

IN REVIEW

House of Flawed Analysis

◆ REVIEWED BY VERN MCKINLEY

Atif Mian and Amir Sufi's recent book, *House of Debt*, has received much praise from such prominent New Keynesians as Paul Krugman, Carmen Reinhart, and Christina Romer. Mian, of Princeton University and a former visiting scholar at the Federal Reserve Banks of New York and San Francisco, and Sufi, of the University of Chicago and the National Bureau of Economic Research, offer plenty of theoretical and empirical evidence for their analysis of the recent financial crisis and policy proposals for avoiding future crises. However, they often stretch (sometimes well beyond the breaking point) that evidence, leaving me unconvinced of many of their ideas.

Household debt and spending / The book opens with a compelling story of plummeting sales and layoffs during mid-2008 at Monaco Coach, a manufacturer of recreational vehicles with a heavy presence in northern Indiana. Mian and Sufi use that vignette to illustrate the broader calamity of the 2007-2009 "Great Recession" and promise "an evidence-based explanation for why the Great Recession occurred and what we can do to avoid more of them in the future." That, they say, is something that "laid off workers at Monaco, like millions of other Americans who lost their jobs, deserve."

Their opening chapter presents a lengthy time series of the ratio of U.S. household debt to income. It shows a steady climb from the early 1950s to about 2007, as both consumers and lenders grew increasingly comfortable with financing consumption. But then the housing bust came and there was a dramatic decline in the ratio as lenders and borrowers retrenched.

The authors are highly critical of the steep increase in household debt that occurred between 2000 and 2007. They present a wide variety of both U.S. and international evidence that deep downturns like the Great Depression and the Great Recession were preceded by such increases in household debt followed by large drops in household spending. In the case of the Great Recession, the spending decline began well before the massive government interventions in financial institutions that started in September 2008. The authors criticize the current financial system for "concentrat[ing] risk squarely on the debtor" and, in a populist vein, argue that the system "works *against* us, not *for* us" and "fosters too much household debt."

The authors do some good analysis early on in presenting the distribution of the roughly \$5.5 trillion in losses in home values during the Great Recession. They break down homeowners into five groups based on net worth as of 2007, revealing that, going into the Great Recession, the poorest homeowners were highly leveraged and had their net worth heavily concentrated in home equity (about \$4 out of every \$5). As a result, they were particularly devastated by the ensuing housing crash. The richest homeowners were the mirror-opposite, with comparatively low leverage and a low concentration of net worth in home equity (about \$1 out of every \$5).

The authors should have seized on that

point to discuss how ill-advised the Clinton administration's interventionist housing policies were during the 1990s, as well as the George W. Bush administration's continuing those policies in the 2000s. The policy objective was to entice low net worth individuals into homeownership through expanded leverage. Much later in the book (chapter 6), Mian and Sufi do mention the "historic" rise in homeownership starting in the 1990s, but somehow they fail to make the connection to government policies and the role they played in that dramatic increase. They only decry the current allocation of risk in debt.

Stretching the evidence / Mian and Sufi structure the book in a manner that lays out a number of important questions and responds to them with dozens of case studies that seem to support the authors' policy conclusions. Some of the case studies are supported by hypothetical examples, others by academic research the authors find favorable to their viewpoint, and some present their viewpoint on current policy issues. This viewpoint consistently calls for a heavy dose of government intervention and redistribution in the system of consumer and mortgage debt: limiting reliance on nonjudicial foreclosures, forcing write-downs of household debt, mandating changes to consumer debt and mortgage contractual provisions. A major problem for me is that their case studies are quite often flawed, which undermines the credibility of their analysis and the arguments for the policy changes Mian and Sufi advocate. Although it is not possible to deconstruct all of their case studies in this short review, a few examples will illustrate my point.

