors argue that their system would still be progressive given the compensating grants and credits given to poor consumers. Through increases in other taxes, the whole proposal would "generate substantially more revenue." *Contra* Kotlikoff and Burns, this is a drawback, not an advantage, of the reform.

As for Social Security, the Purple Plan would phase it out and replace it with another compulsory scheme, the "Personal Security Plan." This new public pension scheme would invest all contributions in an international index of securities and be fully funded, except for a government guarantee of the participants' invested money. Kotlikoff and Burns argue that forcing people to save for their old age is justified because the state would otherwise have to help the improvident ones. They don't seem to understand that there is a difference between ad hoc assistance and entitlements. Can't ordinary taxes be considered a sort of insurance savings, so that an entitlement scheme becomes unnecessary? The authors are strangely silent about who would bear the cost of phasing out the actual scheme. And they don't consider the government's temptation, at some point in time and for some good reason, to expropriate such a large accumulation of assets or to boss around the corporations in which the scheme would own shares.

More generally, what Kotlikoff and Burns do not seem to realize is the irremediable inconsistency between the American ideal of liberty on the one hand and, on the other

hand, the welfare Leviathan and the high taxes and pervasive controls it requires. They don't raise the essential question of the role of the state. They just want to save the present system in a sustainable form. Their proposals show how complicated that is.

The book's last few chapters provide financial advice to those who want to save enough for their retirement. The authors discuss such topics as how to invest and where to live—in other words, how individuals can try to escape the hole in which government policies have put them. This section is not uninteresting. For example, by emphasizing index funds, it silently rehabilitates the Efficient Market Hypothesis. It is, however, not totally consistent with the first part of the book. It discusses at length how to maximize one's returns from Social Security and how to use Treasury Inflation Protected Securities (TIPS) in the context of a diversified portfolio. But hadn't we learned, just a few chapters before, that Social Security will not be able to pay the promised benefits and that the federal government is totally bankrupt?

Trusting the state | The main fault of *The Clash of Generations* is its unbounded trust in the capacity of the state to do good. This is strange for a book that provides a devastating criticism of everything government has done wrong thus far and continues to do wrong now, including the "impending, gigantic, and virtually inescapable failure that will change our lives."

The authors want a new, all-encompassing financial service regulator similar to the Federal Drug Administration (no joke: that's the example they themselves use) to weed out bad financial instruments. They wish for an omniscient government. All information in individual mortgage applications should be available on the web. The federal government would know everything about any individual's health status in order to determine the size of the voucher that each person would receive toward purchasing health insurance. About your finances and your health, the state would know everything and, of course, use that information efficiently for your own good. No more asymmetry of information: Leviathan has it all!

To trust government with information is surprising under the pen of authors who have documented so many ways in which the government uses its control of information to cheat its subjects. For example, they brilliantly illustrate how nobody understands tax law and other legislation. They argue that modeling a certain decision that beneficiaries of Social Security should make requires, under reasonable hypotheses, going through 10^{105} alternative possibilities, a number greater than the number of atoms in the universe. No computer can make such calculations.

In parallel to their irrational trust of government, the authors continuously attack "predatory" finance, "Wall Street," and private greed, apparently oblivious to the fact that financiers work under regulations established by "our government" (as they repeat endlessly and fondly). If the magical "we" and "our" don't occur a hundred times in the book, then I am Bernie Madoff. What's more dangerous, political or financial greed? As John Maynard Keynes perceptively noted, "It is better that a man should tyrannise over his bank balance than over his fellow-citizens."

Kotlikoff and Burns sometimes see ghosts, such as the "rising individualism, increasing personal freedom" since the 1970s. Except for the abolition of the draft, some marginal increase in sexual freedom, and the reaffirmation of the Second Amendment, it is not easy to see where that increase in personal freedom has happened. And despite their generally sound economics, the authors seem to claim that saving would prevent people from being "reliable consumers" à la Galbraith or Keynes. They espouse redistributionist values, but just don't like the current redistribution package from the non-rich young to the non-poor old. Ah, they seem to cry, bring in our ideal state! Bring us a Madoff we can trust!

This being said, *The Clash of Generations* presents many worthwhile observations and ideas that run against conventional wisdom. Even if its solutions fall short, the book does explain a large part of the reason why the American state (mainly the federal government, but also state and local governments) is bankrupt. **R**

Plenty of Nothing

REVIEWED BY DAVID R. HENDERSON

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Red Plenty

By Francis Spufford

434 pages; Graywolf Press, 2012
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Francis Spufford has pulled off a marvelous stunt. His book, *Red Plenty*, is not quite a documentary, although it's full of verified facts and actual historical figures. And it's not quite a novel, although it contains fictional characters. The British *Sunday Telegraph* called it "faction." Whatever one calls it, here's what it is: a work of art that sympathetically blows the whistle on Soviet communism, pointing out its contradictions and its brutality, showing—gently and non-propagandistically—why it couldn't and didn't work.

Spufford, who teaches writing at Goldsmith's College in Britain, is not an economist, but he has a real grasp of what economists call the "calculation problem." Early in the last century, Ludwig von Mises and later Friedrich Hayek pointed out that in a centrally planned economy, the planners lack the information they need to manage a successful economy. They argued that only a decentralized price system—i.e., the free market—can provide that information; but, of course, abolition of the price system was the essence of communist economics. Ultimately, Mises and Hayek won the "socialist calculation debate," as even lifelong socialist Robert Heilbroner admitted in two stunning articles in the early 1990s.

Spufford weaves this lesson into a series of vignettes that track the fictional and nonfictional characters from 1938 to 1970. The last book on the economics of communism that I enjoyed even close to as

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much was Scott Shane's *Dismantling Utopia: How Information Ended the Soviet Union*.

