IN REVIEW

An Unintended Case for More Capitalism

REVIEW BY DAVID R. HENDERSON

One of the most talked about economics books of the last few years is Thomas Piketty's *Capital in the Twenty-First Century*. It is not hard to see why. Piketty, an economics professor at the Paris School of Economics, argues that wealth inequality, which is already high, will increase in the coming decades and he advocates much higher taxes on the wealthy. That taps into people's strong emotions about the "top 1 percent"—a popular topic of discussion in recent years.

Unlike many free-market critics of Piketty's book, I find his big-picture statistical analysis somewhat compelling, although like the other critics I see some serious problems with it. But even if his analysis is correct, I find it much less important than he does, and I find his policy proposals appalling. Beyond his big-picture analysis and policy proposals, he discusses many issues: Social Security, the history of tax policy in the United States and France, global warming policy, immigration, and many others. On some of these, his analysis is good. On others, it is weak or outright wrong. Sometimes he gets his history wrong, and in important ways. Finally, Piketty has a bad habit of questioning the motives of those with whom he disagrees.

Front and center / Start with the big picture. "It is long past the time," he writes in the Introduction, "when we should have put the question of inequality back at the center of economic analysis and begun asking questions first raised in the nineteenth century." The *center*? Really? But if we put inequality at the center, we can easily miss the tremendous growth in well-being for a huge percentage of people in the world and for almost everyone in the United States and Western Europe.

Much later in the book, he shows that he is aware of those improved conditions, writing:

> Nevertheless, according to official indices, the average per capita purchasing power in Britain and France in 1800 was about one-tenth what it was in 2010. In other words, with 20 to 30 times the average income in 1800, a person would probably have lived no better than with 2 or 3 times the average income today. With 5–10 times the average income in 1800, one would have been in a situation somewhere between the minimum and average wage today.

In his own way, he is pointing out, albeit less dramatically, what University of California, Berkeley economist Brad DeLong noted in a study aptly titled "Cornucopia." That well-argued and documented paper examines the 20th century and shows that the price of almost every item we buy—if stated in hours of labor required to earn enough to pay for it—has fallen to a fraction of its cost in 1900. Moreover, that reduction in cost *understates* the improvement in well-being because many crucial items that we buy today did not exist in 1900. Antibiotics, for example, are a 20th century invention. Their price in 1900 was effectively infinite.

In my view, a steady increase in well-being for the vast majority of the world's inhabitants, as well as the policies necessary to achieve that, are what should be central to economic analysis. But Piketty chooses to put inequality front and center, and so be it. He states his conclusion up front:

> When the rate of return on capital significantly exceeds the growth rate of the economy (as it did through much of history until the nineteenth century and as is likely to be the case again in the twenty-first century), then it logically follows that inherited wealth grows faster than output and income.

The reasoning is fairly straightforward: Assume that someone who owns capital earns an average annual real return of 5 percent and that the rate of growth of the economy is 3 percent. If the owner of capital can live on 1 percentage point of the annual return, his wealth will grow at 4 percent per year, which is higher than the economy's growth rate. We need only one more assumption: that the capital owner has only one son or daughter who, in turn, will live on that 1 percentage point per year. *QED*.

In short, Piketty's conclusion follows logically, *but only if* we include assumptions about the number of heirs and their spending discipline. But if, for example, each wealthy person has three heirs who dissipate the wealth, those heirs will leave little to *their* heirs. So, based on just Piketty's skimpy assumptions, his claim does not follow logically. He, unfortunately, starts out by overstating his case. He could be right empirically, though, and he presents evidence for the growing share of income earned by owners of capital, much of which they inherited.

We are still left with the question: "So what?" Imagine—as Piketty has convinced

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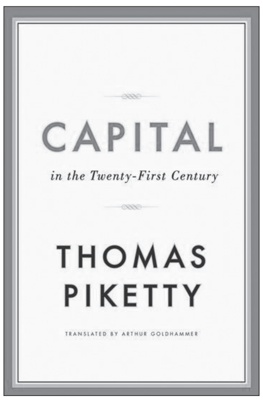
me seems at least plausible—that the share of income going to owners of capital could rise over time, which means that the share of income going to labor would fall. Would that mean that laborers are worse off? Not at all. In fact, they are likely to be better off. Unfortunately, many people who read the book, especially those who are not economists, could easily miss this point for two reasons: (1) Piketty's emphasis on income *shares* rather than on real income; and (2) his misleading language. We would expect an emphasis on shares rather than real income from someone who believes that inequality of wealth and income, rather than improvements in standards of living, is "at the center of economic analysis."



Capital in the Twenty-First Century

By Thomas Piketty

685 pp.; Belknap Press of Harvard University Press, 2014

Misstatement / What compounds the misleading impression is Piketty's misleading language. For example, in discussing his country, France, he writes, "Probate records also enable us to observe that the decrease in the upper decile's share of national wealth in the twentieth century benefited the middle 40 percent of the population exclusively." But as he well knows, French wealth per capita grew enormously in the 20th century, and so the decline in share of the wealthiest does not imply an absolute decline in wealth. Moreover, even if the wealthiest French people *had* lost wealth in absolute terms, the higher share of the people below them is not sufficient evidence that the wealthiest group's decline benefited the middle 40 percent. The middle 40 percent could have done better simply because of their own savings and investments.

Piketty's misleading explanation of the French case above is not an isolated weakness. Throughout the book, he writes as if he thinks that wealth is zero-sum and, thus, that increases in various groups' wealth *must* come at the expense of others. Writing about early 19th-century France, for example, he refers to a "transfer of 10 percent of national income to capital." But a look at his Figure 6.1, on which he bases this claim, shows no such transfer. All it shows is that the share of income going to capital rose. Similarly, in discussing the United States in the late 20th century, he calls an increase in the income share of the top 10 percent an "internal transfer between social groups." Never mind that on the very same page he admits that income for the bottom 90 percent slowly grew over the same period.

Or consider Piketty's statement about the United States and France: "And the poorer half of the population are as poor today as they were in the past, with barely 5 percent of total wealth, just as in 1910." That is nonsense. If the poor have the same percentage of wealth as they had in 1910, they are much richer because wealth is much greater, as Piketty well knows. Here, he has gone beyond misleading language into actual error.

One important factor that Piketty gives very little attention is the mobility of people between wealth levels. There is a constant churn as people gain and lose wealth. Much of this churn is due to what Joseph Schumpeter called "creative destruction." Entrepreneurs and investors come along with new ideas that, if they succeed, will make them a lot of money (the creative part) and cause existing firms to lose money (the destructive part). Piketty's neglect of that churn shows up in his discussion of the *Forbes* 400 list of the wealthiest people in the world. He writes that the average wealth of the *Forbes* 400 rose from about $1.5 billion in 1987 to nearly $15 billion in 2013, "for an average growth rate of 6.4 percent above inflation." Fine, so far. But from this he concludes, "[T]he largest fortunes grew much more rapidly than average wealth." But we can't reach that conclusion based on the *Forbes* 400 data. The reason: in those 16 years, there was huge turnover in who was in the *Forbes* 400. Undoubtedly, the wealth of many of the 1987 *Forbes* 400 who dropped out in later years fell. Whether that was enough to cause the average wealth of members of the 1987 *Forbes* 400 to grow more slowly than the average wealth of the general population, I don't know. What I do know is that Piketty would have had to check that to reach his conclusion—and he did not do so. Or, more correctly, neither his book nor his online technical appendix contains the data that would allow one to reach his conclusion.

Central wealth planner / For those who are worried about growing wealth inequality because their own wealth is not growing, there is a simple solution: save more and invest in stock market index funds. And, to the extent possible, do so with tax-favored 401(k) and 403(b) plans and Individual Retirement Accounts (Roth or non-Roth). When a friend who studies saving patterns of various ethnic groups in America visited me some years ago, I told him that my wife and I normally save between 15 and 20 percent of our before-tax income. His eyes grew wide. "You're Korean," he said, jokingly. Of course, hitting that saving rate meant that we didn't go to Europe or Asia, didn't buy $40,000 cars or $200 shoes, didn't buy expensive clothes, and didn't drink alcohol when we went to restaurants. What a tough life!

Piketty does not give any space in his tome to making that point. He writes as if he is the central planner making decisions from the top down and essentially disregards the fact that people are individuals who want to deal with their individual situations.

But even as central planner, Piketty fails. The driver of his model is his strongly held assumption that the rate of return on stocks will substantially exceed the growth rate of the economy and the growth rate of real wages. Under Social Security, your benefits will grow at no more than the growth rate of real wages because your benefits are paid by Social Security taxes on current workers. So, wouldn't it make sense to let people invest their Social Security taxes in stocks rather than get only the low rate of return that they get now? Piketty says no. He makes one good argument for this, one I myself have made: the transition problem out of the Social Security Ponzi scheme is wicked. But his other argument is that investing in stocks is "a roll of the dice." What happened to his confidence about the rate of return on stocks?

Given his emphasis on—and distaste for—inequality and his conclusion that owners of capital will get an increasing share of an economy's output, it's not surprising that Piketty favors much higher taxes on wealthy people. He argues briefly that the optimal top income tax rate in richer countries is "probably above 80 percent." He claims that such a rate on incomes above $500,000 or $1 million "will not bring the government much in the way of revenue"—I agree—but will drastically reduce the compensation of high-paid people. He also suggests an annual "global tax on capital," with rates that would rise with wealth. "One might imagine," he writes, "a rate of 0 percent for net assets below 1 million euros, 1 percent between 1 million and 5 million, and 2 percent above 5 million." One might imagine many things; I take it, as virtually every reviewer pro or con has, that Piketty is not just "imagining" those taxes, but actually *advocating* them. He adds that "one might prefer" a stiff annual tax of "5 or 10 percent on assets above 1 billion euros."

But if there is anything we know in economics, it is that incentives matter. An annual tax on capital will reduce the incentive to create capital. With less capital than otherwise, the marginal product of workers will be lower than otherwise. Bottom line: Piketty's proposed tax on capital would hurt labor.

How does Piketty handle this serious problem? He doesn't. The only behavioral response to a tax on capital that he discusses at length is that owners of capital would move to lower-tax countries. To avoid that happening, he puts a lot of thought into how to form, essentially, a tax "cartel" in Europe. He would have countries in the European Union agree to tax capital, making it harder for people to move to lower-tax countries.

Even an economist who likes Piketty's book and favors his tax on capital has pointed out its bad effects on economic well-being. In his *New Republic* review, MIT economist Robert Solow, who won the Nobel Prize in economics for his pioneering work on economic growth, wrote:

> The labor share of national income is arithmetically the same thing as the real wage divided by the productivity of labor. Would you rather live in a society in which the real wage was rising rapidly but the labor share was falling (because productivity was increasing even faster), or one in which the real wage was stagnating, along with productivity, so the labor share was unchanging? The first is surely better on narrowly economic grounds: you eat your wage, not your share of national income. But there could be political and social advantages to the second option. If a small class of owners of wealth—and it is small—comes to collect a growing share of the national income, it is likely to dominate the society in other ways as well.

Translation: if capital is taxed heavily, workers' well-being will not improve, but because a tax on capital will likely stem the increase in the share of income going to owners of capital, wealthy people will dominate the society less than otherwise.

What's the problem? / For Piketty and, presumably, Solow to calmly countenance the possibility of stagnating real wages just to keep capital's share from increasing, they would have to see some large problems with increasing inequality. Solow does not point out any such problems, which makes sense because his review is short. But Piketty, in over 600 pages, does not make a clear statement about why increasing inequality is a problem in a society where almost everyone's lot in life is getting better and better.

So let's fill in the gaps. How big a problem is wealth inequality? In my opinion, if people came by their money without cheating others and without getting special government favors, then there is no problem with those people becoming very wealthy. What really matters is inequality in consumption and, here, the differences between poorer Americans and wealthier Americans are probably as low as they have ever been. Most lower-income people have color televisions, cell phones, refrigerators, comfortable clothing, and three square meals a day. That was not true 60 years ago. Or take a longer view: In the mid-19th century, the poorest people in American were probably slaves. The largely rich people who "owned" them could treat them very badly if they wanted to. And even if they did not want to, let me repeat that these poor people were *slaves*.

