In Praise of Stimulus and Bailouts

REVIEWED BY VERN MCKINLEY

After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead
By Alan S. Blinder
443 pages; Penguin Press, 2013

Alan Blinder, one of the real true believers in the government crisis-management response of Keynesian economics and multiple federal bailouts, has now released After the Music Stopped, a book with his take on the recent financial crisis. He served on President Bill Clinton’s Council of Economic Advisers (CEA) and also had a brief tenure under Chairman Alan Greenspan as the vice chairman of the Fed. More recently Blinder has held what might be called the “Al Hunt seat” as an opinion writer for the Wall Street Journal, playing the role of big-government advocate, regularly motivating dozens of disapproving readers to unleash a torrent of critical letters to the editor every time he appears on the Opinion page. If, as expected, Fed chairman Ben Bernanke steps down in early 2014, Blinder is considered a possible pick for the next chair, albeit in the second tier of candidates behind Janet Yellen, Roger Ferguson, Larry Summers, Tim Geithner, and Donald Kohn.

After the Music Stopped has a number of positives going in its favor. The information is presented in an easy-to-read format that is a cross between one of Blinder’s Princeton lectures and an International Monetary Fund report. It has charts aplenty and informational boxes that break out issues like “Contagion and Financial Panics” separately so the reader can either drill down and review a topic if basic knowledge is required or skip the box entirely if the reader is already familiar with the topic.

In many parts of the book, Blinder’s conclusions make a lot of sense: He recognizes that the Fed was “adding fuel to the housing boom” with its monetary policy in the buildup of the bubble during the 2000s. He also recognizes that getting rid of Glass-Steagall was not a chief cause of the financial crisis. His discussion of the stress-tests of European financial institutions and especially his comments on the lack of realism in their implementation is also quite good, although he gives far too much credit to similar stress tests in the United States, saying that “they marked the end of the acute stage of the financial crisis and the beginning of the return to normalcy.”

Ducking blame | Probably my greatest curiosity in anticipating Blinder’s book was to see how he would present the causes of the financial crisis and either accept or deflect blame for it. After all, many rightly blame the Clinton administration (in which he served) for kick-starting the homeownership craze that ultimately led to the housing bubble and the subsequent credit collapse. Serving on Clinton’s CEA, Blinder would have been in agreement with—if he was not an architect of—the plan to boost homeownership. The administration bragged about the rising homeownership rate and ran on it as a campaign issue in 1996. (I should note that George W. Bush did the same in 2004.)

In the first chapter of the book, Blinder gets off to a promising start when he notes that “homeownership simply reached an unnatural high of 69 percent of all American housing units in 2004 and 2005—up from 64 percent a decade earlier.” Unfortunately this passage does not segue to the logical step of issuing a mea culpa for the Clinton administration’s role in driving up homeownership to an unnatural, unsustainable level through its pro-homeownership policies. Instead he tries to pin the blame for mortgage and consumer overleveraging almost solely on the George W. Bush administration:

[T]here was a bit of a debt explosion between 2000 and 2008 ... [as] total household debt (mortgage plus personal) rose from about 100 percent of GDP to about 140 percent in only eight years. The lion’s share of that increase came in mortgage indebtedness.

While it is true that household debt rose steadily during the Bush-43 years, it was rising steadily before he took office. The upward trend actually started during the mid-1980s after mortgage rates fell from their peak in the high teens. According to Bureau of Economic Analysis and Federal Reserve data, the ratio stood at roughly 45 percent before its uptick, and it reached 70 percent about the time Bush 43 took office. While it is true that the ratio continued to climb to nearly 100 percent, some of this increase was due to the forward momentum of the policies implemented during the Clinton era. Additionally, it’s unclear how Blinder comes up with the calculation that household debt reached 140 percent of gross domestic product—he cites not one source for that number, which makes it difficult to agree with his conclusions.

He is skeptical that Fannie Mae and Freddie Mac had much of anything to do with the crisis: “Facts like these make
it hard to see how anyone can cast Fannie and Freddie in leading roles in the run-up to the crisis, and the [Financial Crisis Inquiry Commission’s] majority agreed with this assessment.” First of all, it is very clear based on the size of their market share, the losses they sustained, and their duopoly position in the conforming secondary market that Fannie and Freddie were a significant part of the overall push toward increasing homeownership. What “facts” does Blinder cite for the proposition that they did not contribute to the housing bubble? The two GSEs’ “balance sheets shrank slightly over the 2003–2007 period” and “their market shares in the mortgage business fell dramatically.” But what Blinder neglects to explain is that, as detailed in a 2011 Wall Street Journal column on the subject, Fannie and Freddie’s next step was critical: “seeking to regain lost market share, [the GSEs] loaded up on riskier subprime and Alt-A loans in 2006 and 2007 just as the housing market was starting to tank.” Unfortunately Blinder does not choose to bolster his argument with one of his illuminating charts that covers the entire timeframe from 2003 to 2008.

Blame the libertarians | Blinder also blames the financial crisis on bubbles as an “unavoidable consequence of speculative markets,” a financial system with “far too little regulation for the public good,” and the “libertarians” in charge of the Federal Reserve:

It was led for more than eighteen years by Alan Greenspan, a self-described disciple of the libertarian philosopher Ayn Rand, and proud of it. Greenspan was, shall we say, a less-than-enthusiastic regulator.

For good measure Blinder makes the further point that Ben Bernanke “also characterized himself as a libertarian—before the crisis.” So there we have it: the libertarians are to blame for the whole mess, notwithstanding the fact that both Greenspan and Bernanke did some very un-libertarian things as part of the build-up of the bubble and in response to the financial crisis.

Blinder also lob a few shots at Bush’s treasury secretary, Henry Paulson, a “firm believer in free markets,” who similarly did some absolutely un-libertarian things during the crisis. Finally, Blinder makes an apparent reference to another group of “libertarians,” so-called “moral hazard Ayatollahs” who criticized the Bear Stearns bailout and tried to tie the hands of the interventions pushing through the bailout. In particular, he besmirches Anna Schwartz for being a member of this group.