Human story | But Spufford's book is so much more because it is, essentially, a novel. He takes a sympathetic look at what the best-intentioned communists were trying to achieve. That makes communism's failings all the more poignant. So, for example, we see fictional character Galina, who, as a loyal communist, gets to attend a 1959 exhibit in Moscow in which Americans show off some of the latest fruits of capitalism. Her job is to refute American propaganda and spout communist propaganda.



But she finds herself marveling at "little plastic beakers" that she believes, however hard she tries not to, an average American family can afford. Moreover, she is convinced that Americans can own the beakers "without having to do anything to deserve them." They can own them "[w]ithout having to part with anything except banknotes. Just by going shopping." Galina, who has already spent a large part of her life in queues for goods in short supply, notices that the American demonstrating these things "talked about the money things cost as if that were the only consideration."

For women who have given birth and men who have been with them during the process, the vignette on how health care providers in the communist system care for patients is chilling. In 1966, when Galina goes to the hospital to give birth and complains about the pain, she is asked if she has taken the psychoprophylaxis classes. Psychoprophylaxis, Spufford explains in a footnote, was the dominant doctrine on childbirth in the Soviet Union at the time. It turns out that Galina hadn't taken the classes, but when she talks to another woman giving birth, she learns that the classes were mainly about how to prepare baby food and why one should take lots of walks. Says the other expectant mother,

"[T]hen there were five minutes at the end about labour pain being an illusion promoted by capitalist doctors, and how it was really only messages from the subcortex of the brain which you could turn off by stimulating the cortex." When Galina replies, "I don't know what that means," a teenager in the bed on the other side says, "I do. It means they're not going to give us any painkillers." She does get morphine, but only by pulling rank: threatening the midwife with consequences because of her husband's high-level position in the Communist Party.

Capitalism vs. central planning |

Although the idea of taking childbirth classes in which you learn almost nothing may sound strange to Americans—my wife and I learned a lot in ours—the key is that the people taking the classes didn't pay for them. When you don't pay, you're not the customer. So the supplier has little incentive to provide something useful.

The fact that customers had no power was the problem economy-wide. In one scene that takes place in 1962, a fictional character—an attractive 30-something female biologist named Zoya—meets some flirtatious, idealistic 20-something male graduate students in economics who are excited about their ability to improve what they agree is a messed-up economy. One of the students, Kostya, asks Zoya, "Did you know that last year more than half of the hosiery delivered to shops was substandard?" Zoya replies, "Let's say that I had an anecdotal appreciation of that fact, from trying to put some of it on."

Kostya thinks this can be solved under communism. "What we need," he asserts, "is a planning system that counts the value of production rather than the quantity. But that, in turn, requires prices which express the value of what's produced."

"The value to whom?" asks Zoya.

Kostya replies: "Not just the value to the producer, or even to the consumer, because that only gives you capitalism again, surging to and fro, doing everything by trial and error. It's got to be the value to the whole system; the amount it helps with what the whole economy is trying to do in the present planning period."

Kostya then goes on to assert that the

whole problem can be solved by complete centralization combined with high-powered computers. This view was widespread at the time, both in the Soviet Union and elsewhere. Polish socialist economist Oskar Lange, who was on the losing end of the socialist calculation debate but didn't admit it, called the free market "a primitive pre-electronic calculator." Of course, it turned out that it was central planning that was primitive.

Meanwhile, Soviet citizens had to live with what was already a highly centralized system. Because the central planners classified the city where Zoya, Kostya, and the others lived as a college town, food was allocated to it based on the assumption that college students, lifting pencils and wiping blackboards, did not need much food. But the "college town" also contained 40,000 industrial workers. Spufford writes, "[A] locust would have been hard put to find a spare crumb," and, "Sausages were as rare as comets."

In the early 1960s, many economists, including MIT's future Nobel laureate, Paul Samuelson, thought that Soviet economic growth would so exceed U.S. economic growth that the USSR would become the dominant economic power. But that, as Spufford points out, is because of how Soviet growth was measured. Here's Spufford's comparison of the measurement of growth in market and socialist economies:

It wasn't in the essence of a market economy that it should always do a little more this year than it had last year. The planned economy, on the other hand, was created to accomplish exactly that. It was explicitly and deliberately a ratchet, designed to effect a one-way passage from scarcity to plenty by stepping up output each year, every year, year after year. Nothing else mattered: not profit, not the rate of industrial accidents, not the effect of the factories on the land or the air. The planned economy measured its success in terms of the amount of *things* it produced. Money was treated as secondary, merely a tool for accounting.... By counting actual bags of cement rather than the phantom of cash, the Soviet economy was voting for reality, for the material world as it truly was in itself, rather than for the ideological hallucination. It was holding to the

plain truth that more stuff was better than less. Instead of calculating Gross Domestic Product, the sum of all incomes earned in a country, the USSR calculated Net Material Product, the country's total output of stuff—expressed, for convenience, in roubles.

Do you see any room in there for Joseph Schumpeter's creative destruction, by which people got not just 10 percent more "stuff," but different things that are worth more and, sometimes, require *fewer* materials? Me either. As Spufford points out in a footnote, industrial growth "in the USSR did not carry over into general prosperity." A big part of the reason is that value was often measured by weight. One of the characters in the book doesn't want to sell a machine that another factory desperately needs because the factory that produces the new machine will be paid less than was paid for the old, inferior machine. The reason? Equipment is priced mainly according to weight. The new, superior machine weighs less.

Wait! It gets worse! Spufford points out that one economist found the Soviet economy actively destroyed value. He gives an example of some awful Soviet shirts that no one valued, produced from valuable cotton that could have been sold on the world market. (He footnotes a nonfiction book that tells that story.)