Or consider finer differences between the middle class and the wealthiest. You would have to look carefully—at least, I would—to see the difference in the quality of clothing between billionaires and those with a net worth of "only" $100,000. Both can travel by jet, but the wealthier person can get there more quickly and easily on his private jet. The rest of us have to share space. The private jet is certainly nicer, but is that really a major social problem?

Irrelevancies and error / Piketty, not to his credit, sometimes uses ad hominems in place of actual argument. I note two. Although Piketty does not name the targets outright, one ad hominem is targeted at my Hoover Institution colleague Kenneth Judd and economist Christophe Chamley. Judd and Chamley, in separate articles, found that under certain strong assumptions, the optimal tax rate on capital is zero. Under those assumptions, they concluded, taxing capital would, by reducing capital, make workers worse off than otherwise. How does Piketty deal with their finding? By challenging their motives. He writes, "Some economists have an unfortunate tendency to defend their private interest while implausibly claiming to champion the general interest." It might surprise Piketty that Judd is a dyed-in-the-wool registered Democrat with whom I argue about redistribution. (I'm the one who's against it.)

Piketty's second ad hominem is, surprisingly, against Yale University economist William Nordhaus. In discussing global warming, Piketty contrasts the views of Nordhaus and British economist Nicholas Stern. Stern wants governments to act quickly and massively to reduce global warming, while Nordhaus wants a more gradual approach. Piketty claims that Nordhaus's position is "opportunely consistent with the U.S. strategy of unrestricted carbon emissions." Besides being an ad hominem, Piketty's accusation of opportunism makes no sense. Why? Because Nordhaus is one of the leading U.S. economists who *does* want the U.S. government to use carbon taxes to restrict carbon emissions.

On this issue, Piketty is also badly misinformed in another way. He argues correctly that one main difference between Stern and Nordhaus is the interest rate they use to compute future benefits of reducing carbon. But he incorrectly claims that Stern uses a discount rate of about 1 percent per year. In fact, Stern uses a discount rate of 0.1 percent per year, a big difference when considering benefits out over 100 years.

Interestingly, Piketty does not completely understand the economic case for carbon taxes as a way to deal with global warming. He writes, "There is good reason to believe, however, that the price signal [that carbon taxes would lead to] has less of an impact on emissions than public investments and changes to building codes (requiring thermal insulation, for example)." Certainly some level of carbon taxes could have a greater effect on emissions. But that is not the point. The case for carbon taxes over government picking of winners and government regulation is that the taxes lead to a given reduction of emissions at a *lower* cost.

Early in the book, Piketty writes about his frustration with mainstream economics: "My thesis consisted of several relatively abstract mathematical theorems." I share that frustration. But there is a lot of very good economics, both within and outside the math. You do not need much math to show the superiority of carbon taxes over government spending and regulation.

I should not leave this review without mentioning a glaring historical error on tax rates. According to Piketty, the top income tax rate under President Herbert Hoover, Franklin D. Roosevelt's predecessor, was 25 percent. In fact, it was Hoover, a president from the progressive wing of the Republican Party, who raised the top rate to a whopping 63 percent.

Conclusion / I end with a positive: In his chapter on global capital taxes, Piketty writes:

> A seemingly more peaceful form of redistribution and regulation of global wealth inequality is immigration. Rather than move capital, which poses all sorts of difficulties, it is sometimes simpler to allow labor to move to places where wages are higher.

He calls immigration "the mortar that holds the United States together." Unfortunately, he also sees immigration as something that "postpones the problem" of global wealth concentration. Let's see: Deregulation of labor markets will allow hundreds of millions of poor immigrants to be substantially better off but will only postpone a problem that Piketty worries about and I don't. I'll take it. *R*

A Clumsy Case Against Markets

REVIEW BY DWIGHT R. LEE

Jeremy Rifkin, president of TIR Consulting Group and the Foundation on Economic Trends, occasionally acknowledges the productivity of capitalism in his new book, *The Zero Marginal Cost Society*. But he is happy to explain why this productivity is decimating capitalist profits and rendering private property and market prices unnecessary relics. Capitalism, he says, is being replaced by far better economic arrangements.

Of course, that claim has been made by many others, including Karl Marx. Rifkin's argument, however, is quite different from Marx's. Of the two, I am more sympathetic to Marx because he was unaware of the many subsequent advances in economic understanding that undermined his ideas. Rifkin has no such excuse. He should have noticed the bright red warning signals those advances were flashing at him as he blissfully made his case that technological progress is relegating market-based capitalism to a minor economic role.

For example, he believes marginal cost provides such strong support for his argument that he includes it in his title. Yet he overstates the prevalence of "near zero marginal costs," while making an argument about marginal costs that is undermined by both theory and experience. He completely fails to notice that the technological progress he highlights is increasing the advantage and extending the range of markets.

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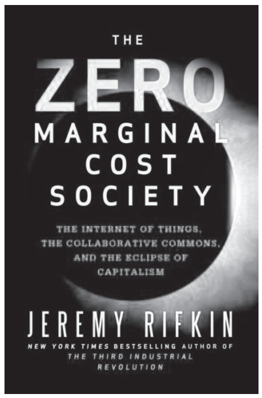
Coase knew better / In Rifkin's view, technological advances are rapidly increasing the number of goods that can be produced at very low marginal cost. Further, "when near zero marginal cost is reached, goods and services become nearly free, profit margins evaporate, and private property exchanged in markets loses it reason for existing. The market mechanism becomes increasingly unnecessary in a world of nearly free goods…, and capitalism shrinks to a niche economic realm."

But never fear, in the "Collaborative

Commons” that he says is replacing markets, “[t]he new spirit is less … concerned with the pursuit of pecuniary interests and more committed to promoting quality of life; less concerned with accumulating market capital and more with accumulating social capital; less preoccupied with owning and having and more desirous of accessing and sharing.… [T]he new social entrepreneurs [are] less driven by the invisible hand and more by the helping hand.”



The Zero Marginal Cost Society

By Jeremy Rifkin

368 pp.; Palgrave Macmillan, 2014

Rifkin is correct in observing that technology has increased the number of goods and services that can be provided at nearly zero marginal cost. How large that number is is another matter, as are some of his examples such as health care and energy, although I shall largely ignore those matters. I will also give him a pass for leaving the impression that nearly zero marginal cost makes a good nearly free. He clearly recognizes throughout the book that there are significant fixed costs that typically have to be incurred to produce goods at nearly zero marginal cost. Indeed, he uses that fact to explain why he believes profits vanish for nearly zero marginal cost goods because efficiency requires nearly zero prices for them.

However, goods produced at nearly zero marginal cost have long been supplied profitably and rationed through markets more efficiently than they could have been without markets. Rifkin forgets that the marginal cost of consuming a good can be high even though that consumption does not add much, if anything, to production costs. A price high enough to equal the marginal production and consumption costs can be high enough to cover a large fixed cost of production.

Consider Rifkin’s discussion of the debate between economists Harold Hotelling and Ronald Coase over how to finance bridges and provide and distribute broadcast spectrum and hydroelectricity. Hotelling argued that once the investment was made to build the bridge, provide and allocate broadcast spectrum, or furnish the equipment necessary to generate and distribute hydroelectricity, market competition would result in the price to consumers being only enough to cover marginal cost, and government would ultimately have to cover the large fixed cost. Coase, on the other hand, realized that though the marginal cost of such goods would often be nearly zero, firms likely would find ways to cover the fixed costs, and the resulting efficiency meant it was still better to use market mechanisms.

Eclipse of capitalism? / Rifken ignores at least two reasons why providing and rationing high-fixed-cost and low-marginal-cost goods and services is best done through market prices, as Coase argued. First, using the example of a bridge, the marginal cost of using a bridge is effectively zero only until some capacity constraint is reached. And building a bridge so large that its capacity constraint is never reached would be wasteful. Once that constraint is reached, each additional user imposes cost on other users, but that marginal cost does little to discourage use because the cost created by each driver is spread almost entirely on other drivers. During rush hour that cost can become very high, as reflected by long delays. Fortunately, technological advances Rifkin sees as undermining the price system make peak-load pricing schemes possible. The price of bridge use could be easily adjusted to closely match the changing marginal cost of use. There is, of course, no guarantee that those prices will be enough to cover the bridge’s fixed costs. But if that cost is not covered, a monthly or yearly access charge could be levied on regular users that, along with the marginal charges, would cover all of the bridge’s fixed and variable costs.

Second, private pricing arrangements also provide suppliers with information on how large high-fixed-cost facilities providing relatively low-marginal-cost goods should be, and how much to expand the size and number of such facilities when the social value of doing so exceeds the social costs. Further, the information comes in the form of anticipated revenues that motivate suppliers to respond appropriately to it.

Not surprisingly, many high-fixed-cost and low-marginal-cost goods and services, such as electricity, exercise facilities, education, book publishing, hotels, airline travel, software, amusement parks, country clubs, moving pictures, television broadcasts, and rock concerts, are being provided privately, profitably, and efficiently through markets. There is no evidence that the private firms and organizations providing those goods and services are an economic Titanic that has hit the technological iceberg Rifkin believes is leading to “the eclipse of capitalism.” In contrast, it is when government is financing and often providing services such as education, passenger rail service, postal delivery, or infrastructure maintenance that we find the best examples of excessive costs, poor service, and general disregard for the interests of those paying the bill.

Renting or ‘sharing’? / Interestingly, Rifkin never discusses the work for which Coase is best known, which is his study of transaction costs. According to Rifkin, “Coase’s singular achievement, which helped secure him the Nobel Prize in economics, came … when he penned his treatise on privatizing the [broadcast] spectrum.” That work was certainly an important contribution, but first and foremost, the Nobel Committee recognized Coase “for his discovery and clarification of transaction costs and property rights for the institutional structure and functioning of the economy.”

Perhaps Rifkin ignores Coase’s work on transaction costs because it explains why markets—which have always been the best means for realizing the sharing and social cooperation that he applauds—are achieving those goals better than ever because of technological advances that Rifkin claims are undermining markets. Coase recognized that there are transaction costs associated with all exchanges and they prevent some exchanges that would otherwise be beneficial. By reducing transaction costs, technological advances are increasing the advantages markets provide.

Yet Rifkin sees near zero marginal cost as the critical factor in what he describes as the birth of a "sharing economy…, a different kind of economy—one far more dependent on social capital than market capital…, an economy that lives more on social trust rather than on anonymous market forces." What distinguishes this new and different kind of trusting and sharing economy from the old, soon-to-be-eclipsed capitalism based on markets? His answer: more renting!

Of course, Rifkin introduces his new economy in more grandiose terms, seeing it as a "powerful new economic movement [that] took off overnight, in large part because a younger generation had a tool [i.e., the Internet] at its disposal that enabled it to scale quickly and effectively and share its personal bounty on a global Commons." But what is being shared? He lists automobiles, bicycles, homes, clothes, tools, toys, and skills as some of the things that millions of people are now sharing. Interestingly, not one of those items has a near zero marginal cost of production. (Earlier, Rifkin does mention people freely sharing zero-marginal-cost music obtained through Napster, which could temporarily be done at no personal cost.)

Most of the items he discusses are not shared primarily as gifts, but are commercially available through new or improved rental markets made possible because of reduced transaction costs. As he discusses under the heading "Sharing Everything," Internet services are—for a price—allowing more people to conveniently rent out rooms in their homes, exchange their children's toys through rental or barter arrangements, and expand the rental market for men's, women's and children's clothing. Earlier in the chapter he applauds car and bike sharing arrangements that result in more people making more productive use of those items than in the past. But again, the explanation for such practices is not near zero marginal production costs for cars and bikes or a more generous younger generation; instead, recent reductions in transaction costs make it commercially feasible to move cars and bikes, and an increasing number of other goods, to people who can make the most valuable use of them, even if only for a short period of time. Markets are being improved and expanded, not eclipsed, by such technology advances.