He also criticizes what I think was one of the few good decisions made during the response to the crisis—allowing Lehman Brothers to fail—as the primary cause that transformed a run-of-the-mill recession into the “Great Recession.” This point is at the core of Blinder’s argument, but he presents an amazing lack of evidence to support it. For example, he shows that economic data after the September 15, 2008 fall of Lehman look really, really bad, but he shows little direct linkage between the failure at Lehman and what happened afterward. After all, a lot of bad things were happening that September, including the meltdowns of Fannie Mae, Freddie Mac, and AIG, along with the collapse of large banks and savings associations like the failure of Washington Mutual and the run on Wachovia. Blinder relies on the so-called “interconnectedness” argument and talks of the “cascade of failures and near failures that followed the Lehman bankruptcy.”

The weakness with this argument is that it has been discredited by many with post-2008 research into the makeup of Lehman’s liabilities, the best and most recent analysis of which has been completed by Hal Scott in his paper “Interconnectedness and Contagion” (November 20, 2012). An especially surprising conclusion:

And it worked. The worst was avoided. Financial markets returned to something approximating normalcy much faster than seemed likely. There was no Great Depression 2.0.

As for the future and the unwinding of the massive Fed interventions through the various “quantitative easings,” Blinder is convinced that this will be a piece of cake: “Can’t the Fed just retrace its steps, like a hiker who cuts bark off trees to mark her path and then follows it back to the trailhead? In large measure, the answer is yes.” He later adds, “unless [Federal Open Market Committee] members are derelict in their duties, their error [in executing an exit] should be modest.” In recent weeks there has been great anxiety and volatility in global markets in anticipation of the mere possibility of phasing out the Fed’s quantitative easings. A much more turbulent exit than Blinder anticipates appears likely.

Overall there is not really much new here and Blinder could have easily put this book out for release in 2010, 2011, or 2012. One has to wonder why it came out as late as 2013. A perusal of his notes and sources in the back of the book finds a bland mixture of many an article from the New York Times, Washington Post, and Wall Street Journal, and of course lots and lots of his editorials and studies. So if you are the type who gets highly frustrated by Blinder’s arguments in print, this book will merely be a 443-page dose of the same. Unfortunately with a book, as opposed to one of his editorials, you cannot zip off a nice letter to the editor to vent your built-up frustration.
The Glory of Gridlock

REVIEWED BY IKE BRANNON

Balance: The Economics of Great Powers from Ancient Rome to Modern America
By Glenn Hubbard and Tim Kane
368 pages; Simon and Schuster, 2013

The mantra these days seems to be that we need the government to do something, anything, to fix the problems bedeviling our country. A do-nothing Senate and a deliberately obstructive House of Representatives have made the passage of substantive legislation almost impossible, the story goes, leaving President Obama no choice but to use his executive branch power to bypass Congress and get things done—witness his recent announcement about imposing new restrictions on greenhouse gas emissions despite congressional inaction on the matter. It’s high time that Congress and the president get together to fix what’s wrong with America, the thinking seems to be.

Tim Kane and Glenn Hubbard warn us against this sentiment. Centralizing power so that the government (or its executive) can act with more alacrity may be one way to jumpstart the stalled economy we’re living in, but it’s also a formula for disaster—too much centralized decisionmaking can be hazardous to a country, whether it occurs in the military or in the rest of government. As a result, we’re left with a promotion system that can’t assure us that we have the best people in the most important jobs. While the two books seem on the surface to be almost completely unconnected, they share a common thread: too many forms. An independent bureaucracy, and hidebound promotion procedures ultimately frustrate nearly everyone hoping to make a career in the military. As a result, we’re left with a promotion system that can’t work or even want to drive us into a ditch.

The authors know a little something about government. Kane was an Air Force officer and later worked for Congress, while Hubbard was head of the Council of Economic Advisers and rumored to have been Mitt Romney’s choice for treasury secretary had Romney won the 2012 election. To be in the belly of the beast is frustrating, as I can readily attest. In my time as a congressional staffer, the one change I can point to with any pride-in-ownership was when the Senate Cafeteria began offering barbecue sauce as a condiment. But it is hard to be surrounded by well-meaning, ambitious, and confident lawmakers and staffers on both sides of the aisle and not come away a bit frightened as to what they would do if left to their own devices.

Checks and balances | Balance offers an interesting juxtaposition to Kane’s previous book, the well-regarded Bleeding Talent. That book looked critically at the U.S. military’s officer class and asked whether we are fully taking advantage of its prodigious talents. To that question Kane answered an unambiguous “no”: the sclerotic bureaucracy and hidebound promotion procedures ultimately frustrate nearly everyone hoping to make a career in the military. As a result, we’re left with a promotion system that can’t work or even want to drive us into a ditch.

Kane and Hubbard argue in Balance that a key to a long and prosperous society is the ability to survive bad leaders. No country can ensure that only the wisest people will ascend to be president, prime minister, or dear leader, so there needs to be a check on their ability to ruin things. These checks and balances can take many forms. An independent bureaucracy, a parliament or Congress invested with real powers, and a system of local governments with the ability to make their own laws are some examples of this. Our Founding Fathers believed this in their bones and strove mightily to design a system that would invest our government with such checks. Unfortunately, we’ve been slowly unraveling it ever since.

Andrew O’Shaughnessy, in his magisterial book The Men who Lost America, argues that it was the gradual rise of parliamentary power in the 18th century at the expense of the monarchy that allowed Britain and its empire to withstand a monarch like King George III in his latter days, when he took leave of his senses. The monarchy survived only because of its diminution of powers; had it been any other way, the country might not have withstood future wars intact or a parliament irritated by his eccentricities might have bothered to depose him.

The United States doesn’t score so well on the centralized power metric of late, with both Democratic and Republican administrations doing their best to invest more power in the executive, and congressional leaders of all stripes barely paying lip service to the now-quaint notion of federalism.

Replacing democracy | While we may lament this state of affairs, some of these checks can go too far, Kane and Hubbard argue—especially the non-democratic kind. The Eunuchs in China, originally conceived to provide sage advice untainted by rent-seeking or avarice, eventually gained enough leverage to steer the government to their advantage, as did the Janissaries in Turkey.