Facts behind the fiction | That brings me to the footnotes. They are truly spectacular: I read every single one. Reading the first pages, I found myself wondering about the historical accuracy of Spufford's many claims. After checking the first few footnotes, I quit wondering. When he makes true claims, he gives the citations. When he takes poetic license with his work of "faction," he cites the sources on which he bases that license. Were I putting together a syllabus on Soviet economic planning, I would start by just working through his footnotes.

The book ends with a sympathetic portrayal of Nikita Khrushchev in 1968. Khrushchev, who was forced into retirement in 1964, looks back, sadly and angrily, at the huge amount of blood spilled for communism. He had thought the losses were worthwhile because he and his comrades were creating paradise. But here are his actual words, which Spufford tells us in a footnote were on tapes that Khrushchev recorded but that were held back from the memoir his son smuggled to the West:

Paradise is a place where people want to end up, not a place they run from. What kind of socialism is that? What kind of s**t is that, when you have to keep people in chains? What kind of social order? What kind of paradise? R

Punishing Success

REVIEWED BY DAVID R. HENDERSON

Rich-Hunt: The Backdated Options Frenzy and the Ordeal of Greg Reyes

By Roger Donway

180 pages; Atlas Society, 2012

Ayn Rand once provocatively referred to big business as "America's persecuted minority." Although she didn't do enough to point out how big businesses often sic government on their competitors, Rand had a point. There is a strain of thought in America that assumes that big, successful businesses, no matter how they achieved their success, *must*

be dishonest. Unfortunately, some of the people who fail to distinguish the honest from the fraudulent means of acquiring wealth end up as business reporters. Their news stories often betray an ignorance of basic economics, but their readers typically don't pick up on that.

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So honest businessmen and women who succeed are often subject to attack in the media because of their success. And the many vaguely worded laws and regulations on business mean that businessmen, small and large, can get caught in a Kafkaesque wringer.

That's what happened to Greg Reyes. From 1998 to 2005, Reyes was the chief executive of a small Silicon Valley firm, Brocade Communications System, which he made very successful. Reyes followed the standard practice of using stock options to attract high-quality employees and, on the advice of various people, used "back-dating" to maximize the value of stock options to these employees. This backdating landed him in a legal mess that could have put him in prison for 30 years. The good news is that he went to prison for "only" 18 months and was fined "only" \$15 million. In *Rich-Hunt*, philosopher Roger Donway tells the detailed story of how Reyes ended up in this position and how little the prosecutor cared about truth, let alone justice. The result is a chilling page-turner. If you don't know much about how vague federal laws and regulations can put innocent people at risk, or if you already know but want to know more, *Rich-Hunt* is for you.

Backdating | Donway, who heads the Business Rights Center of the Atlas Society, makes his position clear from the outset. He sees Reyes as a hard-working, clear-thinking, entrepreneurial hero. He also sees the law that Reyes was charged with violating as pernicious and vague. But even if one thinks that Reyes was not a hero, and even if one thinks that the law was a good law, Donway gives ample evidence that the legal system badly abused an innocent man. The abuse involved prosecutorial misconduct and mischievous actions by a federal judge. Another player that comes off looking very bad is the *Wall Street Journal's* news section, which hyped the backdating controversy as if it was obvious that options shouldn't be backdated.

A little explanation is in order. The stock options at issue are "call" options. They give the holder the right to buy a stock only after the end of a "vesting period" and at a certain price, called the "strike price." The lower the strike price, the more valuable is the option. Why use options to pay employees? As an incentive to attract good employees.

Reyes had chosen as his "consigliere" and corporate-governance expert a legendary Silicon Valley lawyer named Larry Sonsini. Donway calls that choice "the worst decision of Greg Reyes's life." Sonsini suggested that, to decide on the number of stock options, the strike price, etc., to offer to lower-level employees, Reyes appoint himself as a "compensation committee of one." But Sonsini, allegedly a corporate-governance expert, did not bother to tell Reyes about the need to comply with various regulatory and accounting options, a fact that Sonsini, in a later deposition, admitted.

A big issue for anyone who awards options is what strike price to set. A method that many companies used was to backdate so as to set the lowest price that the stock had reached in the previous quarter. This made the option more valuable to the employee than if the strike price had been set at, say, the average of prices in the previous month. Reyes, as a committee of one, chose this backdating method. At no point did he get to choose the strike price for his own options.

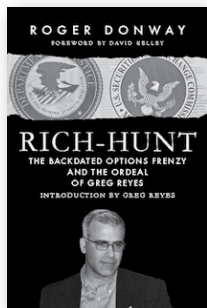
In 2005 and 2006, the *Wall Street Journal* ran a series of articles on backdating, treating it as a scandal. In a May 22, 2006 article, for example, *Journal* reporters Charles Forelle and James Bandler wrote, "[A]n analysis by the Wall Street Journal found the probability that that pattern [choosing the date in the previous time period when the share price was at its lowest for that time period] occurred merely by chance is tiny—around one in 20 million." Well, duh. Of course it was not random, but the news story's unstated implication was that somehow it should have been. In a May 31, 2006 *Journal* article, Forelle and Bandler argued, "[B]ack-

dating an option grant to yield a better price vitiates the incentive purpose of the grant." But that assumes that the main purpose of the option grant is to incentivize employees to increase the firm's value and, thus, the price of the firm's stock. As Donway notes, though, that is unlikely for employees "with the possible exception of the CEO."

On July 21, 2007, Christopher Cox, the head of the Securities and Exchange Commission and a former "conservative" Republican congressman from southern California, and Kevin V. Ryan, the U.S. attorney for northern California, held a joint press conference at which they announced their pursuit of criminal charges against Greg Reyes and Stephanie Jensen, previously Brocade's vice president of human resources. Earlier that day, the *Wall Street Journal* had run an article by Steve Stecklow titled, "How One Tech Company Played with Timing of Stock Options." The "One Tech Company," of course, was Brocade. Was it a coincidence that the article ran the same day as Cox and Ryan made their charge, or had Stecklow been tipped off? Donway, quite reasonably, thinks the latter.