One of the first case studies in the book concerns the "harshness of debt" and the supposed one-sided nature of it. Supposedly, debt disfavors debtors because they are in a "first losses" position, but favors the lenders and savers who fund it. Mian

and Sufi offer the hypothetical example of a home purchased for \$100,000, with the borrower taking out a loan of \$80,000 and making a down payment of \$20,000. An aggregate 20 percent drop in home prices is then assumed, which wipes out the borrower's equity. The authors claim that the lenders and savers' position "improves" after the price drop because they now "own 100 percent of the home." But surely that *is not* an improvement: Before the 20 percent crash, lenders and savers had an \$80,000 first claim on the home. After the crash, they still have just an \$80,000 first claim on the home, but that claim is now at greater risk because of the increased likelihood that the homeowner, who no longer has an equity stake, will walk away from the mortgage.

The authors' main point in this example is that the system is rigged against borrowers, and so lending contracts should be rewritten. But this narrative is disingenuous in its explanation of the allocation of risk in borrowing arrangements. Like any "equity" participant in a deal, borrowers take on risk, but they also have the upside potential from an "up" market and most housing markets have been up over the past few years since the worst of the crash. Lenders and savers assume comparatively less risk, but they also have a cap on their upside: the principal they will get back is limited to what they loaned, with no equity kicker. Mian and Sufi give nary a mention to that concept.

Another example of flawed analysis is the authors' hypothetical of a married couple in their late 50s, approaching retirement. The authors assume that the couple gets caught up in the above example: they have 20 percent equity in their home and the market undergoes a 20 percent price collapse. Because of the

collapse, they "no longer have sufficient wealth to cover their planned spending in retirement. As a result, they cut spending in order to build up savings." Here the authors compose a sad narrative in order to justify their policy proposals. But their hypothetical does not withstand close scrutiny; Mian and Sufi's numbers capture few if any "real world" examples.

The average first-time homebuyer is in his mid-30s. One reason this age is not higher is that lenders are hesitant to offer a 30-year mortgage to someone who will likely enter retirement before the loan is paid off. So someone who was a first-time homebuyer in his 30s will have been a homeowner for 20–25 years when he reaches the age of Mian and Sufi's hypothetical couple. At that point, unless the couple has been "using their home as an ATM" (i.e., taken out a second mortgage or home equity loan), they should have equity in the range of 50 percent or more, not the mere 20 percent used by the authors that was so easily wiped out in a down market.

Write-downs / The authors then transition from hypotheticals to specific policy issues. They apply equally flawed logic to a critique of Sen. Bob Corker's (R-Tenn.) opposition to legis-

latingly requiring principal write-downs of underwater mortgages—that is, banks (and their depositors and investors) would be made to forgive a portion of the outstanding loan. The write-down would certainly benefit the underwater homeowner, but what about the lenders?

Corker realizes that his state's residents, who were not heavily swept up in the housing bubble, would be cross-subsidizing residents in states whose typical mortgage is deeply underwater (Nevada, Florida, Arizona). Mian and Sufi acknowledge that Tennessee

mostly avoided the housing boom and bust.... [H]ouse prices in Tennessee rose by only 25 percent, far below the 60 percent growth in California and Florida.... Households in Tennessee came into the recession with debt levels well below the national average.

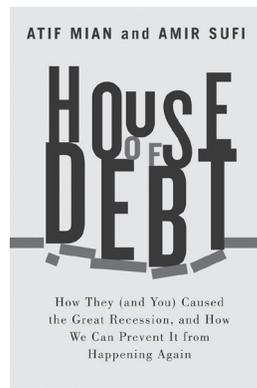
But then they go through a convoluted and largely unrelated discussion regarding the indirect effect of economic weakness in a state with underwater mortgages on a state like Tennessee (which has a high concentration of auto manufacturing jobs). Their redistributionist argument that Tennessee residents should support write-downs for underwater mortgages is unconvincing, especially given that over time those mortgages have been getting less and less underwater (or even getting above water) as home values have recovered.

Another tendency of the authors is to make overly broad statements regarding the mortgage market. For instance:

Foreclosures are bad for everyone. They kick families out of their homes, depress house prices, and elicit major losses for lenders, who typically want to avoid foreclosure except in extreme circumstances.

Okay, sure, foreclosures are bad. But that does not mean that government intervention intended to prevent foreclosure must be better. Yet, Mian and Sufi seem to believe that is the case, arguing that there must be some sort of "market failure." Their reasoning ignores the social benefits of foreclosure: without it and the added financial security it provides, most lenders would not even consider extending funds for a home purchase.