Ditto the imperial bureaucracy in England and the legislative staff in California, who do much of the heavy lifting in a legislature where term limits force neophyte legislators to assume the chairmanships of important committees. Eventually, they argue, the entitled class of government overseers in each case turned their societies away from an open, expansionary purview—the time-worn path to economic prosperity—and toward an inward-looking, restrictive orientation. Whether it involved burning all ocean-going vessels, forbidding interactions with foreigners, building a Hadrian’s Wall and pulling back the Roman Legion, or raising the state income tax...
over 13 percent, the retrenchment of economic activity sounded a death-knell for these empires, argue Kane and Hubbard.

Peter Orszag, soon after he left his position as head of the Office of Management and Budget, wrote a much-discussed essay lamenting the inability of the government to implement policies that he believes are appropriate and important. His solution is to do with a bit less democracy and invest more power in the unelected bureaucracy. Balance is replete with examples as to how such a maneuver would eventually end: badly.

That brings us to the one positive message of Bleeding Talent, at least in the context of Balance: for better or worse, the officer class in the United States has relatively little sway over military expenditures.

Return to federalism | If Kane and Hubbard don’t want to give the executive branch more power, how would they solve the United States’ current malaise, with our stagnant economy, overdue entitlement reforms, and a woefully outdated tax code?

Balance is by-and-large bullish on America; the authors do not see any signs that we are going down the fateful roads taken by Rome or Imperial Japan or the British Empire (although California should watch it). They would point out that none of America’s very real problems represent an existential threat, at least not at the moment. The U.S. economy is still experiencing solid productivity gains and is still bigger and more productive than any other nation’s. Our military remains far stronger than any other nation’s, even after the sequestration budget cuts.

A government where the states did more (such as financing and building their own roads, rather than waiting for the federal government to send them money and tell them what to do with it) would mean we’d need less intervention from the federal government and it could reduce its own knowledge constraints, don’t usually learn from their mistakes, don’t consider the perverse incentives they create for the people they are supposedly helping, and who often have incentives of their own that do not dovetail with their humanitarian missions. Those are, of course, the same reasons why domestic policy measures intended to help the poor fail or even prove counterproductive. In sum, Coyne has taken the Hayekian and “public choice” insights that explain the defects in programs such as government job training and applied them to their international analogues. Much as we are inclined to judge humanitarian actions by their good intentions, he insists that we think realistically about what they accomplish and suggests that those who are truly interested in helping poor and suffering people around the world should look for nongovernmental avenues for doing so.

Men of system | Adam Smith wrote in The Wealth of Nations about the type of person he called “the man of system,” who “seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess board.” Coyne finds Smith’s observation about
these blinkered, arrogant individuals to be pertinent to his topic and refers to the type who runs international humanitarian programs as “the man of the humanitarian system.” Those people believe that suffering can be relieved or prevented just as we managed to put a man on the moon: it is merely a technological problem that can be solved, provided that we devote enough resources and exert enough will. They are mistaken but, unfortunately, humanitarian programs have fallen almost entirely under their sway.

Out of every dollar the U.S. government devotes to humanitarian aid, only about 10 cents go for relief following disasters such as famines, earthquakes, and tidal waves. The rest goes to “developmental aid,” which is to say, spending on projects meant to enable native peoples to enjoy a rising standard of living through economic growth. Coyne argues that it is a terrible allocation of resources because disaster relief, while often wasteful, at least does some good. Developmental aid, *per contra*, is mostly squandered. The programs are administered by those “men of the humanitarian system” who seldom see that their ideas about what the local people need are different from what the people themselves would do with additional capital. For instance, the men of system usually assume that more formal schooling for children is a high priority, so they build schools and measure success by the number of boys and girls enrolled. The problem is that formal education is often a low priority for the natives and putting resources into it is wasteful.

Several of Coyne’s illustrations of failed development projects come from Afghanistan. One particularly good example relates to a dam in the Helmand Valley that would provide farmers with more water. Unfortunately, Coyne writes, “those who planned and implemented the program never asked how farmers would deal with the significant inflow of additional water.” The officials in charge, both western and Afghan, blithely assumed that the farmers would know what to do with more water, but as it turned out, they didn’t. Their fields were flooded and crop yields decreased.

The “experts” responsible for the project were still well paid for their time. The adverse effects fell upon the poor locals. Because the experts bear no costs when they’re wrong, Coyne argues, they keep making the same mistakes over and over.

In the field of development economics, there is a long-running battle between those who argue that external aid is essential to catalyze growth in poor countries, and advocates of a rival view (associated mostly with the British economist Peter Bauer) that such aid is harmful because it props up obstructionist governments. Bauer argued that free trade policies would be much more beneficial than foreign aid in helping poor nations develop. Coyne sides with Bauer and says that humanitarians ought to push for the elimination of trade barriers rather than supporting the development aid status quo.

**Disaster aid** | What about disaster relief? Shouldn’t we send food when people are starving and medicines when they face epidemics? Coyne doesn’t argue that we should throttle our impulse toward generosity, but he points out that such aid is not likely to accomplish as much good as we think.

One reason is that disaster relief aid is often of the wrong kind or delivered to the wrong place. What Americans witnessed with the Federal Emergency Management Agency’s bungling of aid following Hurricane Katrina was illustrative of international efforts. Coyne notes a study of drug donations in response to the 2004 tsunami that devastated coastal areas of Indonesia. The study found that 70 percent of the medicines had labels in foreign languages that could not be understood by local medical practitioners and had to be discarded. Some 600 tons of medicine had to be destroyed, at a cost of $3 million.

Moreover, disaster aid can have the effect of rewarding the rulers for policies that cause and sustain crises. North Korea, for example, has been using the widespread hunger of its population to leverage aid from the United States for many years.

**R2P** | The third part of humanitarian intervention is military, i.e., using land, sea, and air power to fight against state-controlled violence that threatens innocents. Under the “Responsibility to Protect” (R2P) doctrine, the United States, other nations, and the United Nations have sworn to use their military power whenever necessary to prevent “genocide, war crimes, ethnic cleansing, and crimes against humanity.” In 2011, President Obama invoked R2P to justify American intervention in the Libyan conflict that eventually led to the ouster and killing of Libyan ruler Muammar Gaddafi.

Coyne does not delve into the serious legal and moral issues that R2P raises, but considers only its practical problems. Military humanitarianism, like its peaceful siblings, “can never do merely one thing,” he writes, “because there are a series of unpredictable consequences over time and space that emerge from any single intervention in a complex system.” One of those unpredictable consequences is “blowback,” retaliation against the citizens of the intervening nation by people who were on the disfavored side of the conflict.