In the article, Stecklow revealed Reyes's practice of changing employees' start dates to give their stock options more value. Reyes did do this, and the reason was to *legally* get around a regulation that was part of the 2002 Sarbanes-Oxley law. Stecklow did not mention that fact in his 3,000-word article.

Stecklow completed his indictment by noting two facts: (1) Reyes was a tough manager "who was known for firing questions at any employee who passed him by without making eye contact," and (2) Reyes was very wealthy, having bought "a 12,000-acre California ranch and hunting grounds, an Alaskan fishing lodge, a stake in the San Jose Sharks hockey team, a 10,000-square-foot home in Saratoga, Calif., and more than a half-dozen cars including a Porsche and a Ferrari." What is American capitalism coming to when capitalists ask tough questions of employees and buy expensive things? Apparently, the only honest CEOs are the ones who hug their employees and drive beat-up Toyotas.



The trial | It is hard to summarize the courtroom drama. What I can say is that Donway is a master storyteller and that pages 53–134 are well worth reading. Still, I'll give some highlights.

The major question in the Reyes trial was not about backdating options or giving artificial start dates to employees, because neither of those practices was illegal. The question was whether Reyes had committed fraud in accounting for the cost of the stock options. The more “in the money” the options were, the bigger the cost to Brocade’s shareholders. You might think that if the shareholders had been hurt, the prosecution would have come up with a shareholder who said he was hurt. It didn’t. Moreover, it was the prosecution, not the defense, that excluded a Brocade shareholder from the jury.

Unfortunately for Reyes, the presiding federal judge was Charles Breyer. Although Donway doesn’t mention this and possibly doesn’t know, Breyer had achieved some notoriety in 2003 by presiding over the trial of another entrepreneur, Ed Rosenthal, for growing marijuana. During that trial, Breyer had forbidden Rosenthal’s lawyers from pointing out that Rosenthal was acting as an agent for the Oakland, Calif., city government’s medical marijuana program. After Rosenthal was found guilty, some jurors expressed outrage when they learned that fact. On the surface, it looks as if Breyer was a good guy for having sentenced Rosenthal to time already served, but those of us who followed the case are not so sure. Before the sentencing, some of Breyer’s neighbors had verbally attacked him and his family members. There is some reason to think, therefore, that the light sentence was due more to pressure from neighbors than from any humanitarian leaning.

Sure enough, Breyer inserted himself into the Reyes trial in a fairly aggressive way. A witness for the prosecution had argued that the way Reyes accounted for stock options negatively affects the market’s valuation of the stock. According to Donway, the trial transcript shows that Breyer, without a single objection having been raised by the prosecution, blocked the defense’s cross-examination

of this witness nine times in just 14 pages. Moreover, during the closing arguments, prosecution lawyer Timothy Crudo lied about a key issue. When defense lawyer Richard Marmaro moved on that basis for a mistrial, Breyer’s flaccid remedy was to tell the jury that closing statements are only arguments, not evidence, and that the attorneys’ “comments may have been in error.” Shockingly, though, Breyer did not tell the jury whether he had in mind the attorneys for the defense or the attorney for the prosecution.

Fortunately, a three-judge panel of the Ninth Circuit Court threw out the conviction based, in part, on the prosecutorial misconduct noted above. Unfortunately, Donway never tells that to the reader explicitly, but leaves us to figure it out. More unfortunately, the Ninth Circuit left it up to the prosecution to decide whether to have a retrial, and the prosecution, upset at being tongue-lashed by the Circuit Court, chose a retrial. Reyes, tried once again in front of Breyer, was con-

victed. He has now served his sentence.

Conclusion | One moral I took away from this book is that we should avoid vague laws that put people at risk of long prison sentences for what are, at most, accounting errors. The other big moral is that more books like this need to be written. Over a century ago, when Emile Zola wrote his open letter “*J’Accuse*,” French society was much less wealthy than ours is. Contributors now donate at least hundreds of millions of dollars annually to think tanks that argue for freedom. But Roger Donway is the only author I know who has taken a specific judicial outrage against a businessman, examined it carefully, and told the story compellingly. There should be 10 more such books. If donors were to give a few tens of thousands of dollars to each qualified person who researches and writes such books, the world would be a better place and free markets would have a better chance. **R**

Getting Rich Is Glorious

REVIEWED BY PIERRE LEMIEUX

How China Became Capitalist

By Ronald Coase and Ning Wang

256 pages; Palgrave Macmillan, 2012

A 2010 GlobeScan opinion poll shows that more Chinese (67 percent) than Americans (59 percent) strongly or somewhat agree that “[t]he free market system and free market economy is the best system on which to base the future of the world.” Most analysts never suspected that the communist giant would, in three decades, become a capitalist (or near-capitalist) country and go from one of the poorest countries in the world to the second largest economy and the largest trading nation.

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In *How China Became Capitalist*, Ronald Coase (the Nobel laureate in economics, who will celebrate his 102nd birthday a few days after this review appears) and Ning Wang (professor in the School of Politics and Global Studies of Arizona State University) chronicle how China realized this incredible feat. For the non-initiated—and perhaps for the student of Chinese affairs, too—their book is full of surprises.