On that issue, Mian and Sufi personally (and rather viciously) attack Edward DeMarco, former head of the Federal Housing Finance Agency that oversees Fannie Mae and Freddie Mac, arguing that he impeded legislation to require write-downs. The authors seem not to understand that DeMarco's agency is obligated to conduct its operations "in a manner [that] maximizes the net present



House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again

By Atif Mian and Amir Sufi

190 pp.; University of Chicago Press, 2014

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value return from the sale or disposition of such assets” and “[that] minimizes the amount of loss realized.” They only seem to care about their redistributionist viewpoint and the fact that “principal forgiveness would have resulted in a more equal sharing of the losses associated with the housing crash.”

Conclusion / The final chapter of *House of Debt* has the curious title of “Sharing.” It demands a series of presumably compulsory changes in the precise terms and conditions governing contracts in the consumer and mortgage market to address the inflexibility of debt contracts. Those changes include “risk sharing” in student loans (“recent graduates should be protected if they face a dismal job market upon completing their degrees. In turn, they should compensate the lender more if they do well”); and “shared responsibility mortgages” (“[1] the lender offers downside protection to the borrower, and [2] the borrower gives up 5 percent capital gain to the lender on the upside”). In tandem, the authors decry the fact that “the government thus pushes the financial system toward debt financing, even though debt financing has horrible consequences for the economy,” but imply that if their preferred contract provisions are imposed, this pushing can continue.

House of Debt provides some useful questions for consideration in the wake of the recent financial crisis. The authors are right that government policy puts a collective “thumb on the scale” in favor of debt financing. However, Mian and Sufi’s suggested policy responses of even more government micromanagement of the terms of consumer and mortgage lending is completely off base. That is probably why only their fellow Keynesians believe those proposals have merit. If these are truly desirable provisions, then there are plenty of market incentives for them to be adopted voluntarily. The fact that they have not been adopted, and that Mian and Sufi want government to force them on borrowers and lenders, is insightful. 

The Rise of Modern American Bureaucracy

◆ REVIEW BY TREVOR BURRUS

In *Tocqueville’s Nightmare*, Georgetown law professor Daniel Ernst tells the story of the growth of the administrative state between 1910 and 1940. The book is less a recounting of the major signposts on the road to the modern administrative state than it is a fascinating discussion of the jurisprudential and practical considerations

around delegating power to commissions, agencies, and other specialists. Although dealing with agency discretion is an omnipresent fact of modern life, Ernst shows how we only arrived at this modern world slowly and with considerable philosophical and jurisprudential debate.

During his 1830s trip around the United States, Alexis de Tocqueville observed that the young country lacked the kind of “centralized administration” that bedeviled the monarchical states of Europe. To him, centralized administration was synonymous with meddling bureaucracies that had the power to impose their will upon the people. If a centralized administration ever developed in the United States, he worried, it would mean that “a more insufferable despotism would prevail than any which now exists in the monarchical states of Europe; or indeed than any which could be found on this side of the confines of Asia.” This was “Tocqueville’s nightmare,” a sprawling and out-of-control administrative state.

Ernst argues that, despite the United States’ development of a vast administrative state, this nightmare has not come to pass. For Ernst, America “faced down” that nightmare and conquered the fears of overweening bureaucracy. *Tocqueville’s Nightmare* tells Ernst’s version of how this happened in order to “answer the complaint that has gained in popularity since the eruption of the Tea Party movement in 2009: the statebuilders of the early

twentieth century abandoned an American tradition of individualism in what amounted to ‘the decisive wrong turn in the nation’s history.’” For Ernst, that claim is overblown. In fact, “the reformers who supposedly sent the Constitution into exile actually designed the principles of individual rights, limited government, and due process into the administrative state.”

Whatever the accuracy of Ernst’s claim that we have avoided the worst tendencies of meddling bureaucracy (about which more later), it should not undercut the virtues of his historical narrative. *Tocqueville’s Nightmare* is a scholarly and interesting examination of the debates over the administrative state during its formative period. He skillfully weaves together a story that features law professors, Supreme Court justices, politicians, and presidents all playing crucial roles.