Conclusion / Even if Rifkin were convinced that his analysis is wrong and markets are improving, I suspect he would continue hoping his "Collaborative Age" renders them obsolete. His arguments and hope for this age ultimately depend not on economic considerations, but on his desire for "an expansion of empathy to include the whole of the human race as our family" and the quick elimination of "the remaining ideological, cultural, and commercial boundaries that have long separated 'mine' from 'thine' in a capitalist system mediated by property relations, market exchanges, and national borders." In other words, he is trying to convince readers that we will soon dispense with private property and market exchanges, as men and women (motivated by empathy alone) somehow acquire the information to coordinate their actions with "hundreds of millions of human beings—I suspect even several billion—" to better serve the interests of all by "tearing down the walls that have long divided people by gender, class, race, ethnicity, and sexual orientation."

Transaction costs prevent some exchanges. By reducing those costs, technological advances are increasing the advantages that markets provide.

Rifkin's book has sold a lot of copies. (Interestingly, the Kindle edition sells for almost $13, despite the near-zero marginal cost.) I suspect those sales reflect the emotional appeal of a morality based on intentional sharing and cooperating. That morality blinds large numbers of people to the benefits we all realize from the extended market order. Rifkin is so hopeful that the morality of good intentions (appropriate in families and small groups) is also one on which the global economy can be based that he fails to see the widespread sharing and cooperation already being achieved through markets. Billions of people are sharing a multitude of goods with each other every day in response to market prices that are constantly motivating some to decrease their consumption of particular goods so those who value them more can increase their consumption. This is a far more effective way of sharing than is remotely possible without the information communicated through market prices, no matter how much empathy and caring we feel for the billions of members of our "global family." Of course, Rifkin—along with many others who yearn for an economic order based on people intentionally caring for each other—finds it difficult to accept responding to market prices as sharing. And sharing on a global scale is a special case of the global cooperation that can be achieved only through the motivation and information communicated through markets anchored in the morality of obeying general rules that promote the general interest.

Rifkin's book provides economists a window on the difficulty we face in communicating to the public our understanding of the virtues of markets. Explaining the desirable consequences of markets is necessary if a strong case is to be made for them, but it is not sufficient. We have to also recognize the powerful appeal and importance of morality based on intentions and explain how it is consistent with, and complementary to, the rule-based morality of global markets. R

IN REVIEW

The Problem of Water

REVIEW BY GARY D. LIBECAP

As I write this, California is in the midst of a severe drought that the National Climate Assessment Review claims is a consequence of climate change (never mind that tree-ring data show that California long has experienced severe drought). Water has always been important in the West, but now it is one of the top political issues.

Challenges include how to get urban users to conserve (e.g., replace landscaping with drought-tolerant varieties, install low-flush toilets), augment urban supplies (e.g., desalinization, recycling), shift some water use away from agriculture (where up to 80 percent is now consumed), and protect natural habitats (e.g., instream flows, endangered species, recreational use).

Those challenges can be addressed far more straightforwardly than is evident in most of the policy discussions. Solutions lie in strengthening existing private water rights, improving water measurement, and defining groundwater rights and the hydrological links between surface and groundwater use. Other possible steps include providing trading platforms, streamlining the regulatory process for water rights trading, and continuing adjustments in beneficial-use requirements for maintaining water rights to include environmental flows.

With clearly defined private rights, markets reallocate water to meet new demands, communicate opportunity costs, signal scarcity, and provide incentives for irrigators, urban dwellers, industrial users, and environmentalists to moderate demand and invest in conservation. Remedies can be quite simple because a water rights system is already in place. We need only clarify those rights where they are ambiguous, as I discuss below.

Unfortunately, this opportunity is not the one called for by advocates for greater state intervention, regulation, and management. For many, the public nature of water makes meeting resource challenges through markets inappropriate, and hence the corresponding demand for government action. Viewing water as a public resource rather than a private one limits entrepreneurial solutions to the problem of water. Pronouncing water a public resource places so many interests at the policy table that few creative solutions emerge—there are too many conflicting objectives and no clear way of arbitraging across them. Gridlock and waste are the results. This is Michael Heller's tragedy of the anticommons, whereby multiple gatekeepers block socially productive results.

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Water in the West / Where does the public nature of water come from? One source is that water is necessary for life, and in semi-arid and arid regions communities congregate around water sources and only there can natural habitats flourish. Hence, water supposedly is too critical to be entrusted to markets. State ownership, distribution, and management are the alternatives. These are the conditions faced in most of the world and they provide many of the examples of corruption, waste, and neglect that David Zetland cites in his new book, *Living with Water Scarcity.*

A strong claim for the public nature of water was made in Joseph Sax's influential 1970 *Michigan Law Review* article that called for water to be a public-trust resource, an issue I examine below. Another source is the recognition that multiple parties share the same water. For example, under the "prior appropriation" doctrine that grants water rights on the basis of time of claim in the U.S. West, initial water diverters may consume 50 percent or less of it, with the remainder percolating back to the source for subsequent use by others. Changes in consumption reduce return flows, possibly affecting third parties. This is the basis for regulation of water trades, and some states like New Mexico accomplish this more smoothly than do others like California where the process is more cumbersome.

The private nature of water arises because water is a productive input into virtually every human activity, from food production, to copper mining, to Google Internet searches, to recreational fisheries and river rafting. Water can be measured and bounded, though that can be difficult because water is a fluid. Nevertheless, water can be partitioned among competing uses so as to avoid open access and the tragedy of the commons. Water can be traded. Where private water rights exist, water is conserved and effectively used far better than where private water rights do not exist, such as in many developing countries where water is a communal or state-owned resource. Accordingly, the problem of water is due to the lack of definition of water rights and missing markets, rather than a fundamental, unique characteristic of the resource.

Prior-appropriation water rights developed in the U.S. West through first possession in the same manner as private rights to mineral and agricultural lands. Claimants searched for stream locations where flows would last through much of the year, filed for ownership of sufficient water to meet their needs, and constructed diversion dams and ditches to transport water.

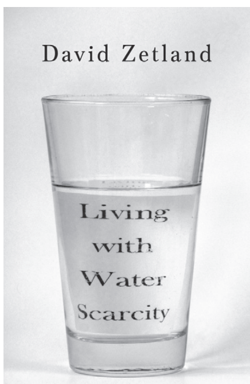
The water had to be put to beneficial use so that excess remained for others. Under this arrangement, mining and agriculture—the two early sources of the region's economic development—grew. Mutual ditch companies or irrigation districts were formed to coordinate infrastructure investment. Later, the Federal Bureau of Reclamation (BOR) provided dams, canals, and agricultural subsidies—a result of interest-group politics. After 1926 the BOR could only contract with irrigation districts for water delivery.

Urban areas also got into the act. Los Angeles built the Los Angeles Aqueduct and later the Colorado Aqueduct to transport water to the city, as did San Francisco from Hetch Hetchy. To obtain water, Los Angeles bought water rights from farmers in the Owens Valley, an exchange that has been misrepresented by critics of water markets. (See "The Myth of Owens Valley," Vol. 28, No. 2.) California's State Water Project largely is designed to bring water from the north to the highly urbanized south. Water potentially can be bought and sold along the system's vast infrastructure.

Rising urban use today, along with increased demands for stream-flow maintenance, calls for movement of water from historical agricultural uses to cities and the environment. Drought intensifies the need for reallocation. This does not have to be a problem, however. More water can be purchased. Unfortunately, what could be a straightforward process has been made more difficult by the refusal of many advocates to rely on existing water rights and by the failure of politicians and agency officials to smooth the regulatory process. As a result, formal water trades in California, for example, have been flat since roughly 2005 despite the drought, and throughout the West water marketing is far more limited than one would expect.

Why is that? It is because too many parties want additional water without paying for it, an objective legitimatized by the public trust doctrine. Accordingly, water does not flow routinely from one use to another through markets as demands and supplies shift. The failure to rely on markets means that opportunity costs are not fully reflected in new calls for environmental flows, in construction of desalinization plants and other supply-augmentation capital, and in farm planting and urban development decisions. Moreover, incentives for conservation or investment in water quality are diminished. Not all water would leave agriculture, but water of lower marginal value would move to other applications.

Missed opportunities / In his book, Zetland had an opportunity to clarify the policy debate because he generally understands water and he writes well and engagingly. But it is an opportunity that was missed. *Living with Water Scarcity* is a short book of water parables—so many are presented that they do not explain Zetland's points well, and some that stress community ownership are both confused and unhelpful.



Living with Water Scarcity

By David Zetland

124 pp.; Aguanomics Press, 2014

In the best part of the book, "Water for You and Me," Zetland examines private water uses, particularly urban water and the problems encountered when monopoly urban water supply organizations fail to price water effectively. He points to the absurdity of the Southern Nevada Water Authority in Las Vegas underpricing water while at the same time paying households to use less. He might have placed more emphasis on the power of pricing as evidenced in Phoenix and Tucson, where residents in Phoenix face flat prices and use over 50 percent more water per capita than do people in Tucson who face steep block-pricing schedules. One city looks like an oasis, whereas the other looks like the desert city it is.

Chapters 1–4 provide valuable arguments about why urban water management seems so out of sync with new supply and demand conditions and offer suggestions as to what might be done to improve things. Chapter 5, "Food and Water," and Chapters 6–10 in the second part of the book, "Water for Us," are far less carefully argued or thought out. Here Zetland allows the public nature of water to confound potential private solutions. Despite earlier criticisms of bureaucrats and politicians for inefficient water pricing, infrastructure investments, and distortive water subsidies, he is far too quick to call for community management of water in line with the public trust. The community is never defined, and why politics fails in one case but not another is not explained.

In Chapter 5, Zetland describes his strongest policy recommendation: farmers should be required to buy and sell water through an auction process so that they bear the full opportunity costs of the water they use. Minimum environmental flows are to be deducted following the recommendations of scientists, and the remaining water should be auctioned. On first glance, that all seems great, but then many objections come to mind. First, how will scientists weigh the value of competing uses or opportunity costs? A lack of cost-benefit analysis already occurs under the Endangered Species Act and few would find expansion of this practice a useful approach for water. Second, farmers are not the source of the problem. They are aware of opportunity costs, and most would be pleased to sell or lease water that could earn them more than they generate from agricultural production. Indeed, farmers in the Palo Verde Irrigation District in California have done just that by selling options to San Diego to draw on some of their water during drought-induced shortages.

The ability to trade water makes opportunity costs and scarcity values apparent to existing rights holders. Where agricultural trades have been blocked or made very costly arises when water rights are not clearly defined and community approval is mandated. This has occurred in the Imperial Irrigation District's effort to sell water to San Diego and the recent abortive effort of the Oakdale Irrigation District to lease water to the Westlands Irrigation District (California's largest). A similar setting exists in the Turlock Irrigation District where farmers pay $30 per acre-foot of water (325,000 gallons), but they could sell it for $2,000 per acre-foot or more to Westlands if they were allowed to do so. In all three cases, community members are granted a veto over proposed water transfers.

In these cases, water rights are so diffused and uncertain that no party (except farmers) bears the opportunity costs of failed exchanges. The solution is to define water rights more precisely. Those who seek to keep water in the community could buy it in competition with outsiders. Additionally, because distributional issues loom large in rural areas, a limited mitigation fund could be set up from some of the transfer revenues to compensate parties economically harmed. The Palo Verde trade to San Diego included such a fund, even though farmers had clear rights to sell. The practice of restricting trades is a broad one. Some 22 counties in California have enacted ordinances to block groundwater transfers out of the county.

Zetland calls for "getting rights right" via auction, but as shown above this is not the solution to the problem. Auctioning would confiscate existing prior appropriation rights, not strengthen them. No high-priority rights holder would find this remedy attractive, and the prospect would only shorten time horizons and dim assessment of opportunity costs. If auctions are mandated, water would be moved from existing owners into the political process. The brief book discussion does not make clear whether such auctions would be recurring, or how or if water secured through auction could be traded subsequently and for how long.