How was the miracle accomplished? The short story is that it was done simply by letting individual incentives work, by allowing people to try and get rich on the market. Deng Xiaoping, one of the main Chinese political leaders from 1978 to the early 1990s, had a mantra: “getting rich is glorious.” “[L]et some people get rich first,” he also famously said. Nian Guangjiu, an illiterate man who had been twice convicted of street peddling, took the idea seriously and, four years after Mao’s

death, became one of the first Chinese millionaires, amassing his fortune by selling watermelon seeds. It is fascinating that this simple idea apparently escaped the development economists who spent much of the 20th century devising economic models, foreign assistance proposals, and government schemes to kick-start economic growth in underdeveloped countries.

Central planning | Coase and Wang's study of institutional change is informed by economic theory, as any empirical or historical research must be:

What we have attempted is mainly a historical narrative of the chain of actions that brought [the market transformation] about. But there is no way to present a coherent narrative of how China became capitalist without certain theoretical perspectives. Facts have to be selected and their significance assessed. Neither can be accomplished without proper guidance from theory.



The Great Helmsman, as Mao was called, had only contempt for academic learning. He rejected the traditional role of Confucian intellectuals who, according to Coase and Wang, provided a check on power. Mao's successors professed to be influenced by facts ("seeking truth from facts") and not theories, but their implicit theories must have been better than Mao's because they correctly identified the reasons for poverty: central planning and the crushing of individual initiative.

À la Hayek, Coase and Wang remind us why central planning does not work. Without market prices, information on relative scarcities cannot circulate and provide the right incentives. Moreover, state minions are motivated to hide problems (and their own failures) from central bureaus. The absence of a free press adds to this wall of silence. Coase and Wang remind us that "the ultimate rationale for the market is human frailty." The failure of central planning had disastrous consequences in China. During the Great Leap Forward (1958–1961), which created a famine that killed 30 million people, the Chinese gov-

ernment was pushing farmers to produce unusable steel in backyard furnaces. Without prices, who knew that more wheat was needed?

As the market developed, producers started to respond to real consumer demand and the allocation of labor became more efficient. Incomes provided the right incentives. "Self-employed barbers, for example, came to earn higher incomes than surgeons in state hospitals," write Coase and Wang. "Street vendors who sold noodles and snack foods earned more than nuclear scientists."

Only after 1981 was a genuine price mechanism established over most of the economy. When Milton Friedman visited China in 1980, an official from the Ministry of Materials Distribution asked him, "Tell us, who in the United States is responsible for the distribution of materials?"

Nurturing capitalism | Opening to the world and to international trade was a crucial ingredient in China's evolution. As early as 1977, a communist apparatchik had been shocked to discover that villagers in Hong Kong (still an independent territory) earned a hundred times as much as their counterparts just across the Shenzhen River in China. Needless to say, illegal emigration was booming. Soon Chinese leaders were visiting Europe, America (in 1979), Japan, and other market economies, and discovering with astonishment that farmers and workers were earning more than themselves.

In the early 1980s, the first Special Economic Zones were established. Mostly free of government control, they were devoted to foreign trade. Their original purpose was to "appropriate capitalism for the good of socialism."

Richard Nixon's visit to China in 1972 had paved the way. Ronald Reagan's visit in 1984 was very timely. "The United States of America," note Coase and Wang, "came to replace the Soviet Union as role model for China," particularly in the minds of young Chinese coming to study in America.

Although this is not part of Coase and Wang's topic, today's China-bashing (by

both the Republican and the Democratic presidential candidates in the recent election) is a big step backward. If trade with China were to be substantially affected, American consumers would be hit with large increases in the low prices of manufactured goods they now take for granted. And the Chinese might conclude that the free market is not what they thought it was. "[T]he charge that the Chinese economy poses a threat to the global market order is based more on fear and misapprehension than on reason," write Coase and Wang.

In a typical Coasian perspective, the book reminds us that the market depends on a broader institutional background that includes the rule of law and property rights. After Mao's death, the Chinese legal system started to be rebuilt. Interestingly, Coase and Wang note that in China, "[t]he delineation and transfer of [property] rights took place in one step" as the authorities released controls on resources in favor of specific private individuals or businesses. After three decades of reform, most of the Chinese economy had thus been privatized, with the exception of some state corporations.

A fascinating aspect of the story told by Coase and Wang is how change occurred in an unplanned and unexpected way, despite—as much as because of—what the authorities were doing. They identify four "marginal revolutions" or "marginal forces" that developed largely outside the central government's control. Private farming spread, and demonstrated its efficiency, before the government approved it. Self-employment in cities grew briskly after the government approved it to fight unemployment. The Special Economic Zones also emerged outside the central government's control. Besides these grassroots movements, corporations belonging to local governments fueled competition and often hosted private businesses.

While the Communist Party takes credit for these reforms, they were more like "crossing the river by groping for stones." "The story of China," write Coase and Wang, "is the quintessence of what Adam Ferguson called 'the product of human action but not of human design'.... [A] reform intended to save socialism has

inadvertently turned China into a market economy.”

The march toward the market was helped by the diversity and decentralization of China, with distinct governments in its 32 provinces, 282 cities, 2,862 counties, 19,522 towns, and 14,677 villages. Even if local governments are nominally subordinated to Beijing’s rule, their initiatives, experiments, and competition often undermined the central planner’s goals. As the Chinese saying goes, “The mountain is high and the emperor far away.”

Strange Marxists | After Mao’s death, the gradual development of markets proceeded by leaps and bounds against a background of communist reaction and sometimes strong ideological opposition. The late 1980s and early 1990s—the epoch of Tiananmen Square—marked a pause. Surprisingly, most of the time, the advocates of liberalization hid their activities behind double-talk, from “socialist modernization” (already a big improvement over “class struggle”), to “socialism with Chinese characteristics,” “a commerce economy with plan,” and a “new political economy of Marxism.” It was not until the 1990s that the market was recognized as the main foundation of the “socialist market economy.” Deng Xiaoping, one of the main artisans of the reform, always claimed he was a Marxist: “Marxism,” he said in 1992, “is the irrefutable truth. ... Marxism is not abstruse. It is a plain thing, a very plain truth.”