Another undesired effect of R2P may be to actually encourage violent opposition to states. Coyne cites the work of political scientist Alan Kuperman, who argues that it “creates a form of insurance for potential substate groups considering rebellion because the international community has indicated that it will, in principle, intervene to stop genocidal violence.”

Thus, much as we abhor organized violence abroad, we shouldn’t think that military intervention intended to stop it will have only the desired effects. The 2012 violence in Mali following the fall of Gaddafi in Libya is a reminder of that.

**Privatizing aid** | *Doing Bad by Doing Good* presents a depressing picture of the results of the work done by the “men of the humanitarian system.” Therefore, what should people who want to alleviate suffering do? Coyne argues that we’ll do far more good for those we want to help if we move away from state humanitarian-
ism and toward private, non-state efforts.

One form of non-state humanitarianism is money remitted to poor homelands by individuals who have emigrated and become comparatively prosperous in advanced countries. Remittances sent by Haitians living in the United States to families and groups in Haiti do an enormous amount of good, Coyne points out, because the money is targeted and does not have to pass through the sticky fingers of bureaucrats. If the United States allowed more immigration from poor countries, we would indirectly but efficiently help to relieve poverty.

Coyne also observes that for-profit businesses have been very effective in providing aid after natural disasters in the United States and says that humanitarians should put aside biases they may have against the help such businesses can provide. That’s undoubtedly right, but then he leaves this point dangling: since natural disasters often hit countries with weak business sectors, how can those countries benefit from the superior ability of profitable enterprises to help afterward? Haiti doesn’t have Walmart and Home Depot. Is there a way for such firms, perhaps with donations from American citizens, to avoid the local kleptocrats and directly help the suffering people? If there currently is not, could such an avenue be opened? This seems like an opportunity for true humanitarians to channel some of their energies.

Finally, what about humanitarian aid in the cases of organized violence? Coyne doesn’t have much to say about alternatives to state action in those cases, but it’s worth remembering that Americans and others used to get involved voluntarily in conflicts they cared about. In the 1930s, for example, volunteers risked their lives in the Spanish Civil War and the Russo-Finnish War. If we abandoned R2P and its idea that governments must take responsibility, would individuals and voluntary associations find ways to act? I think so and hope that Coyne or other scholars will further explore that question.

Despite my few quibbles, Coyne is to be congratulated for a book that strongly calls into question the conventional wisdom that we must look first to government to accomplish humanitarian ends.

Beyond Government Authority

REVIEWED BY ART CARDEN

The Problem of Political Authority: An Examination of the Right to Coerce and the Duty to Obey

By Michael Huemer

365 pages; Palgrave Macmillan, 2013

Governments are almost universally tolerated, and even celebrated, for doing things for which you or I would be roundly condemned and justly punished if we did them as private citizens. Why? A lot of people have offered justifications for this difference, but few of those justifications have been satisfying in any respect, and none have been completely convincing.

What should we make of this failure? Michael Huemer, a professor of philosophy at the University of Colorado, offers a remarkable answer in his new book The Problem of Political Authority: governments’ claims to political authority are illusory and governments are illegitimate. The fact that he provides 365 pages of heresy against mainstream civic thought does not mean he’s wrong; rather, he begins from uncontroversial moral premises and then arrives at a robust theory of the illegitimacy of the state.

In the tradition of libertarian classics like Murray Rothbard’s For a New Liberty and David Friedman’s The Machinery of Freedom, Huemer defends his radical thesis against a number of traditional objections. The book is a handy and penetrating complement to recent works like Mark Pennington’s Robust Political Economy in that it offers a deeply practical treatment of serious political problems. While Huemer admits that he is writing for the educated and interested layperson and not an audience of specialists, scholars will have much to learn from The Problem of Political Authority.

Invalid claims to authority | In Part I, Huemer explains and then criticizes popular theories of the social contract, noting (for example) that moral reasoning leads to the conclusion that explicit dissent trumps implied or hypothetical consent, and “consent” cannot be present when there is no reasonable way of opting out. He argues in a series of examples and thought experiments that we are not actually bound by a social contract. On p. 31, to use just one example, he writes the following with respect to unconditional imposition (the idea that “an action can be taken as indicating a person’s agreement to some scheme only if the person can reasonably be assumed to believe that, if he did not take that action, then the scheme would not be imposed on him”):

Almost everyone knows that the state will still impose the same laws and the same taxes on one, regardless of whether one objects to the government, accepts government services, or participates in the political process. Therefore, one’s failure to object, one’s acceptance of government services, and even one’s participation in the political process cannot be taken to imply agreement to the social contract.

I suspect that a lot of readers will reject Huemer out-of-hand because they will think he is claiming to do what he explicitly says he is not doing: he is not trying to build a complete theory of justice. Rather, he is showing—on the basis of premises that people will not find contro-

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versial—that claims to political authority are invalid. Instead of trying to derive and apply cosmic principles, he takes ideas on which there is widespread and intuitive agreement and then uses them to make arguments non-specialists can understand. From uncontroversial ethical premises, he derives what is obviously a shocking and controversial conclusion: “I shall ultimately conclude that political authority is an illusion: no one has the right to rule, and no one is obliged to obey a command merely because it comes from the government.”

**Dangers of authority** | Huemer exhibits the virtues that make him a serious political philosopher. As an economist, I took deep satisfaction from the fact that he was constantly asking, “Compared to what?” In particular, he shows that many of the objections to statelessness based on intuitive senses of obligation fail when we consider whether anarchy is in fact actually better than a society with a state. He deconstructs welfare state apologetics, for example, by noting that the way the programs work in the real world is very different from the way they work in the ideal scenarios envisioned by interventionists. As he notes on p. 154, “Existing programs are almost entirely aimed at the wrong people and the wrong problems.”

One of the most interesting bodies of research at the intersection of cognitive science, psychology, economics, and politics is the discovery of ways that human brains don’t work particularly well. Rolf Dobelli catalogues these in *The Art of Thinking Clearly* and Daniel Kahneman offers a detailed and incisive explanation of how we are simply not good intuitive statisticians in *Thinking, Fast and Slow*. These discoveries have important implications for how we understand political authority—but not in the way a lot of people believe.