As generally outlined in the second part of the book, water would become a public or communal resource. The conditions under which communal management of any natural resource is successful and when it is not are not outlined. As Nobel economics laureate Elinor Ostrom's work has revealed, common management works best under settings where participants are few in number and fairly homogenous in resource objectives. That does not describe water. We have other empirical evidence. Consider the more than 370 million acres of so-called public lands in the continental United States that are under the supervision of the U.S. Forest Service and the Bureau of Land Management. Although environmental advocacy groups and others who seek political access and control over those lands benefit from this arrangement, most studies indicate that the public lands are less well managed and allocated across uses than are private lands. This government management experiment has been running for a long time, so why should we believe that greater political oversight of water would have a different outcome?

Zetland is concerned about protecting stream flows, but this is possible with markets. Private water rights are routinely traded for augmenting stream flows by Oregon's Freshwater Trust. Rights are respected, instream flows count as beneficial use to maintain the right, and environmentalists pay for the water desired for streams. Hence, state environmental mandates are not necessary to protect aquatic and riparian habitats. Moreover, more public control and management of water under the public trust doctrine is counter to trends with other natural resources where government regulation has been found wanting. In fisheries, individual transferable quotas and rights-based arrangements provide important advantages relative to command-and-control regulation. (See "Learning How to Fish," Vol. 37, No. 1.) Similarly, in air quality, a nationwide market in sulfur emission permits rapidly met clean air objectives at lower cost than did Clean Air Act regulations. Tradable development rights and conservation habitat credits have lowered the costs of achieving land use controls relative to government mandates. Why should water be different?

Sax's commons / As a legal principle, the public trust doctrine historically applied narrowly to the right of the public to access navigable waterways without being impeded by private riparian owners. Through the 19th century there was limited extension of the doctrine to public ownership of some tidelands and subsurface lakebeds. The much broader idea that the public had superior rights to non-navigable waters, wildlife, and other natural resources was outlined in Sax's 1970 paper, contemporaneous with the rise of the modern environmental movement.

Sax argued that the public trust doctrine could be employed as a powerful tool for judicial intervention for environmental regulation. The judiciary could direct public policy for protecting diffuse public uses from narrow private ones. The article energized legal scholars and advocacy groups to expand the doctrine and weaken private property rights. Under the public trust, the rights of the public are vested in the state as trustee, and the state administers, protects, manages, and conserves the resource. Any existing uses have only usufruct rights that can be withdrawn whenever the state deems that they are inconsistent with the public trust. The public trust doctrine, therefore, provides for a major extension of the police powers of the state. The counterfactual outcome of state administration is never made clear by advocates. Other than private property rights and markets, what political model do they have in mind that would make politicians and bureaucrats more responsive to shifts in resource demand and more concerned with efficient management and conservation? Advocacy groups and agency officials are critical of private property rights because if rights are well defined, those parties have little ability to direct the resource in a manner they desire unless they pay for it. This, however, is not a compelling argument for how to address the problem of water.

The most celebrated incorporation of the public trust doctrine came in 1983 when the California Supreme Court in *National Audubon Society v. Superior Court* ruled that the "core of the public trust doctrine is the state's authority as sovereign to exercise a continuous supervision and control over" the waters of the state to protect ecological and recreational values. The ruling expanded the role of the state in reallocation of water as public values changed; asserted that existing rights were nonvested and therefore could be reallocated without compensation; and affirmed broad, open standing to citizens to raise a claim of harm under the public trust against private water users.

The focus of *Audubon* was conflict over Los Angeles's water rights to the Mono Basin. The city acquired those rights in the 1940s and began major diversion of water in 1970. Owens Valley and the Mono Basin supplied 80 percent or more of Los Angeles's water that was so pure it required no treatment and its flow through the Los Angeles Aqueduct generated hydropower. Over time, however, Los Angeles's water diversions had substantial adverse effects on Mono Lake and its surrounding environment. That brought growing opposition. Advocacy groups such as the National Audubon Society, Friends of the Earth, the Sierra Club, and the Mono Lake Committee brought suit in 1979 to curtail Los Angeles's export of water under the public trust doctrine. The suit challenged the city's water rights. Ultimately, the California Supreme Court ruled in favor of the plaintiffs. The 1983 ruling, however, did not resolve the conflict; rather it opened the door for numerous parties to get involved and mandated the State Water Resources Control Board to intervene. The dispute took nearly 20 years to resolve, with multiple court cases and involvement by various constituent groups and government agencies. In the end, Los Angeles lost its ability to divert Mono Basin water. All the while during 20 years of conflict, Mono Lake's environment continued to worsen, streams remained dry, and riparian and aquatic habitats were unrestored.

The purchase of Los Angeles's water rights was the obvious policy alternative, but that remedy was not chosen. The case underscores how the public trust doctrine undercuts property rights; how costly it is to resolve disputes under it; and points out the absence of any clear metric, other than interest-group lobbying, for signaling changes in trust-resource values. Markets perform far more smoothly and less contentiously in communicating new values and in reallocating resources.

A major reason settlement was not reached in the Mono case was the many parties granted standing by the doctrine. It made Mono Basin water a common pool. When one plaintiff reached agreement with Los Angeles curtailing water diversions, other plaintiffs called for new, more extreme restrictions. There was a progressive rise in demands on the city. Another reason why litigation took so long was the nonvested nature of property rights under the doctrine. The city not only faced losses in water rights and associated high water replacement costs, but had to bear the costs of stranded, nondeployable capital in water export and hydroelectric generation. Los Angeles faced an all-or-nothing battle while advocates used the Mono case to elicit donor contributions. Those competing positions prolonged the process and blocked the more optimal, timely reallocation of Mono water that market transactions might have brought.

Although there was a lull in public trust efforts after 1983, those and other community management demands are rising today as drought places pressure on existing water supplies. If those demands play an important role in addressing the problem of water, as Zetland outlines in the second part of his book, then property rights and markets will be weakened further and solutions made far more costly and ineffective. That is not the best way for living with water scarcity. *R*

The Morality of Incentives

REVIEW BY PHIL MURRAY

Incentives are ubiquitous. An online retailer gives customers an incentive to buy more items by offering free shipping. A local government gives an incentive to pay taxes sooner than later by reducing the bill. Ruth W. Grant begins her book, *Strings Attached: Untangling the Ethics of Incentives*, with several examples. Some relate to business: "Companies pay schools to install soda machines or televisions in their lunchrooms." Some relate to government: "A state legislator suggests paying poor women $1,000 to have their tubes tied." What they have in common is that someone is trying to induce someone else to take a course of action. One of the author's goals "is to make visible the problematic ethical issues involved in the use of incentives." Another "is to find ways to distinguish legitimate from illegitimate incentives."

Incentives in word and deed / Readers will learn that Adam Smith never used the word "incentive." Grant tells the story: "starting in about 1600, the word 'incentive' meant 'inciting or arousing to feeling or action, provocative, exciting.'" That, of course, is not exactly the contemporary meaning.

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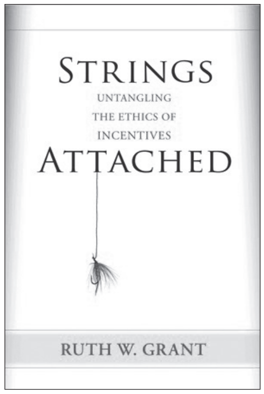
By telling the history, she aims to dispel "contemporary misconceptions that incentives are identical to market mechanisms; that they are, therefore, alternatives to social and political control; and that they have always been largely uncontroversial." I see no misunderstanding that incentives are "identical to market mechanisms." Parents pay their children to do chores. Politicians prod us with taxes and regulations. The idea that incentives are "alternatives to social and political control" sounds reasonable, even if the wording does not. People who study or deploy incentives might view them as a means of social and political *order*, but not necessarily "control."

I was ignorant of the history of incentives and therefore any past controversy. Thanks to the author I now know the historical controversy. But contrary to her view, I see plenty of current controversy. In fact, her whole book is chock full of

IN REVIEW

controversial incentives.



Strings Attached: Untangling the Ethics of Incentives

By Ruth W. Grant

202 pp.; Princeton University Press, 2014

After disappearing for decades, the word "incentive" resurfaced during the Progressive era in the subjects of "scientific management," "socialist economics," and "behavioral psychology." Frederick Taylor, a founder of scientific management, implemented incentives in the forms of "piece-rate, bonus, or premium wage systems." Scholars who debated the feasibility of socialism equated incentives to "motivation." Behavioral psychologists devised incentives to micromanage behavior.

Grant views scientific management, socialism, and behavioral psychology as social engineering. She declares that "incentive systems are one of the tools in the social engineer's toolbox." This point convinces readers, especially those who resist social engineering, that incentives were controversial during the Progressive era. However, her point that there is "danger" in today's concept of incentives is less convincing.

What is the danger? If we associate "incentive" with "motivation," Grant claims, people will think "that motivation works in the same manner described by behavioral psychologists: an external stimulus produces a response, as the smell of cheese stimulates a mouse to navigate a maze." People may be inclined to think this way. If so, the author reasons, "The danger is that all motivation will come to be conceived this way." That reasoning is perhaps unwarranted. Just because people recognize external sources of motivation, such as wages for labor, does not mean they can't see internal sources, such as the desire to do a good job. Maybe both hunger and the scent of cheese placed by an experimenter cause a mouse to search for food.

The author correctly points out that people think of incentives as "both market forces and behavior-inducing social policies." By thinking that way, she claims, "the distinction is lost between cooperative exchanges and bargains involving the exercise of power." This concern is peculiar at this place in the book, because later she equates exchange to bargaining and classifies both as "exercises of power." Nevertheless, she is onto something. We should understand the difference between, say, Walmart lowering its prices to attract customers and Congress inducing us with vouchers to sell our used cars and buy new, fuel-efficient ones. "The danger," according to her, "is that all sorts of bargains will come to seem equally benign."

Grant's 'incentives' / Grant adopts "a narrower definition of incentives" in order to evaluate which are ethical and which are not. She thinks of them as a particular kind of offer:

- an extrinsic benefit or a bonus that is neither the natural nor automatic consequence of an action nor a deserved reward or compensation,
- a discrete prompt expected to elicit a particular response, and
- an offer intentionally designed to alter the status quo by motivating a person to choose differently than he or she would be likely to choose in its absence.

The author's definition thus clashes with everyday usage. The first criterion rules out thinking of incentives as intrinsic motivation, such as the obligation parents feel to raise good children. It also rules out market prices such as wages, even though people think of wages as "compensation" for work. It is unclear whether any given offer must satisfy each of those points, or any one, in order for Grant to consider it an incentive. She admits that hers is not "the only correct" definition of incentives, and that she is not trying to impose it on everyday conversations. The problem is that such a restrictive meaning might be unnecessary to achieve her goal of differentiating between ethical and unethical incentives.

The author views coercion, bargaining (including incentives), and persuasion each as "a form of power." Although it is easy to think of persuasion as harmless, coercion as drastic, and bargaining somewhere in between, she argues that those differences are superficial. Coercion may be legitimate, as in a homeowner driving out an intruder at the point of a gun. Persuasion may be illegitimate, as in a young man charming a rich widow out of her money. With this understanding, consider Grant's three necessary conditions for any exercise of power to be ethical: "legitimate purpose," "voluntary response," and "effect on character." Her analysis of "plea bargaining, payment to recruit human subjects for medical research, conditions attached to loans by the International Monetary Fund, and incentives used to motivate children to learn" comprise the largest chapter of the book.

In the case of plea bargaining, Grant grapples with the criterion of purpose. The courts, according to her, are supposed to find the "truth" and serve "justice." Plea bargaining is unethical because it subverts both goals. When a defendant charged with murder in the first degree, for example, pleads guilty to murder in the second degree and waives his right to a trial, the evidence is not weighed to determine guilt. In other words, we do not learn the truth. As for justice, the author states, "Either the defendant is guilty but gets off easy by copping a plea, or the defendant is innocent but pleads guilty to avoid the risk of greater punishment." When a truly guilty defendant pleads guilty to a lesser charge, justice is not served to society. When a truly innocent defendant pleads guilty, justice is not served to the defendant. What if a case goes to trial and a truly guilty defendant goes free or a truly innocent defendant gets convicted? Those possibilities may be why Grant makes the qualification: "A plea bargain … is therefore, *in principle*, an inappropriate means toward the end of meting out justice."