As time passed, the chasm between the Newspeak and the reality became more obvious. People called “putting on a red hat” the practice, in the early 1980s, of purchasing a nominal affiliation with a state enterprise in order to conduct a private business. In 1992, vice premier Tian Jiyun suggested that the opponents of liberalization should go and live in a “special leftist zone” with planning, shortages, and rationing. (This would be a good idea in the West, too!)

This long disconnect between official Newspeak and the reality of reform raises the issue of the role of ideas, if any. For Coase and Wang, ideas played a paramount role in Chinese institutional change. Para-

phrasing Hume, they claim that “interests are the slaves of ideas.” They report that Wen Jibao, the Chinese premier until very recently, was an outspoken fan of Adam Smith’s *The Theory of Moral Sentiments*. The cover page of many Chinese editions of the book says in big red letters: “A Classic by a Master, Highly Recommended Five Times by Premier Wen.” The progression of classical liberal ideas under the double-talk of communist ideology is fascinating. Recent articles in *The Economist* and the *Wall Street Journal* suggest that, instead of Keynes, Hayek is having much influence on economic policy in China.

The Chinese reform was made gradually and without any grand ideological design. Is it possible that liberal revolutions can be more easily achieved this way than by the Thatchers and Reagans of the world? Coase and Wang don’t formally raise this question, but they provide much food for thought.

Chinese traditions helped the reformers. The country has a long commercial and entrepreneurial history. During more than a thousand years, the Silk Road symbolized trade between China and the rest of the world. Many inventions were first made in China, although they were often better exploited in the West. When Marco Polo visited China in the 13th century, he was impressed by the country’s industry and commerce. Coase and Wang argue that free market elements were present in Taoism, one of the main threads in China’s intellectual history. “So long as I [the ruler] do not attend to anything, the people will of themselves get prosperous,” said Lao-tzu 1,500 years ago. “In its attempt to build a market economy with Chinese characteristics at the end of the twentieth century,” write Coase and Wang, “China ... has come full circle to embrace its own cultural roots by way of capitalism.”

How China Became Capitalist is somewhat equivocal on the role of government. On the one hand, China’s market revolution was done without a grand central design; it was a bottom-up affair. Sometimes, central government’s dictates were simply ignored. The first stock exchange opened in Shenzhen at the end of the 1980s despite Beijing’s refusal to

grant permission. This sort of practice was referred to as “get on the bus first, buy the ticket later.” So we might think that enforcing property rights would suffice for the role of government. On the other hand, Coase and Wang suggest that government may be useful as a provider of “organizing services” and a social insurer. In China, the central and local governments acted as organizers when they established Special Economic Zones and, later, thousands of local industrial parks. The central government played the role of a social insurer by creating unemployment insurance, state pensions, and health insurance, thereby freeing government employees from their public jobs perks. Yet, “it is misleading,” the authors write, “to suggest that Chinese economic reform represents the triumph of state interference over market forces.”

East and West | Is this “capitalism with Chinese characteristics” really capitalism? Coase and Wang think so. Some of these “Chinese characteristics” represent purely cultural factors. The questionable ones relate to the privileges retained by large state corporations, the role of local governments in competition, the absence of brand names (who knows the name of a single large Chinese company beyond Lenovo and Foxconn?), the poor state of government-controlled higher education, the absence of democracy, and the strangulation of the market for ideas by a suspicious central government. Coase and Wang note that the lack of a free market for ideas, including political ideas, (a deep weakness compared to the West) is harming China much more than the absence of formal democracy.

What is capitalism anyway? Even in the West, many don’t agree on the answer. Here, we can go farther than Coase and Wang. For libertarians, several components are necessary: private property of capital, no central planning, free markets and prices, individual rights, and a minimal role for the state. If we use this gauge, China has not yet become capitalist. Mind you, no Western country is either. If one is willing to make exceptions for state corporations, some regulation of markets, some

organizing and insurance role for the state, and individual rights, then China may be nearly as capitalist as Western countries.

In other words, the Chinese system is “capitalist” if and only if the term refers to the mixed economy we now have in the West. Wang Zhen, a high-level apparatchik who visited Britain in 1978, wrote that “Britain would simply be our model of a communist society if it were ruled by a communist party.” Meant as laudatory for Britain, this comment is very incriminating. China and the West have converged much over the past half-century, the first becoming more capitalist, the latter much less so—and even a bit communist if we are to believe Wang Zhen. *How China Became Capitalist* reveals, perhaps unwittingly, the weaknesses of the West as much as its strengths.

One major difference is that individual rights are much better protected in Western countries—even if the situation has not been improving, including during the very years when the Chinese discovered the benefits of freedom. The Chinese state’s birth control policy has been both a tyrannical enterprise and an economic disaster. The lack of a free market for ideas in China is closely related to the absence of formalized individual liberty. *The Economist* recently wrote that “[t]o get rich is not always glorious,” as many of the richest

Chinese seem to be targeted by government authorities. Can capitalism survive without freedom being also recognized in other fields? Coase and Wang seem to agree that real capitalism and individual liberty are inseparable: “Without a free and open market for ideas, China cannot sustain its economic growth.”

A less charitable interpretation of the Chinese model would identify it with crony capitalism. Many large Chinese corporations still belong to the state, hold monopolies over some sectors, and get privileged treatment in their financing. Of *Fortune*’s 500 largest global corporations in 2010, 46 were Chinese (of which four were from Hong Kong), but only two of those were private. Under crony capitalism, getting rich is neither glorious nor necessarily conducive to prosperity. One would then conclude that the Chinese system is even worse than our own, although we may be heading in the same direction through regulation, bailouts, and central banks’ bond holdings. Coase and Wang, however, provide many good arguments against this interpretation of Chinese capitalism. And there must be something capitalist in a country where taxes don’t exceed 20 percent of gross domestic product.