Reliance on judges / In the Anglo-American legal tradition, administrative agencies exist in a sort of legal limbo. The Anglo-American tradition has always stressed the importance of judicial review. Ancient English rights such as the right to habeas corpus, trial by jury, and confronting your witnesses all share a common thread: the view that properly constituted judicial procedures are the hallmark of a just legal system. There seem to be few problems that we think a bit of good judging cannot solve, from signing off on search warrants to deciding whether to assassinate people with drones.

English law professor Albert Venn Dicey perhaps best articulated the prin-

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ciple behind the Anglo-American reliance on judges. He considered the actions of common-law judges deciding “the rights of private persons in particular cases brought before the Courts” as a crucial component of the rule of law. Submitting disputes to “ordinary tribunals” rather than special administrative courts was crucial to maintaining a society founded on bottom-up, common-law liberty. Ordinary judges are devoted to the principles of individual liberty embodied in the common law. Administrative tribunals, however, tend to view disputes “from a government point of view.” Dicey believed that “the whole scheme of administrative law was opposed to those habits of equality before the law which had long been essential characteristics of English institutions.”

In America in the late 19th and early 20th centuries, Dicey’s view was quite popular. Yet that view would collide with the burgeoning support for an administrative state. If the rule of law, under his view, required judges to “take the whole case” when they reviewed agency determination of private rights, then the usefulness of “rule by experts” would be severely limited. Allowing non-expert

judges to overrule factual and legal determinations of experts would essentially nullify the experts. Ernst’s book is largely about how a middle course developed between unreviewable agency discretion and pure rule by judges.

If there is a main character in Ernst’s story, it is Charles Evans Hughes Sr., attorney, governor of New York, associate justice of the Supreme Court, Republican presidential candidate, secretary of state, and chief justice of the United States (in that order). As a governor, associate justice, and chief justice, Hughes pushed for a middle course that would allow regulators large areas of discretion while providing an avenue for judicial review when errors were

pronounced. Although he often used language similar to Dicey’s when describing the “insidious encroachments upon liberty which take the form of an uncontrolled administrative authority,” Hughes also was a committed advocate for the expert regulatory commission.

In 1905, he was chief counsel of a committee investigating alleged abuses by New York City gaslight franchises. According to Ernst, Hughes’s “methodical cross-examination revealed that the Consolidated Gas Company had grossly exaggerated the value of its assets in calculating rates for its service.” Hughes drafted legislation to create a regulatory commission charged with limiting gas and utility companies to receiving a fair return upon their capital investments. That and other public successes helped sweep him into the governor’s office, defeating newspaperman William Randolph Hearst in the election of 1906. Hughes immediately pushed for a public service commission law to extend regulation of public utilities to the railroads.

In 1910, he became Justice Hughes and soon had the chance to decide crucial rate regulation cases. In 1912, a series of challenges to state railroad commissions made their way to the Court. They were consolidated into the *Minnesota Rate Cases*. Hughes was assigned the majority opinion and he stayed true to his commitment to broad agency discretion: “We do not sit as a board of revision to substitute our judgment for that of the legislature, or of the commission lawfully constituted by it, as to matters within the province of either.”

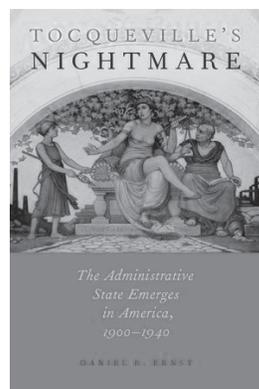
He would leave the Court in 1916 to run as the Republican nominee for president, losing a close election to Woodrow Wilson. He was reappointed to the Court by Herbert Hoover in 1930, this time as chief justice. Throughout the New Deal, Hughes’s Court was the center of contro-

versy as it struck down many significant pieces of New Deal legislation. Hughes himself often split his vote between the “Four Horsemen” (Justices George Sutherland, Pierce Butler, Willis Van Devanter, and James McReynolds), who generally voted to strike down New Deal legislation, and the “Three Musketeers” (Justices Louis Brandeis, Benjamin Cardozo, and Harlan Stone), who generally voted to uphold it.