Assuming that a medical research project has a good purpose, the author considers whether incentives to recruit subjects meet the criterion of voluntariness. Critics argue that "incentives can be too large, constituting 'irresistible' or 'coercive' offers" that therefore do not satisfy the criterion of voluntariness. Proponents of offering monetary incentives to recruit medical research subjects argue that "undue inducements" do not even exist. The critics may be on weak ground because, by their reasoning, offering $1 million to a poor person in return for being a research subject might be unethical while making the same offer to a millionaire might not. Debating voluntariness is good mental exercise, but inconclusive in this case. So the author turns to the criterion of character.

Grant tells us that "the ethically suspect incentive is one used to induce someone to do something to which they are strongly averse, particularly if the aversion is a principled one or a matter of moral scruple." Such an incentive degrades the recipient's character, as offering a bribe encourages a person to violate his or her responsibility. In one actual case, researchers approached the parents of retarded children. If the parents allowed their children to be subjects in a study "requiring the children to be infected with hepatitis," the researchers would furnish the children with care in a premium facility. Because the offer aimed to override the parents' natural inclination to protect their children from harm, Grant reasons, it was unethical. After examining a wide range of ethical issues related to medical research incentives, she recognizes this tradeoff: "The ethical responsibility to improve medical care must be balanced against the ethical responsibility to treat research subjects as autonomous individuals deserving of respect."

Today's IMF makes loans to encourage economic development. "IMF loan 'conditionality,'" the author explains, "is the practice of requiring governments to adopt certain policies and practices as a condition of receiving a loan." Those policies include "reducing budget deficits, raising taxes, raising interest rates, privatization, and trade liberalization." Grant discusses whether loan conditions satisfy her three criteria of legitimacy at length, but to no clear resolution. Thus she turns to her additional criterion and raises the question: "Does the incentive work?" Her summary of the empirical evidence is this: "Twenty years of studies [of the effects of IMF requirements] show little or no impact on growth, while the most recent studies show negative impacts on growth." If efficacy is a condition for an incentive to be ethical, IMF loan conditions are not. Yet I wonder how ineffectiveness makes an incentive *unethical*. Good intentions do not necessarily produce good results, but do bad results imply unethical incentives?

Grant equips the reader with interesting criteria to ponder the legitimacy of incentives and engages the reader into applying those criteria.

The relation between incentive and outcome arises in the case of paying students to achieve educational goals. According to Grant, the key criterion here is the effect on character. She sets a high standard: "the concern with character involves encouraging children not only to do the right things but also to do them for the right reasons." The problem is that paying students to learn will "crowd out" the intrinsic desire to learn and adversely affect character. Research shows, for example, that students who learn for nonintellectual benefits tend to cheat. Cheating is bad form. However, in my view, it is the cheating that is unethical, not the monetary incentive. Grant is not categorically against monetary incentives in education; if a student has no intrinsic motivation, then there is none to crowd out, and paying the student might kindle an interest in learning. But this reasoning seems too convenient, given the author's earlier arguments. Is the author suggesting that achieving the desired outcome legitimizes a monetary incentive to learn, even though it is not one of the "right reasons"?

Conclusion / Grant's analysis enlightens and frustrates. It enlightens because she equips the reader with interesting criteria to ponder the legitimacy of incentives and engages the reader into applying those criteria. Her analysis frustrates because, here and there, she uncritically embraces claims that seem muddled or questionable. Take this line: "The evidence suggests that when ethical motives and self-interested motives are both present, they do not act independently or reinforce each other." Does the author assume that "ethical motives and self-interested motives" are mutually exclusive? And does she believe that the "evidence" she cites overturns Adam Smith's observation on the consistency between self-interest and the common good?

Grant will side with neither libertarians who prefer the market nor progressives who want government intervention. She prefers "to distinguish legitimate from illegitimate incentives whether we find them in public or private arenas." She succeeds in this respect by putting forth the necessary conditions for an incentive to be ethical, along with several supplemental ethical questions. Progressives have something to learn from her, such as how vote trading may produce legislation contrary to the general welfare. Libertarians have something to learn, too, such as viewing voluntariness as not just requiring "choice" but also "autonomy" on the part of the chooser.

Grant asserts that both progressives and libertarians assume that human beings compute the advantages and disadvantages of every decision they make. While that may be the case, both groups would probably disagree with her subsequent assertion that they both "will tend to find incentives generally benign." Reading *Strings Attached* will nevertheless enhance the ongoing debate between progressives and libertarians. R

IN REVIEW

The Entitlement 'Crisitunity'

REVIEW BY IKE BRANNON

Writing about our nation's entitlement problem can be a bore. Anyone who is paying attention and not wearing political blinders is already aware of the problem, and there is no shortage of economists, former politicians, and other public policy mavens who have endeavored to tell the masses how much trouble we face if we do not fix this problem at once. Former comptroller general David Walker has made it his mission in life to inform the world that the sky is falling, although in such an unctuous way that most people immediately turn him off. To be fair, the intricacies of the topic lead to an eye-watering gaze.

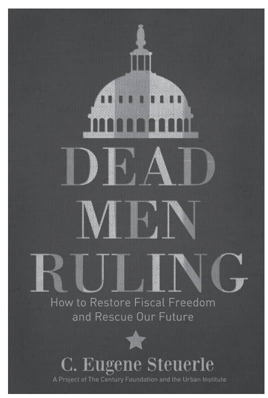
There are two different think tanks in Washington, D.C., devoted solely to producing op-eds, position papers, and conferences on the topic, and there is not a day that goes by without a sober analysis of the problem coming from *someone*. So do we really need another book on the subject?

This one we do. Eugene Steuerle has something new to say on the matter. His message—laid out in a precise and engaging manner—is that liberals, who normally are loathe to tinker with our cherished entitlement programs, have the most to lose from allowing the problem to continue metastasizing.

Social insurance with an army / Entitlements—that is, the spending on Social Security, Medicare, Medicaid, the various retirement benefits for federal government workers and veterans, and interest on the national debt—constitute fully two-thirds of federal spending in fiscal year 2014. That proportion is only going to grow in the ensuing decades: with the baby boom generation reaching retirement age and longevity rapidly increasing for those who make it to age 65, entitlement costs are on pace to constitute three-fourths of all spending by 2030, according to the Congressional Budget Office.

Before General Motors' bankruptcy, the joke among pension *cognoscenti* was that the company was really a retirement fund that happened to make cars. So what does that make a government that uses 75 percent of its tax revenue to finance its senior citizens or debt-holders? A social insurance entity with an army, perhaps—and probably not a very big army, if recent history holds true. The previous five years of trillion-dollar deficits has driven a robust bipartisan coalition to acquiesce in continuing defense cuts. While the wind-down of U.S. involvement in Iraq and Afghanistan afforded some of the cuts, the reductions have left us with a military that has significantly fewer resources to call upon should another conflict arise. This pattern has already played out in Western Europe, where the cabinet position of power long ago ceased being defense minister and is now the health minister, where the budgets are much bigger.

But Steuerle is not writing to warn the neocons. Rather, he is sounding a clarion call to liberals that they will need to choose between leaving entitlement spending untouched and their other cherished programs. Spending on education, infrastructure, health research, and general science are all at risk if we continue on the current path, he avers.



Dead Men Ruling: How to Restore Fiscal Freedom and Rescue our Future

By C. Eugene Steuerle

200 pp.; Century Foundation Press, 2014

GOP ideas? / Republicans largely (but not wholly) understand the depth of the crisis, although they usually embrace facile solutions that do not come anywhere near solving the problem. For instance, in the 2005 fight over Social Security reform, a substantial Republican contingent balked over including any reduction in the growth of the initial benefits of wealthy new retirees, a step that could have reduced as much as two-thirds of the multi-trillion-dollar shortfall. Instead, they argued that eliminating the employee's portion of the payroll tax would generate so much additional economic growth that it would not only replace the forgone revenue but also generate so much more revenue that it would erase the long-term deficit.

Cato scholar Jagadeesh Gokhale, whose book *Social Security: A User's Guide* stands apart as the most piquant analysis of the program and its shortcomings, patiently explained in a number of different places that the fact that we currently index initial benefits to wages makes it arithmetically impossible for economic growth to save Social Security. More growth ultimately begets higher wages that, in turn, beget higher benefits down the road, capturing most or all of the revenue gains from growth.

Gokhale's analysis was set aside and the push for lower payroll taxes and undiminished benefits continued until the George W. Bush administration and everyone else gave up on reform. These days there are few Republicans who lend credence to this version of Social Security reform fantasy. Reform must entail reducing the growth of benefits or increasing revenue (or both), but no politician will deliver that message to voters unless reform is an actual possibility.

Republicans have historically shown more concern about long-term structural deficits, fearing that higher government spending inevitably crowds out potentially

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more productive private spending. It goes without saying that politicians, when offered the chance, nevertheless embrace dubious spending proposals that benefit their district as well as their chances of reelection. For an example of some, simply look for Amtrak projects that are outside the Northeast Corridor.

Steuerle does not let Republicans off the hook for the current morass. His complaint is that while they may have been no more than accomplices during the various entitlement expansions (although, when it came to Medicare Part D, they were willing to do the job themselves), their tax cuts have left current Congresses unable to contemplate anything resembling a new agenda. Every dollar raised (and then some) must be dedicated to current spending plans, which cannot (owing to political constraints) be reduced enough to return us to a balanced budget in the foreseeable future.

Fiscal federalism / While Steuerle bewails such an outcome, I have a much more sanguine view of the matter. If we have truly managed to tie the hands of Congress regarding new programs, it ought to be grounds for celebration. Perhaps then we can return some of the powers and duties of the federal government to the states, where they belong.

For instance, Congress recently kicked the can down the road after considering legislation that would fund future road construction projects over the long term. The hurdle is that while everyone involved wants to do more construction than can be financed via the gas tax, there is little support for increasing that tax, and Congress's appetite for funding roads via general tax revenues (or, to be more precise, borrowing) has ebbed.

This could be a very good thing. Thanks to the diminution of gas tax revenue and the insistence by the poorer, less politically connected states that transportation monies be allocated more evenly, Congress is less able to treat the federal transportation trust fund as a giant goody bag to reward favored constituencies. If the federal government were to cut the gas tax by 95 percent and federal highway projects by the same amount, the states could choose their own projects and their own road financing mechanisms. Congress may be content with some modest redistribution and coordination, thus shrinking the federal Department of Transportation. If this were to happen, a few states would quickly come to embrace a market-based system of road financing that would result in less congestion, less need for building new roads, and less pollution as well. Once it succeeds in one state, it would spread to others.

Tying Congress's hands / The last thing I want to see is for our national budget problem to be solved before Congress hands over a few of its spending priorities to the states. But I think Steuerle underestimates the ability of Congress to rationalize away our budget predicament when it is politically expedient to do so. Congress will keep doing this until financial markets begin downgrading their expectation that the federal government will repay its debt, resulting in higher interest rates. That might not happen for a decade or two.

In the education of a political staffer on the Hill, the first lesson (besides the fact that identity politics trump all) is that it is impossible to tie the hands of future Congresses to keep them from undoing any brilliant legislation they may be considering. But the staggering future debt *is* tying Congress's hands. Capitol Hill gridlock at present is due more to the lack of money available to grease potential legislative deals than to the intransigence of Senate Majority Leader Harry Reid or the Tea Party insurgency.

It would be a shame if we were to let this crisis go to waste. *R*

Total Regulation for the Greater Whole

REVIEW BY PIERRE LEMIEUX

Published more than eight decades ago, Rexford Tugwell's *Industrial Discipline and the Governmental Arts* provided an academic defense of broad government management of the U.S. economy. The federal government had intervened in the national economy before, of course, but often under the guise of temporary measures to address national emergencies—for example, during what was then called the Great War. Even New Deal policies—of which Tugwell was an architect—were initially thought by many to be emergency actions. But Tugwell wanted that intervention to be permanent, and so it has become in many fields. It thus seems appropriate today, following another round of economic crisis and permanently expanded government intervention, that we look back on his arguments. After all, they are often the same naive arguments that we hear for expanded intervention today.