Conclusion | Some criticism can be addressed to *How China Became Capitalist*.

I wish the authors had provided more evidence about the power, and the current evolution, of the large state-owned enterprises. On a more theoretical level, the book too often ignores the teachings of Public Choice economics and seems to assume that the Chinese state has been selflessly aiming at the happiness of the Chinese people. It would have been useful to learn how Chinese politicians and bureaucrats thought they could benefit from the marginal revolutions they launched or tolerated. As I am finishing this review, I find corroborating evidence under the pen of Jamil Anderlini of the *Financial Times*: “In the many small uprisings that continually bubble up across China, the protagonists almost always believe that if the country’s enlightened leaders only knew about local corruption, they would descend like a *deus ex machina* to administer justice.” The authors of *How China Became Capitalist* have not stressed enough the persistent tyrannical trends within the Chinese state and Communist Party. Power corrupts.

Yet, *How China Became Capitalist* is a fascinating book that teaches much about what China is and, as Coase is fond of saying, “what happens in the real world.” It will change many of the reader’s ideas on China and suggest a host of interesting questions about the world. **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

Electric Cars

- “Spatial and Temporal Heterogeneity of Marginal Emissions: Implications for Electric Cars and Other Electricity-Shifting Policies,” by Joshua Graff Zivin, Matthew J. Kotchen, and Erin T. Mansur. October 2012. University of California Center for Energy and Environmental Economics Working Paper WP-047.

Do electric vehicles emit less carbon than conventional gasoline-powered vehicles? Many people would probably say yes. But the actual answer depends on the type and amount of fuel used to generate the electricity used to charge the batteries.

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To compare emissions for the current American fleets of both types of cars, the authors of this paper use the continuous emissions data for 2007–2009 for electricity generating plants in the United States. They create hourly estimates of the effects of marginal increases in electricity use on carbon emissions at the level of the nation’s three electricity transmission systems: east of the Rockies, west of the Rockies, and Texas.

The average emissions rate is 2.1 lbs. of carbon dioxide per kilowatt-hour (kWh) of electricity, taking into account generation and transmission losses, which amount to 4.6 and 9.6 percent respectively of gross generation. Current plug-in electric vehicles (PEVs) consume 0.35kWh per mile, and thus result in 0.735 lbs. of carbon dioxide emissions per mile. Gasoline-powered autos and light trucks in the United States in 2009 averaged 21.7 miles per gallon, and each gallon of gasoline consumed

resulted in 19.6 lbs. of carbon dioxide. Thus, conventional vehicles emitted 0.9 lbs. of carbon dioxide per mile on average. That means that PEVs have lower carbon emissions than the average conventional vehicle in operation.

But if one already uses a high-mileage conventional car, then the scope for carbon improvement through the use of a PEV is much smaller. Consider the Toyota Prius: If one gets 50 mpg, then an emission-equivalent electric vehicle would have to be charged from generators whose carbon emissions were less than 1.13 lbs. per kWh. Only 12 percent of fossil-fuel-fired generation have emission rates that low.

An all-electric Nissan Leaf would emit 0.735 lbs. of carbon dioxide per mile, while fuel-efficient conventional vehicles like the Honda Civic, Toyota Corolla, Chevy Cruze, and Ford Fiesta get 31 mpg and thus emit 0.63 lbs. of carbon dioxide per mile. Some 59 percent of fossil-fuel-fired generators that would be used to recharge the Leaf would produce more carbon than the conventional cars would produce through gasoline combustion.

Another complicating factor in comparing PEVs to conventional cars is the time and place that PEV owners choose to charge their vehicles. Marginal carbon emissions from electric generators vary by region and by time because of the composition of fuel used by generators—primarily the tradeoff between coal and natural gas. Charging an electric vehicle between midnight and 5 a.m. anywhere east of the Rockies would result in more carbon emissions than driving a gas-electric hybrid like the Prius because of the dominant role of coal-fired electricity generation during those hours.

Air Quality

- “Defensive Investments and the Demand for Air Quality: Evidence from the NO_x Budget Program and Ozone Reductions,” by Olivier Dechenes, Michael Greenstone, and Joseph S. Shapiro. July 2012. SSRN #2109861.

Estimates of the health benefits from air pollution reduction are difficult to obtain because of the lack of natural experiments. Most evaluations of emissions markets combine engineering models of emissions with atmospheric chemistry and transport models and epidemiological models of dose and health response. The epidemiological models, in turn, are grounded in cross-sectional statistical relationships in which differences in aggregate pollution exposures are compared to differences in health outcomes across metropolitan areas.

For six years, from 2003 through 2008, the summer cap-and-trade system for nitrogen-oxygen molecules (NO_x) was in operation in the Eastern and Midwestern United States. On May 1 of those years, emission levels dropped 35 percent and then rose again on October 1 when the summer season ended. This created a natural experiment that the authors of this paper used to create estimates of changes in exposure and health effects. Their work also examined asthma drug expenditures in order to

estimate people’s willingness to pay to avoid negative respiratory health outcomes.

The authors used a triple-difference estimator that compares winter vs. summer, participating vs. nonparticipating states, and before- and after-2003 pollution and health outcomes. In the participating states in the summer, ozone average concentration dropped 6 percent while peak ozone levels dropped 23 percent. In that time period, asthma drug expenditures decreased 1.9 percent, or \$900 million. That cost exceeded the cost of abatement, which was less than \$761 million per year (365,750 tons per summer multiplied by the average permit cost of \$2,080 per ton). Summer mortality decreased 0.5 percent, or 1,800 fewer deaths per summer among people age 75 and over, but those benefits may simply be the result of short-term displacement from the summer to the winter.