Controlling agencies / By the New Deal era, the administrative state had fully arrived. Franklin Roosevelt’s administration created scores of new three-letter agencies. Questions remained, however, about how courts would deal with challenges to administrative decisions. Anti-New Dealers were calling for increased judicial oversight of administrative agencies. Those questions came to a head in New York in 1938, first in the form of a fight over a proposed “anti-bureaucracy” amendment to New York’s Constitution, and second in that year’s Senate campaign fight between hardened New Dealer Robert F. Wagner (namesake of the Wagner Act, or the National Labor Relations Act) and anti-bureaucracy Republican John Lord O’Brian. In both instances, the “anti-bureaucracy” cause lost.

Yet the push for controlling agencies did not die out. With a brief interlude for World War II, the Administrative Procedure Act of 1946 can be seen as a direct consequence of those early philosophical and jurisprudential fights.

Living the nightmare? / Have we avoided “Tocqueville’s nightmare,” as Ernst argues? Perhaps we should ask Mike and Chantell Sackett, who in 2007 were told by the Environmental Protection Agency that their property was a wetland and given no opportunity to challenge that order before incurring noncompliance fees of \$75,000 per day. Or perhaps we should ask Marvin Horne, a raisin farmer who lives under the arbitrary jurisdiction of the Raisin Administrative Committee and is obliged to turn over up to 47 percent of his crop every year to the government without compensation.



Tocqueville’s Nightmare: The Administrative State Emerges in America, 1900–1940

By Daniel R. Ernst
226 pp.; Oxford University Press, 2014

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Or perhaps we should ask Hein Hettinga, a dairy farmer who labors under Byzantine dairy regulations that, because of pressure from his competitors, were specifically altered to shut down his business model.

The Sacketts and Horne had their days in the Supreme Court, and they won unanimously. Yet those victories merely helped them resolve a threshold matter—namely, whether they were even permitted to challenge administrative agencies' actions. At the end of costly, years-long fights, the Sacketts and Horne were both told that, yes, they can challenge the government, but both parties face more years of costly litigation and, in Horne's case, perhaps a second trip to the Supreme Court.

True, this is a form of judicial review, and perhaps the kind of meaningful judicial review of grievous agency errors endorsed by Chief Justice Hughes. But it is extremely costly and drawn-out. Most people who endure the iniquities of rogue government agencies have neither the funds nor the time to challenge the government in court. The Sacketts had to rely on the largesse of the Pacific Legal Foundation, a public interest law firm funded by donations.

Would it be better if courts were charged with giving a full and meaningful review to

agency determinations, as Dacey would have wanted? On one hand, we would be asking more of our scarce judicial resources than we do now and challenging an agency action could take even longer. On the other hand, perhaps insulating agency decisions from judicial review has essentially subsidized the growth of the administrative state. When there are fewer challenges available to their actions, agencies can do more.

Dacey was right: meaningful judicial review is a cornerstone for any well-organized judicial system. Even cursory judicial review is better than nothing. Unfortunately, the modern administrative state is so big, its rules so numerous, its power so great, litigation so expensive, and judges so deferential that most people do not even receive cursory judicial review. In other words, despite the best efforts of Hughes and others, and contrary to Ernst's claim, it is still Tocqueville's nightmare.

Yet, my problems with Ernst's thesis are quibbles about an otherwise fine and interesting book. He has penned a welcome addition to the libraries of those interested in the legal history of the administrative state and in the still-relevant jurisprudential questions surrounding judicial deference to administrative decisions. R

City and state governments have sunk billions into these projects over the last decade, always with the expectation that they will produce a gusher of spending from outsiders. The reality is quite different. These investments are almost without exception boondoggles. "While communities have proven remarkably capable of building new and larger centers, they have proven remarkably unsuccessful in filling them. From Atlanta to Seattle, Boston to Las Vegas, the promises of local officials and the forecasts of consultants have come up short," Sanders writes.