Tugwell (1891–1979) was a radical liberal (in the American sense) and a card-carrying member of the establishment. After obtaining a doctorate in economics from the University of Pennsylvania's Wharton School and spending some 15 years on the economics faculty of Columbia University, he became one of the close advisers to Franklin D. Roosevelt. On June 25, 1934, he made the cover of *Time*, in the wake of his confirmation as undersecretary of agriculture by a Senate majority of 53 to 24. He left the Roosevelt administration in 1936, worked in business for two years, and then became chairman of the New York

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City Planning Commission. In 1941, Roosevelt appointed him governor of Puerto Rico. Five years later, Tugwell returned to academic life, notably at the University of Chicago where he was director of the Institute of Planning and, until 1957, a professor of political science. In reality, he was always closer to politics than economics.

The Industrial Discipline and the Governmental Arts

By Rexford Guy Tugwell

241 pp.; Columbia University Press, 1933

The Industial Discipline and the Government Arts betrays the influence that the progressive era, World War I, and the Great Depression had on Tugwell's economic thinking. What is especially interesting is how little the book makes use of the standard tools in the economist's toolbox, despite its being written by an economist.

Planning Utopia / The book argues that the historical development of industry had made central planning inevitable. People did not live in Adam Smith's world anymore, Tugwell claimed, but in a world where mechanization had dramatically increased industrial concentration. The perennial conflict of economic life had turned against workers and consumers, who had become victims of the new business organizations. Consumers were being manipulated by advertisers and workers had fallen into "industrial slavery."

Instead of nurturing efficiency, Tugwell claimed that competition had become wasteful, neutralizing the efforts of others. Laissez-faire was a failure. In the machine age, "efficiency should infuse the whole industrial process." Machines, he said, enabled humans to substitute thinking tasks for menial ones. With tests of intelligence and such scientific measures, the best people could fill all the necessary industrial jobs while the government would support the "unfit."

Only with industrial democracy (the running of firms by their workers and engineers) and rational central planning would society be able to establish efficiency and harvest the full fruits of the machine age, as well as further justice. Like during World War I, Tugwell wrote, "[r]ational planning and control" was to replace "the vagaries of the market." "A civil service in industry," he added, "is not unthinkable."

He conceded that many economists of his time did not see the world the way he did. The reason, he said, was because "they have been lost in a tradition." In saying that—whether he realized it or not—he was confessing that he was not interested in the analytical tradition of economics.

America needed "the substitution of social for individual interest," Tugwell claimed. "Men have to think of themselves, more or less, as instruments of a social purpose":

> The individual, to get anywhere himself, must subordinate himself; must sink or swim with others. He must consent to function as part of a greater whole and to have his role defined for him by the exigencies of his group.

To achieve this, an "effective but happy discipline is required."

According to Tugwell, the public interest dictates that businesses be tightly controlled by government, which includes investment and price controls. Merely a little planning will not do because "controls inserted anywhere in the system have effects, often unforeseen, in many other places." He thus welcomed the slippery slope of ever-broadening government intervention:

> This is one reason why piecemeal regulation tends to widen and why some effort at really national planning becomes a practical issue immediately upon consideration of any planning at all.

He admitted that central planning requires the practical abolition of private property rights in economic life. Echoing the progressives, he lamented that Americans "have an exaggerated fear of invading individual rights." What people really want is security, he claimed; if America does not embrace central planning, "we are surely committed to revolution."

What we've learned / It is understandable that his apologia of central planning did not foresee the many insights into economics and government that developed later in the 20th century. For instance, Tugwell shows no understanding of political and bureaucratic processes—an understanding that eluded economists until development of Public Choice economics a quarter-century later. He assumed that democracy expresses the public interest. And he harbored a deep faith in technicians and engineers in general, and government bureaucrats in particular.

Tugwell attributed the existence of the firm to technical factors and economies of scale. He believed that the pursuit of efficiency would compel firms to grow ever bigger and thus they were destined to replace the market. It would be a few years before Ronald Coase discovered that the firm exists when the costs of using the market (transaction costs) are too large, and that firms stop expanding when the cost of internal coordination gets too high. Coase showed that the firm does not replace the market, it just creates islands of coordination within the market. Contrary to what Tugwell believed, "bigness" is not necessarily good and, when it is, it does not need to be planned by government.

He also seems not to have appreciated the immense information problems faced by central planners, an issue on which Friedrich Hayek was only then starting to write. Ludwig von Mises, however, had started that discussion. The problem is that the information needed by central planners is dispersed among millions of individual minds. Under market conditions, prices encourage those minds to coordinate in real time, but in a centrally planned economy the calculation of prices and quantities is impossible.

Tugwell mistakenly thought that the planner could know more than the participants in the industries he wanted to plan. He assumed that demand for a good could be forecasted, and that the planners could work out "the setting of a price calculated to bring just enough of it into the market." He ignored the shortages or surpluses that price controls generate.

What he should have known / But even if we pardon Tugwell for being unaware of the many important insights that were to come in the decades after *The Industrial Discipline and the Governmental Arts*, the book still ignores much that the economists of his time understood.

For example, Tugwell apparently did not understand the benefits of exchange and did not see the difference between the existence of those benefits and the way they are shared. Three decades earlier, Francis Y. Edgeworth had provided the theory. Each of the parties to an exchange benefits compared to his situation without the exchange; otherwise, at least one of the parties would decline to trade. Through exchange, all parties get on their "contract curve," as economists say. This process represents cooperation, not conflict, contrary to Tugwell's vision. In his view, "[t]he ideal picture which we have of a competitive system assumes conflict as the fundamental basis of organization." The "we" that he describes certainly did not include neoclassical (nor Austrian) economists.

Conflict happens when people are prevented from exchanging or when, once they have completed an exchange, the benefits obtained are redistributed (which the student of economics recognizes as a movement along the contract curve). So the situation is the opposite of what Tugwell saw: exchange is not based on conflict and government intervention on consent; it is the other way around.

Efficiency? / As much as *The Industrial Discipline and the Governmental Arts* emphasizes efficiency among the main goals of central planning, it does not define what the term means. Tugwell uses the term in a way very different from an economist's understanding, whether that be Alfred Marshall or Vilfredo Pareto (both of whom had already developed their economic theories by the time Tugwell was writing). For Tugwell, efficiency does not lie in consumers getting what they value most at the lowest possible prices given production costs; it is instead a purely technical, engineering notion, which amounts to producing what the government thinks should be produced at what the engineers and bureaucrats calculate is the lowest cost.

Similarly, nowhere in the book does the author tell us what the public or social interest is, and what tradeoffs it implies between efficiency and other goals. Instead, he writes (bafflingly),

> [T]he forcing of efficiency will be an interest which will have equal consideration with such other obvious needs as those of raising wages, protecting farmers' incomes, and unwastefully exploiting natural resources.

Extensive central planning requires every individual to be controlled in everything defined as economic. Reconciling that with individual liberty is impossible—something Tugwell may have realized, as he provides this rather unsatisfying promissory note:

> [S]ome means must be devised, better than we now have, to permit the free functioning of each person within his own sphere; and he must be allowed not only his free activity, but also whatever measure of control over the activities of others is involved in his free functioning.

He wants individuals to be both free and able to prevent others from being free. Those who would impose planning in the name of freedom fall in the trap of destroying liberty in order to protect it.

Perhaps he did not understand incentives (even though, for an economist, that is akin to a physicist ignoring gravity). He does not see the efficiency incentives faced by business owners and managers, while he promotes "the incentive which comes from working for the public." Nowhere does he seriously try to reconcile "industrial democracy" with central planning. He does not seem to understand the effects of competition. He implicitly assumes increasing returns to scale, while in reality some cost always starts increasing at some point, which is why a single firm does not dominate all markets. He apparently does not realize that all prices cannot remain too high and all wages too low, because wages and prices will adjust so that everything that is produced is consumed. Other examples of rather elementary economic mistakes could be cited.

Methodologically, Tugwell sometimes seems to adhere to historical determinism: "Nothing else could have happened"; the change is "irresistible." But he is not always consistent. At his Senate confirmation hearing to become assistant secretary of agriculture, he told one senator: "Chance has substituted itself for the anthropomorphic interpretation of history as a casual sequence." The senator asked what he meant. *Time* commented about Tugwell, "His vocabulary sometimes exceeds his ability to express himself." His numerous, undefined, and annoying use of "we" when discussing what *he* wants betrays a holist conception of society; "as a society we," he writes. He suggests that businesses "become more like social organisms."

A Tugwell man / Tugwell defended a naive theory of planning. Fascinated by industrial machines, he envisioned society as a big machine to be tended by planners and engineers. In an article published in the 1932 Papers and Proceedings of the *American Economic Review*, he described how government would decide whether or not to launch new industries:

> New industries will not just happen as the automobile industry did; they will have to be foreseen, to be argued for, to seem probably desirable features of the whole economy before they can be entered upon.

In *The Industrial Discipline and the Governmental Arts*, he explains that "If democracy will work on the railroads or in telephone systems, it will work in steel mills and glass factories, in making automobiles or in manufacturing hats." He paints a utopian future:

> [I]f the present scale of operations were expanded, if the last vestige of competition were abolished, and if we worked to a plan which encompassed our total resources and required of each

> industrial group its utmost capacity, we should be able to multiply many times even our present possibilities.

In the foreword of the book, he explained how, when he visited Soviet Russia, "I was made to feel very humble as an American." Talking with a poor peasant who, with his family, had to work from dawn to dusk, he thought that there was more meaning in their lives than "in a cheap-Jack town" of New England.

Could facts—say, the late 20th century collapse of the Soviet Union—have changed Tugwell's opinion? It is impossible to know, of course, but his normative values certainly played a major role in his outlooks. He was very dismissive of individual liberty and the rule of law, and only supported federalism because the Constitution would be difficult to change. He admitted that his planning scheme could not be established "so long as certain features of our system remain as they are: private property in productive equipment, voluntary cooperation, competition in business, uncontrolled allocation of capital."

Tugwell did not get everything wrong. (Who does?) Contra John Maynard Keynes (whose *General Theory of Employment, Interest and Money* would be published two years after *The Industrial Discipline and the Governmental Arts*), he entertained a long-term view and did not underestimate the importance of investment. He understood that work is not the goal of economic life and welcomed technological progress. He blamed the labor unions for blocking change. However, he underestimated the insatiability of human wants and his "trend toward the abolition of employment" was properly utopian.

The Industrial Discipline and the Governmental Arts throws some light on a dark corner of the history of political and (if we can call it so) economic thought, where the benefits of exchange do not exist, efficiency can be defined outside of individual preferences, and the omniscient and benevolent state can lead humankind to heaven on earth. The *Wharton Alumni Magazine* exaggerates when it states that Tugwell left "an indelible mark on America's domestic and economic policies," but he certainly had some influence.

At the beginning of his career, John Kenneth Galbraith, a more recent advocate of planning, had a stint at the U.S. Department of Agriculture run by Henry Wallace (the future U.S. vice president under Franklin Roosevelt, before Harry S. Truman) and Tugwell. "I was a Wallace and a Tugwell man," Galbraith proudly declared in a 2003 interview.

The general current of thought in which Tugwell participated certainly exerted a large influence. As Larry White reminds us in *The Clash of Economic Ideas* (Cambridge University Press, 2012), we tend to underestimate the economists' retreat from laissez-faire that started in the late 19th century. Rexford Guy Tugwell was a product of those dark times. R

Fighting with the 'Good Guys'

REVIEW BY VERN MCKINLEY

Political and philosophical opponents of Sen. Elizabeth Warren (D-Mass.) have tried to place the pejorative "elite" label on her. Her history as a professor at Harvard seems for many just too easy an opportunity to pass up: "Elite Dem Is Far From Middle Class," screeched one *Boston Herald* headline in the early days of her ultimately successful campaign for the seat once held by Edward Kennedy. The "elite" label for a Senate candidate in Massachusetts conjures up images of someone born into wealth, lounging on Daddy's yacht and spending weekends with the other elites in Hyannis Port or some other such exclusive community.