Curiously, people interpret these insights as evidence against markets and evidence for the desirability of government action. This ignores the fact that government actors are hampered by the same cognitive failures, but in this case the cognitive failures are compounded by potentially pathological incentives. The most obvious is the fact that since they face no profit and loss signals, bureaucrats cannot know whether their activities are creating value. (See Ludwig von Mises’ short but excellent *Bureaucracy* for a deep discussion of the problems of bureaucratic management.)

Less obvious is “the psychology of authority,” which Huemer explores in Chapter 6. He invokes two of the most famous experiments in the literature of authority: Stanley Milgram’s work at Yale in which he showed that an unsettling number of people are effectively willing to torture a human being to death as long as they are told to do so by an authority figure, and the Stanford Prison Experiment in which students randomly chosen to be guards heaped horrific abuses on people randomly chosen to be prisoners. In the first case, obedience to authority—“just following orders”—rationalized what would have been torture or murder had the experiment actually been real. (Huemer goes so far as to note that “[r]espect for authority was Hitler’s key weapon” (p. 109).) He further points out that political authority is what ultimately creates murder on the scale governments perpetrated in the 20th century. Similar dynamics were on display during the My Lai massacre. Our buggy cognitive software, what we do with cognitive dissonance, and our tendency to follow authority down very dark paths combine to weaken the case for centralization and strengthen the case for individual autonomy.

The case for autonomy as against authority is further strengthened by the work of scholars like Elinor Ostrom and James Buchanan. Building on the work of Friedrich Hayek, they documented the ways people develop institutions to solve collective action problems through decentralized channels in the face of uncertainty about what some of the problems even are, to say nothing of the appropriate solutions. Developing a context in which we can get the incentives right is of paramount importance, and Huemer documents how political authority is ill-suited to this. Not only do we have faulty cognitive software, but when we claim “political authority” as a means by which societies solve problems, we filter our cognitive faults through a process that allows us to impose large costs on others at very small costs to ourselves. It is very easy, for example, to rationalize our support for prohibitions and then blame those who wish to have sex, imbibe various substances, or take risks of which we do not approve because we pay very small prices for the unintended consequences of our actions.

**Beyond government** | Huemer’s volume is really two books in one. The first part, which I’ve already discussed, criticizes popular theories of political legitimacy. The second illuminates the characteristics of a “Society Without Authority” and explains just how we might establish such a world while avoiding what Harold Demsetz called “the nirvana fallacy.” In discussing that more perfect society, Huemer grounds his claims in generalizations about how people actually are and not how he imagines the “new anarchist man” to be once he is reacquainted with his species-essence.

It’s in this section that readers will especially appreciate Huemer’s skill at structuring his material: this is one of the best-organized books I’ve ever read. He states and re-states his arguments very clearly throughout his chapters, he anticipates and deals with objections to his main points, he offers an analytical table of contents that presents readers with the full argument in just a few pages, and he then summarizes and recaps the argument of the entire volume in his final pages. Throughout, you will ask questions like, “What about the poor? What about defense? What about…,” only to find that he anticipates and answers objections to his thesis quite ably by noting that the offered political “solutions” can be expected to make the problems worse, not better.

Huemer has gone to great lengths and pains to write a book that is clear and accessible, and that avoids the expository gymnastics all too common in academia. I expect that this will become a classic reference for people who agree with him and even those who don’t.
Simpler? Really?

REVIEWED BY DAVID R. HENDERSON

Simpler: The Future of Government
By Cass R. Sunstein
260 pages; Simon and Schuster, 2013

Fresh off a tour as head of President Obama’s Office of Information and Regulatory Affairs, Cass Sunstein, now a professor at Harvard Law School, shares his enthusiasm for simpler regulation in his new book. It is appropriately titled Simpler.

I opened the book with a big question on my mind: how can a smart person—and Sunstein obviously is—who had an up-close look at regulation during the first four years of Obama’s presidency, make a case for simpler regulation? Isn’t he aware that the Affordable Care Act, better known as Obamacare, ran to 2,400 pages and that the regulations to implement the act are now in the thousands of pages? Isn’t he familiar with the fact that the Dodd-Frank financial regulation law was 848 pages long and that it creates about 400 new regulations, many of them yet to be decided on? How can Sunstein both (1) make the case for simpler regulation and (2) justify those two sets of Obama administration regulations?

I won’t leave you in suspense. Sunstein more or less achieves goal 1, while he makes a half-hearted attempt—which ultimately fails—at achieving goal 2. I’ll highlight some of the book’s good aspects below. But he would have been much more credible had he not even tried to defend Obamacare and Dodd-Frank.

Nudges | In the book, Sunstein, who has been a strong proponent of “libertarian paternalism” by government, advocates measures that are more akin to straight coercion. Many libertarians have feared that some of the “nudges” libertarian paternalists advocate would turn out to be simple coercion. I was an early, though cautious, defender of Sunstein and co-author Richard Thaler’s advocacy of nudges in their book, Nudge. (See “A Less Oppressive Paternalism,” Summer 2008.) But based on this new book, I must conclude that many of the libertarian critics’ fears have turned out to be justified.

Sunstein’s argument for much of the regulation he favors will be familiar to those who have read Nudge. He argues that people often make bad decisions because they use “System 1” thinking. That is, people often follow their initial intuitions when facing an important question, rather than employ “System 2” thinking, which is more deliberative and reflective.

Based on evidence from Daniel Kahneman’s book Thinking, Fast and Slow, I can’t dispute this. That is to say, I can’t dispute the problem of System 1 thinking and the idea that carefully crafted government rules could help people make better decisions. One example of such rules is the government’s redesign, partly influenced by Sunstein, of the way auto companies report fuel economy on new cars’ window stickers. He points out that when the companies report miles per gallon, many potential car buyers see this as a linear measure. So, for example, they would regard 20 miles per gallon as 33 percent better than 15 mpg and they see 25 mpg as 25 percent better than 20 mpg. A little reflection on the fact that gallons are in the denominator, not the numerator, would show this to be false. But reflection is exactly what many people lack. His fix was to show the five-year fuel savings in dollars when comparing a given car to the average new vehicle (assuming, of course, a specific price of gasoline.)