Space for conventions (and smaller meetings) can be provided by the private sector, of course. For instance, casino tycoon Sheldon Adelson has a million-square-foot convention center in Las Vegas. The market can supply the need for convention and exhibition facilities. The pressure for government-owned and -operated centers is not because of market failure.

Instead, it stems from the fact that local business leaders have strong motives for placing convention centers in downtown areas and having taxpayers pick up most of the cost. They want big projects that they hope will protect downtown property values and (in some cases at least) serve as buffers dividing the glitzy downtown from "menacing" poor residential and business districts.

In other words, while they pay lip service to improving the economy of "the city," business leaders are really just interested in their own bottom lines. This is just another instance of the sordid game of using politics to further private gains.

Support / Why do politicians almost always go along with these plans? Because, Sanders observes, they suffer from "edifice complex"—they love to be associated with big, newsworthy projects that sound like brilliant policy moves. Such projects have immediate political benefits, but if they do not pay off in the long run, very few voters will know about it or connect them with the fiasco.

Another reason—although Sanders does not stress this point—is that construction firms and unions provide support for

Pork Palaces

REVIEW BY GEORGE LEEF

It is a rare American city of any appreciable size that has not fallen for the siren song that investing in a public convention center is a great way to generate jobs and "economic impact." Supposedly, the inflow of convention attendees will give the local economy a boost and at the same time enhance the city's image and build civic pride.

Since the 1950s, cities as great as New York and Chicago and as small as Cedar Rapids and Omaha have built convention centers, often expanding and upgrading them several times. Officials and business leaders love to tout the apparent success of these centers, but seldom has any skeptical

reporter, scholar, or politician dug for the whole truth.

For that reason, Heywood Sanders' book, *Convention Center Follies*, fills a gigantic gap in our understanding. Sanders, a professor of public administration at the University of Texas, San Antonio, offers a devastating analysis of the phenomenon of public convention centers.

these projects because they mean big money for them. The projects usually require major builders with considerable expertise and equipment, employing high-skilled, unionized workers.

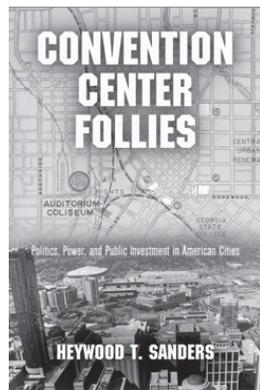
Once the special interest groups and politicians have decided to commit public resources to a new or improved convention center, they commission an “expert study” on its feasibility. These studies invariably forecast great success for the project, and ominously warn about losing out to other cities if it does not go forward.

Throughout the book, we read of one “expert” study after another, all using similar dubious methods and data to reach the same conclusion: the project is a certain winner.

Here is one example of bogus data: The experts routinely assume that the typical attendee will spend three nights in the convention city, staying in a hotel and eating meals at restaurants. Independent studies, however, have shown that the actual number is less than half that. Furthermore, many attendees are local people, so whatever they spend is money they probably would have spent in the area anyway.

Unfortunately, the accuracy of past studies is never an issue. They are not meant as serious analysis. They are just part of the sales pitch and always paint a rosy picture. Sanders gives no instance where a convention center project was turned down because politicians found the study not to be credible, although in one case (Nashville’s Music City Center), the boosters decided to “wait out” an administration where the mayor’s finance director was convinced that the center would become a “serious drain” on resources. They did so and the project was later built.

Backers of these projects turn a blind eye to the current downward trend in the number of conventions and the people who attend them, as online technology makes



Convention Center Follies: Politics, Power, and Public Investment in American Cities

By **Heywood T. Sanders**
512 pp.; University of Pennsylvania Press, 2014

it less and less necessary for people to be physically present to obtain information. For example, the sporting goods Super Show had 112,000 attendees in 1995, but that number fell to 20,000 in 2005, and the show was canceled the following year. This trend never shows up in the “expert” studies because the experts manipulate their data to disguise it, and they can always cherry pick a success story to justify their claim that a city had better build now to catch the coming wave of new convention business.