Anyone who reads the first chapter of Warren's autobiography will be struck by how difficult an argument it is to make the "elite" charge stick. In it, she takes the reader through a whirlwind tour of her upbringing (in Oklahoma, no less): Her dad's heart attack led to him losing his steady-paying job and the family car being repossessed. Young Elizabeth contributed to the family income by baby-sitting, selling puppies, and sewing dresses. The family's weak financial standing cast doubt on the possibility of her going to college, but her debating skills resulted in a scholarship to George Washington University. She then abandoned her scholarship after marriage at age 19, but she moved to Texas and earned a degree at the University of Houston, then took her first full-time job as a speech therapist for special-needs children. She gave birth to a daughter and enrolled in Rutgers Law School in New Jersey because "lawyers were always fighting to defend good people who needed help." Her second pregnancy made it difficult for her to find work because "no one invited me for a second interview." She decided to hang out her own shingle and also took a part-time job teaching legal writing. She then moved back to Houston and took a full-time job as a law professor at the University of Houston, while being backstopped on the childcare front by her Aunt Bee, who was in her late 70s. She divorced her husband who, when she asked him if he wanted a divorce, responded, "No hesitation, just yes." Harvard Law School did not come calling until Warren was well into her 40s.

For those who have toiled for decades on policy issues, Warren's stories on the policy aspects of her work and the posi-

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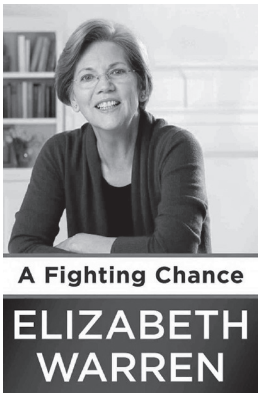
tions they led to will be inspiring. Her stories are in stark contrast to other key members of the Obama administration, like Timothy Geithner who did not do much substantive research or writing for public consumption until after he completed his tenure as treasury secretary.



A Fighting Chance

By Elizabeth Warren

365 pp.; Metropolitan Books, 2014

What causes bankruptcy? / For Warren, it all started with a burning question from her work teaching a bankruptcy class at the University of Texas: "Why were these people broke?" This led her to partner with co-authors Terry Sullivan and Jay Westbrook to "collect hard data about families that went broke," which culminated in her first book, *As We Forgive Our Debtors.* According to Warren, the book transformed the study of bankruptcy from one of "theory" to one based more on an actual database drawn from bankruptcy cases.

This research led her to her first "political" work in Washington as a senior adviser for the staff of the National Bankruptcy Review Commission, which was established in 1995 to review the bankruptcy laws. She juggled that work with a job teaching at Harvard and it led to her first meeting with Senator Kennedy, who championed her views on bankruptcy law. Her opposition to pending reform measures ultimately went down to defeat in 2005 with the passage of bankruptcy reform legislation that she saw as a big gift to the banks. Warren describes the experience in bitter terms: "David really did get the slingshot shoved down his throat sideways."

Protecting the banks' 'fannies' / Her next stop on the Washington policy tour was an invitation in November 2008 from Senate Majority Leader Harry Reid (D-Nev.) to work on the Congressional Oversight Panel (COP) scrutinizing the operational decisions for the Treasury Department's Troubled Asset Relief Program (TARP) bailout.

Compared to bankruptcy reform legislation, Warren was much more out of her element in this position. She was not familiar with the role of COP and had to look it up in the TARP legislation after Reid offered her the position. She was also oblivious to the lack of transparency that the Treasury and Federal Reserve had displayed regarding key information for the bailouts. This is revealed in her reaction to her first meeting with Neel Kashkari, who oversaw the bailouts for Treasury. He told the COP staff that the big bailouts were over, only to have Warren find out two days later that Citi was to receive a fresh $20 billion in TARP funds:

> I was stunned—and furious. I understood that this was a crisis, and I knew that sensitive information might need to be closely held. I also understood that we might be asked to keep something confidential for a period of time or even that some official might say, "I can't tell you that right now" and explain why. But that wasn't what happened.... [Treasury] sent us out of the room knowing we believed that the big bailouts were over and knowing exactly how wrong that belief was.

Anyone following the bailout story closely should have been familiar with the struggles of financial reporting service Bloomberg and its lawsuit filed about this same time against the Federal Reserve to get basic financial information on its wide-ranging bailouts.

Notwithstanding having to play catch-up on bailout details for much of her time as chair of COP, Warren expressed appropriate skepticism that the banks needed to be bailed out and she pressed both Geithner and his predecessor, Henry Paulson, on the efficacy of the TARP program. One of the better quotes from the book summarizes Geithner's philosophy: "[T]he secretary of the Treasury believed that government's most important job was to provide a soft landing for the tender fannies of the banks." COP also did some particularly good analysis regarding what the big banks did with the TARP money: "[Some] did exactly the opposite of what TARP was supposed to encourage.... [T]hey cut back on small-business lending." Meanwhile, the inequities in treatment were clear: as in contrast to the larger banks, the smaller banks were subjected to market forces (as well they should have been): "Some died while waiting [for TARP funds].... [N]early fifty small banks had gone completely under—and many more were drowning."

CFPB / The next move for Warren was to work on getting approval for the creation of what is now the Consumer Financial Protection Bureau (CFPB), an idea that Warren reveals "had been knocking around in my head for a while." In 2007 she set to writing an article using an analogy to a toaster and the fact that there is a government agency in Washington that "actually monitored toasters for basic safety.... But in 2007 there was no government agency that would stop the sale of exploding mortgages." But that year President Bush was still in office and Warren had little hope for her dream to come to fruition.

Then the financial crisis came and the Obama administration entered the picture. (Cue Rahm Emanuel: "You never want a serious crisis to go to waste.... [I]t's an opportunity to do things that you think you could not do before.") Warren raised the idea of a consumer financial protection agency with Obama economic adviser Larry Summers in early 2009. President Obama later used her toaster analogy on the *Jay Leno* show in the early days of his first term. Ultimately the Treasury Department outlined the prototype for a CFPB in its white paper on financial reform and, after fighting with the banks, the enabling framework for the agency was ultimately codified in the Dodd-Frank Act.

Black and white hats / Warren's pet projects put her in the middle of multiple fights in Washington, thus the name of the book: *A Fighting Chance*. Advocates of limited government will notice that when she narrates each "fight," she assumes the "good guys" "who spend their lives fighting for the well-being of regular folks" are the folks who advocate big government. This ignores some important facts.

For example, Barney Frank "was a champion for the good guys" who was leading financial reform, but he was also a key enabler of Fannie Mae and Freddie Mac in the pre-crisis buildup. Meanwhile, during the bankruptcy fight, Warren brands as bad guys the banks that simply wanted to make it nominally easier to collect their debts, while ignoring the role of bankruptcy attorneys who pushed consumers into bankruptcy and were fighting equally hard in their own interest to prevent those changes. She lauds the Clinton administration for fighting the banks and the credit card companies by vetoing the industry bankruptcy bill, but she doesn't recount how President Clinton pushed for housing policies to expand homeownership, which contributed to the housing bubble that was the genesis of the 2007–2008 crisis. On the CFPB, Warren demands the creation of a new government behemoth, but without a hint of irony she mentions that there already are "more than a dozen federal laws … involving consumer credit" and "seven different federal agencies" that exist to enforce them that "the good guys" created years and decades earlier.

Politics / The final act of Warren's narrative is her 2012 Senate campaign. She casts her opponent, then-senator Scott Brown, as essentially an empty suit, which, if her statements of the facts are accurate, is probably not far off the mark. For example, Brown took a cheap shot in a radio interview about Warren's looks. "Thank God," he responded when the interviewer asked him what he thought of her comment at a debate that she did not—unlike Brown—pose nude to help pay for her education. In the same interview he also drew on the Harvard elite line of argument: "Bottom line is, you know, I didn't go to Harvard." In fact, neither did Warren; she only taught there. In their first debate, as a sitting senator, his major attack line was not on a substantive policy matter, but instead on a non-issue regarding Warren's purported abusive leveraging of her American Indian heritage to advance her career. In all, not a pretty picture of the likely Republican nominee for the New Hampshire Senate seat in 2014.

Overall, this book is a good read for anyone who has followed the key financial policy issues of the past two decades—even for those who disagree with Warren's stands on those issues. She keeps the story interesting from her early days as a lonely researcher through her high-profile Senate campaign. Her detailed endnotes are a breath of fresh air when compared to many other books on the financial crisis that either present cryptic citations or do not present any citations at all. Her methods of on-point, detailed research regarding timely financial sector issues combined with her passion and persistence for her policy work can be a useful template for any participant in public policy debates. R

Too Much Information

REVIEW BY GEORGE LEEF

You have probably never heard of the Disclosurites. They sound like some menacing Old Testament tribe, but while Disclosurites are up to no good, they aren't an ancient people. They are the contemporary policy wonks and politicians who insist that Americans must be given voluminous amounts of information prior to making decisions so that those decisions will be "fully informed."

"Disclosurites" is not, of course, an everyday word. It is the term that the authors of *More Than You Wanted to Know* have coined for those who are responsible for putting us in the "kudzu-like" grip of information mandates. Professors Omri Ben-Shahar (University of Chicago) and Carl Schneider (University of Michigan) have written a thoroughly engaging book that makes this convincing argument: Mandated disclosure is not merely a failure because it seldom helps anyone make a better choice, but it can be *counterproductive*. With so much required information cascading down on them, consumers, patients, and others may miss the information that would actually matter to them. Nevertheless, for politicians across the ideological spectrum, mandated disclosure is an easy way to appear to be engaged in solving society's problems. Republicans can claim that more information helps markets work better and Democrats can claim that disclosures help protect "the little guy." Therefore, the mandates keep accumulating.

Costs and benefits / Disclosure mandates usually have their genesis in what the authors call a "trouble story" that attracts attention and makes politicians want to *do something*. Consider one of the many cases discussed in the book: the tragic story of Jeanne Clery, a Lehigh University student who was raped and murdered in her dorm room in 1986.

Once her murder became national news, politicians decided that part of "the solution" to campus violence was to require universities to disclose on-campus crime statistics. Ben-Shahar and Schneider explain, "Lawmakers treated the trouble story as a problem not of campus safety, but as an information problem to be solved by disclosure. A small federal agency publishes a large handbook—200 pages of instructions on safety reporting. Compliance may cost schools something—a

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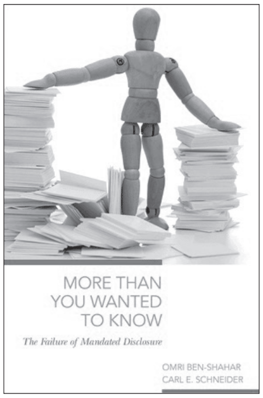
typical disclosure is over 10,000 words and requires managing much information, but costs the government trivially.” The disclosures, the authors conclude, divert resources away from important campus needs (safety and otherwise), but have hardly any effect on either the targeted decisionmakers or the incidence of campus crime.

That story exemplifies the general truth about mandatory disclosure: it entails vastly more cost than benefit.



More Than You Wanted to Know: The Failure of Mandated Disclosure

By Omri Ben-Shahar and Carl E. Schneider

229 pp.; Princeton University Press, 2014

Why is disclosure almost always a failure as a public policy tool? The authors argue that, at root, it is because nonspecialists cannot make complicated and unfamiliar decisions that properly utilize the disclosed information. Requiring that, e.g., prospective mortgage borrowers sign off on a stack of disclosures that are supposed to help them avoid making a bad choice in home financing is unlikely to do them any good. Nor is requiring a person who is contemplating a medical procedure to read and sign a lengthy document informing him about all the procedure’s pros and cons apt to help him make the best decision for his well being.