Sensible policy | To his credit, Sunstein also shows himself to have been, at times, a deregulator. Unfortunately, in one of the best cases he cites of his proposed deregulation, he lost the policy argument. The Bush administration had banned Primatene Mist for asthmatics, but had scheduled the ban to begin on January 1, 2012. Primatene Mist contained chlorofluorocarbons (CFCs), which hurt the ozone layer. Sunstein pointed out that the ban would have left two to three million people without an over-the-counter substitute—the available substitutes all require a prescription and all are expensive. He noted that the CFC emissions from Primatene Mist were “small, even trivial.” So, he argued, the policy issue came down to a trade-off between two health risks: the “small, even trivial” health risk to the world’s population from slightly more ozone, and the more substantial risk and expense to many American asthmatics. On that basis, he argued for extending the deadline. The Food and Drug Administration decided otherwise.

Sunstein also brings some sense to the hot-button issues of genetically modified organisms in food and the pesticide DDT. He points out that genetic modification “holds out the possibility of producing food that is both cheaper and healthier.” And banning DDT, he notes, “eliminates what appears to be the most effective way of combating malaria and may significantly compromise public health.” In discussing those topics, Sunstein shows what is wrong with the so-called “precautionary principle,” according to which people should not be allowed to go forward with an activity or product unless they can show that it is safe. The principle, he notes, is incoherent because it ignores tradeoffs: sure, DDT might be risky for some, but banning it is even riskier for poor Africans.

Coercion | Sunstein is keenly aware of his awkward position as a defender of simplifying regulations and as a defender of the Obama administration. His defense of Obama is feeble. He writes,
“How can a former Obama administration official presume, or dare, to write a book about simplification?” He then writes, “To provide an answer, we need to make a distinction.” The distinction, he explains, is between simplification, which he favors, and reducing government’s functions, which he doesn’t. That’s an important distinction, but he never uses it to answer the question he himself asks. The reader is left thinking that, for Sunstein, simplification takes a back seat to expanding the federal government’s role in people’s lives.

“Libertarian paternalism,” which Sunstein generally advocates, is government choosing regulations that people can easily avoid by just saying no. So, for example, if the government requires an employer to enroll workers in a pension plan but allows the workers to opt out of the plan using a simple process, that would be an instance of libertarian paternalism. The government would be “nudging” people to join their employers’ pension plans. But if the government simply requires that people join pension plans, as it does with Social Security, that is not a nudge; that is outright, old-fashioned paternalistic coercion.

In at least three instances, Sunstein crosses the line from advocating nudges to advocating coercion: price controls, restrictions on the size of soda containers, and graphic warnings about smoking.

Take price controls. (Please.) One of the worst regulations he favors is price controls on health insurance. Sunstein, who is obviously economically literate, doesn’t seem to feel the need to justify this policy, despite the fact that opposition to price controls and the distortions they cause is one of the things that the vast majority of economists agree on.

Or consider New York City mayor Michael Bloomberg’s move in 2012 to limit the size of soda containers to 16 ounces. Sunstein points out an obvious fact: that limit would not have allowed people to choose a larger size. Yet, in discussing comedian Jon Stewart’s negative reaction to Bloomberg’s ban on larger containers, Sunstein writes, “Stewart is capturing a pervasive and general skepticism about paternalism in general and nudges in particular.” Here, Sunstein himself is incoherent. As he had admitted a few lines earlier, Bloomberg’s regulation was a ban, not a nudge. Sunstein might argue that it is a nudge because one can always buy multiple containers, but that is costly. Moreover, what if someone wants 20 ounces of soda? It’s hard to buy a 4-ounce drink. Sunstein seems to be illustrating precisely what many libertarian critics had feared: one of the primary advocates of nudges and libertarian paternalism seems quite comfortable with coercive paternalism.

Or, finally, consider the graphic warnings that the FDA wants to require on cigarette packs. Such warnings include disgusting pictures of people with bad health as a result of smoking. Sunstein claims that such warnings “are a distinctive kind of nudge.” “However graphic,” he writes, “the warnings maintain freedom of choice.” It is true that, with the graphic warnings in place, people would still be able to choose to buy cigarettes. But there’s more than one choice involved. Another choice is the kind of package people buy their cigarettes in. The FDA regulation that Sunstein supports would substantially limit people’s choice. Call it a hunch, but I think most smokers would rather not buy their cigarettes in such packages. My guess is that the reason Sunstein is oblivious to that lack of choice is that he’s not in the market for cigarettes. I wonder how he would feel if, when he ordered a fattening dessert in a fancy restaurant, the server was required to serve it with pictures of people who are in poor health because of overeating such desserts.

Moreover, whether the issue is cigarettes, cars, drugs, or any other good, Sunstein consistently puts a zero weight on the freedom of producers. In discussing the various examples he cites, Sunstein devotes not a sentence of concern for their freedom—or lack thereof.

His indifference to producers’ freedom becomes explicit in his discussion of regulations on advertising airline fees. In 2011, he notes, the Department of Transportation introduced a regulation to require “airlines to disclose prominently all potential fees on their web sites.” “Even better,” he writes, “airlines have to include all government taxes and fees in every advertised price.” He observes that some airlines sued to invalidate the regulation, “complaining especially about the requirement to include taxes and fees and invoking the First Amendment, no less, to say that the requirement was unconstitutional.” In writing this, he misconstrues what the airlines were protesting. The airlines that sued in Spirit Airlines Inc. v. Department of Transportation were willing to tell consumers about the taxes and fees, but wanted to call consumers’ attention to those costs by printing them on the ticket in a font size as large as the font for the overall price.

The regulation prohibits them from doing so. So passengers won’t be as aware of the government’s role in high airfares as of the fares themselves. That sounds like a First Amendment case to me. You would think that Sunstein would understand that. After all, his own book is a commercial product and he left out this important piece of information. In that sense, he’s like an airline that leaves out information about high baggage fees. Yet I bet he would object to a law requiring him to tell the reader the whole story.

To his credit, Sunstein earlier rejected his own tentative proposal for a “fairness doctrine” for the Internet; he had toyed with the idea of legally requiring bloggers to link to contrary views. That he even seriously considered that idea, though, suggests that on the issue of free speech, he has a tin ear.