Turning to states / Another important aspect of the con-

vention center mania is the way boosters have managed to shift away from local votes on bonds or tax increases to finance the projects, and instead depend on state action.

Despite all the cheerleading from politicians, business leaders, and newspaper editors (who seem to fall easily for the Keynesian theory that these “investments” will stimulate the economy through “multiplier” effects), voters sometimes turn thumbs-down on the financing. A considerable number of voters can see through the rhetoric about “revitalizing the city” and understand that it means that one part of the city will benefit at the expense of other, mostly poorer, parts. That has led boosters to avoid voters by turning to state politics.

Horse trading in the state legislature can be easier than trying to persuade local voters, and therefore convention centers are now often part of a package of goodies for different parts of the state. That tactic helps to win the necessary votes and spread the cost more widely. In the 1991 expansion of Chicago’s McCormick Place, for example, the deal for state funding included a requirement that Chicago utility companies would continue to use high-sulfur coal mined downstate.

The book abounds in detail about the machinations in city after city. Readers

learn, for example, that in Phoenix, Ariz., the downtown interests succeeded in getting a vast expansion of the old convention center, naturally saying it would have great economic effects. But when those effects failed to materialize, they said it was because the center lacked a grand hotel. Despite a consultant’s study forecasting success, no hotel chain was willing to invest in one, so the city sold bonds to sink \$350 million into building a 1,000 room hotel that Sheraton now manages. As Sanders acidly writes, “The repeated reluctance of any private developer to finance such a project was taken not as a measure of risk but as simply a short-term impediment to be overcome.” Occupancy at the hotel has been well below projections, and in 2011 Moody’s downgraded the bonds. In 2012, the hotel had to rely on other city resources to meet its debt payments.

The Phoenix story comes early in the book, and for the next several hundred pages we get many more like it. Sanders’ national tour of convention center deception and failure will remind you of the “Peanuts” cartoons where Lucy, time after time, pulls away the football and Charlie Brown winds up flat on his back.

One of the most common mistakes Americans make is to think that people in business are defenders of the free market. This book shows that many business people will happily look to government for projects that give them gains while spreading socialized losses on the rest of the city or state. The convention center story is no different from the sports stadium story or “redevelopment” story: potent local business interests talk politicians into big projects that generate benefits for themselves, while imposing costs on the rest of the population. It is an object lesson in the problem that public choice theory has exposed in democracy, namely that it is easily manipulated by people who claim to be acting for the public good.

Although Sanders does not directly say so, his book’s message is clear: we would be better off if we left the construction of convention centers to capitalism, not government. R

Economic Regulation Reform After the Great Recession

◆ REVIEW BY RICHARD L. GORDON

In September 2005, the National Bureau of Economic Research held an academic conference on economic regulation reform, organized by Massachusetts Institute of Technology economist Nancy L. Rose. In the months after the conference, as its papers moved toward publication, the nation slid into financial crisis and recession.

Rose sensibly delayed publication of the conference papers so that their authors could make revisions in light of the crisis. The resulting book, which was finally released this year, offers chapters that differ wildly in many critical aspects, including outlook, clarity, salience, and the extent to which post-2008 developments are recognized.

The contributors include leading figures in regulatory economics. They and the book share a longstanding ambivalence toward the conflict between the theoretical case for regulation and the barriers of knowledge, expense, and rent-seeking that hinder attainment of those theoretical benefits. Rose makes this particularly clear in her introduction, in which she warns that regulation is likely to have unsatisfactory dynamic effects—particularly when it comes to innovation over time. That warning is repeated by many of the volume's contributors. Nevertheless, some contributors ignore their own caveats and argue that more economic regulation is needed and current regulation can be improved, though several papers also argue that less regulation would be appropriate. In many cases, the writers refute or reiterate applications of ancient fallacies about the supposedly malevolent nature of competition without noting the broader supporting literature.

Rose's introduction is followed by nine reviews of different aspects of regulation. These are all familiar, well-trodden areas,

and all of the chapters deliberately synthesize prior work. Throughout the volume, familiarity with key issues is presumed and the coverage is necessarily selective. Therefore, the book is valuable as an overview of how several leading experts view the state of regulation in the areas treated. Only a few contributions are sufficiently self-contained to serve as guides for non-specialists.