Even if individuals understand the language put in front of them, which is rarely the case, mastering the pertinent concepts and sensibly applying them to the decision at hand is beyond the capacities and time constraints of nearly all of us. When people have to make important decisions, the authors observe, what they need is good advice, not a pile of words and data that usually make them go into “Whatever” mode.

Better disclosure? / Sometimes, the Disclosurites realize that their solution often does little good because most people can’t understand the material thrown at them. The Disclosurites believe the way to make all that information more digestible is through yet another mandate, requiring that disclosures be written in simple language. Thus, Congress passed the Plain Writing Act of 2010 and the Dodd-Frank Act insists that disclosures must give financial consumers “timely and understandable information.” But the simplification approach cannot improve matters, Ben-Shahar and Schneider explain. “At base, simplifying fails because the complex isn’t simple and can’t be made so. Simpler words mean more words and longer (hence harder) documents,” they argue. Putting disclosures into easier *words* does nothing to make difficult *ideas* more comprehensible.

Another simplification gambit is to reduce the disclosure to a “score”—e.g., the restaurant sanitation grades one often sees prominently posted. Disclosurites have touted this as proof of the success of their endeavors, crediting such scores with a decline in food-related hospitalizations. The authors, however, point to research done in New York and San Diego that found no discernible health benefits from the restaurant grades. Instead, the scoring system appears to have caused a misallocation of inspection resources. Digging further into this research, Ben-Shahar and Schneider discovered that there really is no way of accurately encapsulating all of the factors that go into food safety in a single score. Moreover, inspectors are not machines and score very subjectively. So, while the scores seem to be objective and useful to diners in deciding where to eat, in fact they are neither.

Mastering the pertinent concepts and sensibly applying them to the decision at hand is beyond the capacities and time constraints of nearly all of us.

Politics of disclosure / As with regulation in general, disclosure mandates have been subject to a ratchet effect. Lawmakers keep adding new ones and expanding old ones, but almost never is a disclosure pared down, much less eliminated. Ben-Shahar and Schneider observe that lawmakers face a collective action problem in that it is easy and uncontroversial for them to push for more disclosure, but if any one of them were to take a stance in favor of less, he would be attacked as an enemy of the consumer. The structure of our politics locks us into a bad, ever-upward trajectory.

Sometimes mandatory disclosure is used to further hidden agendas, intended not to inform people but to scare them away from choices that some lawmakers and interest groups object to ideologically. For example, disclosure requirements concerning genetically modified foods are less about informed decisions than about driving consumers toward supposedly healthier, more environmentally conscious purchases. Disclosures of that kind, however, don’t seem to have any more effect on consumer behavior than other mandates.

Faced with the criticism that their pet policy does little good, Disclosurites often retreat to making the argument that giving people more information can’t do any harm. Ben-Shahar and Schneider respond that overloading Americans with information is detrimental:

> Mandates can do harm, harm that is disproportionately borne by exactly the people who most need protection. This harm is unintended and unnoticed, but harm it is—and in several forms: mandates can undercut other regulation, deter lawmakers from adopting better regulation, impair decisions, injure markets, exacerbate inequality, and in some important cases, cripple valuable enterprises.

They proceed to back up that indictment.

People are apt to think that because some transaction is accompanied by a lot of official disclosures, it must be all right.

IN REVIEW

Information that might raise important doubts gets overshadowed or buried in the mountains of pages. For instance, sharp and ethically dubious practices by lenders that at least arguably should be dealt with through direct regulation have escaped judicial sanction simply because all the mandatory disclosures were made to the hapless borrower.

The simple time cost of mandated disclosures can be harmful and even fatal. Medical centers that require head-injury patients to sign off on disclosures intended to ensure that they make fully informed decisions about the pros and cons of a treatment often take an hour longer to deliver care than centers that do not put patients through the ordeal of informed choice. As emergency responders say, the first hour after an injury is the "golden hour" when treatment seems to have the greatest effect on a patient's long-term outcome. Not surprisingly, one study of emergency medical disclosures concludes that "the resultant delay in starting treatment could be lethal."

On the other hand, disclosure laws have been used as a sword by customers to inflict damage on sellers who failed to comply perfectly with every aspect of a disclosure law. Lawyers have come up with a term for this: the disclosure defense game.

Conclusion / After thoroughly exploring the failure of mandated disclosure to achieve any detectable improvement in the decisions Americans make and demonstrating its serious unintended side effects, Ben-Shahar and Schneider arrive at the point where the reader expects them offer a solution. If mandatory disclosure is bad policy, what would you replace it with? Their answer: nothing. Asking what to replace mandated disclosure with, they write, "implies that [it] was doing something that needs to be replaced. Our argument has been that it accomplishes so little that eliminating it would deny few people anything."

The authors observe that we are surrounded by unbelievable amounts of information—often free—that people can and do utilize to make better decisions. Often they rely on trusted friends, consultants, and information aggregators (who do not need disclosure mandates to perform their services) when they have big decisions to make. Disclosure mandates waste a lot of time and paper, but are almost entirely irrelevant to people's decision processes. *R*

Working Papers BY PETER VAN DOREN

A SUMMARY OF RECENT PAPERS THAT MAY BE OF INTEREST TO *REGULATION*'S READERS.

Fannie and Freddie

"Stealing Fannie and Freddie," by Jonathan Macey and Logan Beirne. April 2014. SSRN #2429974.

"The Fannie and Freddie Bailouts through the Corporate Lens," by Adam B. Badawi and Anthony J. Casey. March 2014. SSRN #2410887.

Fannie Mae and Freddie Mac have been under government conservatorship since 2008. The government purchased preferred shares of the two government-sponsored mortgage lending firms that were severely damaged in the financial crisis, and shored them up by injecting $189.5 billion. In 2012, the U.S. government revised the terms of the conservatorship so that it now takes all positive cash flows from Fannie and Freddie, leaving nothing for the firms' shareholders. As of early 2014, the flow back to the Treasury had exceeded the $189.5 billion advanced.

Academics are divided in their reaction to the 2012 changes and a subsequent lawsuit by shareholders against the government. Some, including Yale Law School's Jonathan Macey and Logan Beirne, the authors of the first paper reviewed here, argue that the federal conservatorship has acted only on behalf of the interest of taxpayers rather than all Fannie and Freddie creditors, including shareholders, and is eroding the rule of law concerning the treatment of the owners of assets.

Adam Badawi of Washington University School of Law and Anthony Casey of the University of Chicago Law School, the authors of the second paper, hold the opposing view. They argue that in the third quarter of 2012, when the federal government changed the financial arrangements to take all future positive cash flows, the value of shareholder equity in Freddie alone was –$68 billion. That is, for the shareholders to earn anything, Freddie would first have to earn $68 billion, which was more than Freddie had earned in the 19 years prior to its financial difficulties (1988–2006). But if Freddie lost only $4 billion more (which is the amount of losses per week in 2008–2009), the senior preferred Treasury shares would be worthless. The data for Fannie were even worse: it would have to earn $114 billion before common shareholders would earn anything, which is more than it had earned in the 27 years prior to the financial crisis. The authors argue that when equity's real value is negative, the directors' duty to maximize the value of the firm is the practical equivalent of a duty to creditors and not shareholders. The authors argue that the government's actions are consistent with what we would expect from a private creditor and do not violate shareholder rights.

Regional Development

"Are Cities the New Growth Escalator?" by Enrico Moretti. May 2014. SSRN #2439702.

Cities with differing percentages of college graduates appear to be in different universes with regard to wages. High school graduates in cities with many college graduates make more than college graduates in cities with relatively few college graduates. High school gradu-

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ates in Boston average $62,000 per year, or 44 percent more than college graduates ($44,000) in Flint, Mich. The economic disparities across cities are larger than the disparities across education levels.

Why do employers in expensive cities put up with high labor costs? University of California, Berkeley economist Enrico Moretti argues that expensive cities have higher labor productivity because of thick labor markets, thick markets for specialized services, and knowledge spillovers.

Thick labor markets benefit workers because they have more firms bidding for their skills and less risk. Firms also benefit because they find more productive and specialized workers. And thick labor markets solve the "two-worker problem": both spouses can find jobs easily only in thick labor markets. Thick markets for specialized services allow firms to concentrate on their core competency but not compromise on important services including advertising, the law, and engineering.

Knowledge spillovers come from interaction with the well educated. High school workers in cities with more college graduates earn more even in panel studies that presumably do not have the selection effects that might contaminate the comparisons across cities. (The better-skilled high school graduates may migrate to the cities with more college graduates.) Patent data and academic publication also seem to be heavily affected by proximity.

Do these stylized facts justify place-based policies that subsidize development? The track record of industrial location subsidies is not good (with Taiwan being a notable exception). The original semiconductor "big push" worked. The Tennessee Valley Authority, with its cheap electricity, succeeded in transforming Tennessee from agricultural to manufacturing. But that transformation did not alter wages because the increased supply of labor (people moving to the region) offset the increase in demand. Other efforts had even less success. Moretti thinks that picking winners today is much more difficult than in the 1930s when industrial development was so low in the Tennessee Valley that any manufacturing would have succeeded.

Moretti argues that none of the current U. S. geographic successes are the result of policy, including Silicon Valley, San Diego, Austin, and Seattle. Many believe universities are the key to high-tech development and good jobs, but Yale, Cornell, and Washington University in St. Louis are world-class schools that have attracted little high-tech spillover.

Intellectual Property

"IP in a World without Scarcity," by Mark A. Lemley. March 2014. SSRN #2413974.

The transformation of music and art to digital electronic form dramatically altered the economics of copying and distributing content by reducing entry barriers to dissemination to almost zero. Stanford law professor Mark Lemley argues that 3-D printers, synthetic genes, and robots will have a similar effect, decentralizing and reducing the cost of production and thus reducing scarcity.

According to conventional wisdom, intellectual property (IP) law would be especially important in that future world. IP law is intended to increase the cost of copying so that it equals or exceeds the cost of creation, which supposedly is vital to incentivize artists and entrepreneurs to continue creating.

But has IP law proven vital in the music industry? IP law responded to rampant piracy with thousands of lawsuits. Those suits did not slow piracy; copyright infringement remains rampant on the Internet, yet many artists continue to create and distribute content—often explicitly for free. And some people must still be paying for content because total revenue from music is rising.

For Lemley, the creativity sky is not falling. For this, he draws on three lessons from recent events: First, IP owners will fight to retain scarcity. Second, IP owners will lose that fight because decentralized production is too difficult to control. Third, the world will not end as a result. Using the analogy of the transition from agriculture to the current service economy, Lemley asks what happened when the 70 percent of humanity that worked in food production two centuries ago declined to less than 2 percent today? The answer is that the supposedly displaced farm workers have found work doing things that no one imagined in 1800. Lemley believes that in the future people will find work doing things that no one imagines in 2014, even though IP and many other things will not be scarce.

Online Retail Firms and the Sales Tax

"Is Sales Tax Avoidance a Competitive Advantage?" by Jeffrey L. Hoopes, Jacob R. Thornock, and Braden M. Williams. March 2014. SSRN #2403952.

Many believe that online retailers engage in unfair competition with brick-and-mortar retailers because of the nonpayment of sales taxes by consumers of the online retailers. Congress has considered legislation that would allow states to ask online retailers to collect sales tax from customers even though the merchant does not have a physical presence in the taxing state.

The authors conduct a stock market event study on the largest publicly held conventional and electronic retailers. The former were defined as retailers having a physical presence in more than one state, while e-retailers had no physical retail presence at all or presence in only one state. The authors compare the stock market reaction of firms during eight event windows that surrounded congressional consideration of the legislation. Online retailers that have relatively few warehouse locations, such as Amazon and Overstock.com, had –0.7 percent return relative to the market. Brick-and-mortar competitors, such as Staples, that have physical outlets in most states and thus already collect sales taxes from their Internet sales had no reaction to the legislation. Those findings suggest that online retailers' losses are not brick-and-mortar stores' gains and that online and brick-and-mortar retailers are not substitutes for each other. *R*