The authors argue their results stem from ozone reductions rather than other plausible channels. They find no effects on plausibly unrelated health conditions such as those that require gastrointestinal medications. They also find no effects on other pollutant concentrations such as carbon monoxide or sulfur dioxide.

Behavioral Economics

- “Are People Probabilistically Challenged?” by Alex Stein. March 2012. SSRN #2015075.
- “Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty,” by Joshua D. Wright and Douglas H. Ginsberg. September 2012. SSRN #2147940.

The most important intellectual challenge to the belief that adults in market settings make decisions that improve their welfare is behavioral economics. Behavioral economics claims that people commit cognitive errors in choice settings. The result is reduced, rather than improved, welfare.

Many who advocate government regulation of markets use results of behavioral economics as a rationale. The ascendancy of behavioral views as rationales for regulation was confirmed by the appointment by President Obama of Cass Sunstein to head the Office of Information and Regulatory Affairs, the agency that analyzes the cost effectiveness of major federal regulations. Sunstein is the coauthor with Richard Thaler of *Nudge* (Yale University Press 2008), a popular exposition of behavioral thought.

Another important book advocating behavioral approaches to economics is *Thinking Fast and Slow* (Farrar, Strauss, and Giroux 2011) by Daniel Kahneman, one of the first scholars to criticize neoclassical economics from the behavioral perspective. Before this book, the behavioral critique was just a list of cognitive errors, each of which had a name such as “the endowment effect” (people demand more to part with something they already have as compared to what they would pay to get the same good), “hyperbolic discounting” (placing an extremely high weight on present costs and benefits as compared to future costs and benefits), and “optimism bias” (a person believes that bad events are far less likely to

happen to him than to others). Kahneman's book provides an explanatory theory for these errors. He argues that "fast thinking," or intuition, is often susceptible to such errors, whereas "slow thinking," or deliberation, typically avoids them—but unfortunately it is not used very often.

Stein's review of the book praises it for finally providing a theory to supplement the list of cognitive errors that subjects in behavioral experiments make. But Stein argues that the errors made by subjects in behavioral experiments are often the result of subjects having to wade through a narrative fog to figure out what the experimenters were asking them, not simply the product of fast thinking. More explicit questions would have elicited more correct answers, he claims. As evidence for this, he points out that participants in these experiments could only be fooled once; once the scenario became apparent to them, they made rational choices successfully. "Under neither scenario can such a person be considered cognitively incompetent and in need of the government's intervention," Stein claims.

The Wright and Ginsburg paper covers much of the same ground. They provide a comprehensive list of the cognitive errors found by behavioral experiments, but then argue that cognitive shortcomings that exist in experiments may not be relevant in real markets. They reference articles by Charles Plott in the *American Economic Review* that echo the claim of Stein that the results of the experiments are the product of the subjects' inability to understand the instructions of the experiment rather than inherent cognitive limitations. They provide a more comprehensive list of citations that critique specific behavioral experimental results or their relevance for designing policy intervention.

College Graduation

■ "First Degree Earns: The Impact of College Quality on College Completion Rates," by Sarah Cohodes and Joshua Goodman. August 2012. SSRN #2128786.

One of the great puzzles in contemporary applied economics is the failure of college graduation rates to rise in response to the dramatic increase in economic returns to a college degree relative to high school over the last 30 years. Normally, in markets where the returns to a factor increase dramatically, the supply of that factor increases to take advantage of the returns. To be sure, college attendance rates have increased and college graduation rates among those under age 29 have increased from 29 to 33 percent from 2000 to 2012, but the college wage premium remains high.

Private selective colleges and honors programs at public

universities graduate most of their students, while general programs in public universities are less successful. This raises the question, is the design of the general programs flawed, or are the students in those programs somehow "different" in a way that negatively affects graduation rates? Students who apply to the Ivies and honors programs could be different from students in the regular public university systems in ways that are unobservable to the data gathered by researchers. Or private schools and honors programs have "special" production processes (e.g., more financial aid, smaller classes, better faculty, more intimate supportive environment) that aren't being duplicated in the general programs.

As I argued in my review of the book *Crossing the Finish Line* by William Bowen, Matthew Chingos, and Michael McPherson (Spring 2010), the central problem in educational policy research is disentangling selection effects from program effects in educational outcomes. That is, do private school students do well because of characteristics of the students, or the schools? This

issue is usually impossible to adjudicate with normal regression analysis. Instead, true experiments or quasi-experiments are necessary.

The authors describe one such experiment: a Massachusetts aid program that gave aid only for public schools attendance. The effect of this program was to induce students with superior ability to attend lower-quality colleges. So what happens when higher-ability students attend lower-quality colleges?

The authors used a research discontinuity design. That is, they compared students just below and above the thresholds for receiving aid who were presumably identical other than being aid-eligible. The scholarship program covered only tuition and not fees, so the actual reduction in college costs accounted for by the aid program was a 13–15 percent discount. Of the 8.3 percent of students induced by the aid to enroll in public colleges within Massachusetts, only 27 percent graduated within four years. For the marginal student induced by the scholarship to attend an in-state public college, the probability of graduating on time was reduced by 26 percentage points, or more than 40 percent.

In my review of *Crossing the Finish Line*, I argued that even though the intellectual evidence for the positive role of increased educational resources in educational success was suggestive, there was also contrary evidence that made me conclude that selection was still viable as an explanation. Thus, I wrote at the time, before we commit more resources to education, we should make sure that increased resources really alter outcomes for the better. This article adds to the evidence about resources by demonstrating that inducing high-quality students to attend public institutions that have fewer resources lowers graduation rates dramatically. **R**