Government gorilla | In a fascinating chapter, “Invisible Gorillas and Human Herds,” Sunstein describes an experiment in which people were asked to watch a video of a basketball game and count the number of times that players passed the ball. In the video, a person dressed in a gorilla costume roamed among the players, yet many of the test subjects totally missed seeing the gorilla because they were so focused on the ball. The lesson for businesses, individuals, and governments, Sunstein writes, is “that we are all at risk of missing a lot that is happening in the background (and possibly even the foreground) of our lives.” Indeed.
That brings me to the 800-pound gorilla in the room—government—and a large irony in *Simpler* that Sunstein seems unaware of. In one passage, he notes that he delayed getting vaccinated for the dangerous influenza strain H1N1. That delay shows that even Sunstein, the Obama administration’s former chief regulatory official, is subject to the Style-1 thinking or outright coerce, as out of. He admits, just four pages earlier, that for many people, “including those who work in government, what may matter most is today, tomorrow, and next week.” Yet, he wants us to trust these self-same government officials to make major decisions—about drugs, medical care, cars, and cigarettes, to name only a few—for us. If those government officials can’t be trusted to take the long view when their own well-being is at stake, why would Sunstein think that we can trust them to do so for a nation of strangers?

I admit to having many of the human failings that Sunstein writes about. But given the choice between having a government of people with such failings make my decisions for me, and my being free to choose for myself, I choose freedom.

**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**

**Intellectual Property**


James Bessen is one of the leading critics of nonpracticing entities (NPEs)—firms that purchase and hold patent rights but neither innovate themselves nor use the patents in the production of goods. At best, NPEs look to wring licensing fees from productive companies; at worst, they are opportunistic plaintiffs who seek to profit from unsuspecting innovators who unknowingly infringe on a patent. (See “The Private and Social Costs of Patent Trolls,” Winter 2011–2012.)

In their new working paper, Bessen and Brian Love propose a remedy for this problem based on two stylized facts about patent lawsuits:

- Two-thirds of lawsuits brought in the last five years of a patent’s life come from NPEs.
- Actual production companies usually finish enforcing their patents within nine years of issuance, long before the patent expires.

These facts lead Bessen and Love to recommend altering the timing of the current patent fee structure to discourage the mischief that occurs late in patent life. That is, lower the fees for patent renewal early in a patent’s life, and increase those fees near the end. Bessen and Love argue that large fees payable late in the term of a patent would affect only patent-holders acting opportunistically and not affect legitimate innovators who act early or, in the case of many high-tech companies, have no patents at all.

In contrast, Mark Lemley and A. Douglas Melamed argue that “patent trolls” (a pejorative term for NPEs) are a symptom of specific problems with the patent system rather than a direct cause.

**Commodity Price Speculation**


Whenever oil prices increase dramatically, elected officials and the media always focus their attention on the role of speculators and “hoarding” through the use of futures contracts as the cause of the price increase, rather than fundamental changes in supply or demand. Christopher Knittel and Robert Pindyck’s paper carefully provides an analytic framework to distinguish oil price increases that result from changes in fundamentals from oil price changes that result from the actions of speculators.

The authors used their economic model to determine how
much inventories would have increased in 2007–2008 in order to cause the price of oil to increase from $60 to $130 if there were no fundamental shifts in demand or supply. They concluded that inventories would have had to increase by 168 million barrels per month. But actual U.S. inventories fell by 28 million barrels in 2007. In addition, drilling rig utilization was constant and then increasing—facts that are not consistent with hoarding reserves underground in wells. And actual domestic production, which had been falling for decades, actually stopped decreasing from 2006 to 2008, and then increased in 2009, which is also not consistent with speculation through withholding of production. The authors then used their model to estimate what oil prices would have been if there were no speculation in 2007–2008. Their estimates mimic actual prices and at the peak are actually slightly more than actual prices. That is, speculation reduced rather than increased prices at the peak.

Short Selling


Short sellers borrow stock that they then sell. They act in the belief that the price of the stock will fall in the near future, before they have to purchase shares in order to return them to the lenders. Short sellers thus profit from the difference between the price they sell at now and the price they buy at in the future—assuming their belief about the stock’s price movement is correct.

Short sellers are controversial because they bet against companies rather than for them, and are often seen as insufficiently positive about the prospects of businesses. But economists typically see shorters’ role as essential in financial markets because they introduce often-needed skepticism about a stock’s price—that is, they counteract irrational exuberance. Regulation has discussed this function before; see “MOME in Hindsight” (Winter 2004–2005) and “Everything Old Is New Again” (Summer 2011).

One type of shorting is “naked” short selling, which means the seller sells a stock that he hasn’t yet borrowed. This is legal because the buyer agrees to wait to take possession of the stock— in essence the seller “borrows” the stock from the buyer. Again, the naked shorter profits if the stock’s price falls before the shorter purchases the shares. Naked shorting is even more controversial than regular shorting because it seems so improper to sell something that the seller doesn’t possess, but again, many academics argue that naked shorting helps to reduce irrational exuberance. Regulation has also discussed naked shorting before; see “The Economics of Naked Short Selling” and “The Phantom Shares Menace” (Spring 2008).

The financial crisis and the subsequent plunge in stock values intensified the cultural and regulatory attack on short sellers. The Securities and Exchange Commission implemented Rule 201 in May 2010, prohibiting the shorting of stocks that suffer an intraday price decline of at least 10 percent from the previous closing price.

In the “Everything Old Is New Again” article mentioned above, authors Pankaj Jain and Thomas McInish describe the rule’s effects. The article documents that before the existence of Rule 201, short selling declined for stocks that experienced a 10 percent intraday decline, apparently because prospective shorters decided that the stocks had “bottomed out.” That means that Rule 201 is a solution for a problem that doesn’t exist—there isn’t much shorting of the stocks that the rule protects. Short sellers were more active before price declines than after. In contrast, short selling increased for stocks that had experienced positive returns. That is, short sellers leaned against excessive increases in price rather than causing severe decreases. These results held true for all general market conditions, whether the market was up, down, or neutral.

In their working paper “Naked Short Selling: Is it Information-Based Trading?” authors Harrison Liu, Sean T. McGuire, and Edward Swanson examined stock trade data from 2005–2008 to determine what sorts of firms are the subject of naked shorting. The authors regressed naked short interest on the firms’ financial statement fundamentals and a set of control variables. They found that naked short sellers took smaller positions in firms with strong accounting fundamentals, but they took larger positions in companies with high levels of capital expenditures and sales growth, recognizing that those firms will have lower abnormal returns in the future just from regression to the mean.

Those findings indicate that both naked and covered short sales are based on financial statement accounting fundamentals and thus consistent with information-based trading. This result contradicts the belief of the SEC and others that naked shorting is not information-based and does not contribute to stock market informational efficiency.

Consumer Financial Protection


Why was the confirmation of Richard Cordray as the first director of the Consumer Financial Protection Bureau (CFPB) such a gargantuan struggle? Todd Zywicki of George Mason University Law School reviews the history of consumer credit regulation and places the CFPB in that history in this comprehensive working paper.

Consumer credit arose in the late 1800s to help urban workers with uncertain incomes smooth their consumption. One theory of the Great Depression is that too much consumer credit led to heavy debt that borrowers couldn’t repay, crippling creditors. In response, consumer credit regulation occurred with a vengeance. By the late 1960s, loan sharking had arisen to fill the gap in consumer credit—so much so that Paul Samuelson testified before the Massachusetts legislature to eliminate usury ceilings and reduce loan sharks.

In 1978 the U.S. Supreme Court ruled that interest rates on
consumer credit would be regulated by the state in which the lending bank was based, not where the consumer lived. South Dakota had deregulated consumer interest rates to attract financial institutions. Accordingly, all banks moved their credit card operations there and consumer debt flourished at unregulated rates.

The 2008 financial crisis led to a repeat of the credit cycle observed after the Depression, with strong demands by many for paternalistic regulation. The CFPB is the result. It has a director and its own source of money, not dependent on appropriations from Congress. The director sets a budget subject to a cap of 12 percent of the Federal Reserve’s operating budget. The only check on the director’s decision is the possibility of veto by a two-thirds vote of the Financial Stability Oversight Council, which consists of other federal financial officials, including the secretary of the Treasury, chairman of the Federal Reserve, and the head of the Federal Deposit Insurance Corporation.

Zywicki argues that the CFPB is the most powerful and publicly unaccountable agency in history. The single-mission, single-director model will “protect” consumers and stifle innovation, overlooking the benefits of competition and lower prices for consumers. It operates under the belief that the complexity of consumer credit was invented by banks in order to mislead consumers. In fact, complexity allows different people with different risks to be served at different price points.

It is ironic that the CFPB is supposed to usher in an era of simple mortgages with disclosure when the current complicated one is the product of the previous attempt to simplify: the truth-in-lending era. CFPB advocates don’t seem to understand that much of the complexity and lack of transparency of lending stems from truth-in-lending regulation.

Elizabeth Warren and Oren Barr-Gill believe that the financial crisis is the result of complex, misunderstood, and faulty financial products analogous to an exploding toaster. The problem with this theory, as I have stated in a previous “Working Papers” column (Spring 2011), is that the main users of sophisticated products were sophisticated investors who then rationally decided to default when circumstances changed.

Bankruptcy


I have discussed Mark Roe’s work on the role of bankruptcy rules in the financial crisis in previous “Working Papers” columns (Summer 2010, Winter 2010–2011, and Fall 2012). He argues that the spectacular rise in the use of short-term repurchase (“repo”) agreements collateralized by securitized loans was the result of special advantages given to such agreements in bankruptcy reforms in 1978 and 2005. Those advantages put repurchase agreements ahead of all other liabilities in bankruptcy proceedings. Thus, “deposits” in the shadow banking system were bankruptcy-remote, which lowered risk for investors and lowered the cost of capital. The bankruptcy of an investment bank would not tie up investors’ cash because they would take possession of the collateral (rather than give it back to the bank to be part of the pool of assets divided among all investors through bankruptcy) and liquidate it outside of the bankruptcy process.

The downside of the bankruptcy provisions, however, is that if investors ever lost confidence in the collateral used to “guarantee” their deposits, they would flee the shadow banking system just like ordinary retail depositors fled the banks during the Depression. And that is exactly what happened in the last quarter of 2008.

In response, Roe has argued that all creditors should be treated identically in bankruptcy. He thus proposes eliminating the special bankruptcy provisions for repurchase agreements. This would increase market monitoring by the suppliers of deposits on investment and decrease the use of short-term funds to back longer-term investment.

In this new working paper, Roe and coauthor Frederick Tung generalize from the financial crises cases to conclude that the bankruptcy priority rule is not a fixed, immutable rule. It changes over time and is properly thought of as a rent-seeking game. Parties are always seeking to innovate and gain advantage through court rulings and congressional changes.

Short-term asset-repurchase agreements (“repo debt”) at the heart of the financial crisis were just bankruptcy arbitrage devices, in the authors’ view. Debtor-In-Possession (DIP) financing (the interim loans provided to a bankrupt firm for ongoing operations) is often provided by a lender that also provided lending to the bankrupt firm prior to bankruptcy. The DIP financing arrangements often involved repayment of earlier loans in the bankrupt company (“DIP roll-up”). This, of course allowed one creditor, the DIP finance provider, to jump the queue and partially nullify the purpose of bankruptcy: the equal treatment of all creditors. The development of the arm’s-length, bankruptcy-remote special purpose vehicles (SPVs) that owned the loans against which the short-term repurchase agreements were written was an arms-race backlash in response to DIP roll-up.

SPVs and repo started in the 1980s. Their transactions were declared by the participants to be sales and repurchases rather than secured loans, to avoid bankruptcy priority rules. The courts did not agree and so the financial community went to Congress for an exemption and received it.

The bottom line from this paper is that bankruptcy’s priority structure is never definitive. In a world where the Modigliani-Miller Theorem applies (the value of a firm is unaffected by how that firm is financed), less risk and return for one creditor means more risk and return for other creditors. Priority-jumping alters the distribution of resources but not the efficiency of capital markets. But in the real world, efficiency may be affected if creditors cannot adjust quickly enough. In addition, the historical role played by banks in monitoring the creditworthiness of borrowers is severely reduced if more and more borrowing takes place outside traditional banking through bankruptcy-remote institutions.