Antitrust and airlines / Most reviews treat a specific industry, but the initial contribution—the shortest in the book, by Dennis Carlton and Randal Picker—tries to delineate the proper relative roles of direct regulation and antitrust. Unfortunately, the authors only provide overly terse, inconsistent, incomplete treatments of too many, mostly secondary, issues.

The authors begin the book's tendency to state but then ignore the drawbacks of government intervention in markets; they tacitly accept the desirability of antitrust and regulation. In particular, the authors observe that judges in civil actions concerning some market activities are more likely to be independent but less likely to be knowledgeable about industry details than industry-specific regulators and, thus, regulation is preferable to civil action when expertise is needed. Unfortunately, Carlton and Picker's exposition fails badly in making those arguments, let alone recognizing that other scholars strongly dispute them.

The chapter instead contains naive ruminations about the processes by which the U.S. Senate, House, and president

(each modeled as a single entity) could optimally choose between antitrust and direct regulation, a discussion of the (obvious) reasons for seeking exemption from antitrust, an overview of actual exemptions provided, the process by which the Interstate Commerce Commission secured more explicit power to regulate railroad rates, review of antitrust developments from Theodore Roosevelt to Woodrow Wilson, and overviews of regulatory developments in telecommunications, airlines, railroads, and trucks.

In contrast, Severin Borenstein and Rose collaborate in a splendid, comprehensive review of airline development under regulation and deregulation. The era of regulation is examined, the many aspects of deregulation are treated, foreign developments are sketched, and the underlying economics are appraised. The regulation section reviews the familiar conclusions that monopoly rents were dissipated by forced subsidy of unprofitable routes, quality competition, and inflated salaries. The deregulation section ranges over many topics. The level and dispersion across routes and among passengers of prices and loyalty programs are treated first. Attention turns to exit, entry, and the resulting market structure. Changes in service quality are reviewed. Then comes evaluation of key issues. First, Borenstein and Rose report work suggesting that airline profits are volatile because costs are, and thus the often-raised fantasy that airline competition can be "excessive" and "ruinous" is invalid. They argue that innovation was greatest in business practices such as the hub-and-spoke route system, new price structures, and alliances among airlines. They see fears of market power as unjustified. They note the failures of governments at airport development, air-traffic control, and the efficient pricing of airport gates and landing rights.

Television / Next comes Gregory Crawford's valuable survey of cable television regulation. Crawford consistently recognizes that both the price and quality (in terms of the number and quality of chan-

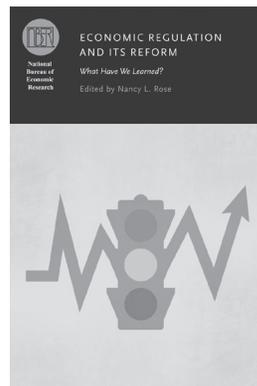
nels available) are important and the value of service improvement eludes definitive measurement. Cable television is increasingly restrained by competition from satellite providers and entry by the two main providers of local land-line telephone service. Thus, the necessity and desirability of regulation is unclear. Crawford provides a sketch of the cable industry and its rivals and then a valuable review of the evolution of regulation. Controls affected (among other things) pricing, what was carried, vertical integration into programming, and mergers.

The bulk of the chapter deals with the implications of this history. Price trends are examined and indicate a small decline from a brief period of federal imposition of price caps and a slower growth as satellite and phone-company competition increased. Subscriber growth has lessened over time and cable subscriptions declined after 1995 thanks to steady competition from first satellite and then phone suppliers. Quality has risen as more channels have become

available. The qualitative improvement is difficult to measure, but rising per-subscriber prices paid to providers suggest gains. Cable companies also provide more services. Crawford attempts to find the benefits, if any, that regulation provides in terms of the price and quality of cable service. He concludes that there is no evidence of such benefits. In contrast, the data clearly show competition lowers prices.

Evidence is unclear about the importance and policy relevance of negotiations between cable companies and content providers over access fees. It is also unknown whether entry of cable companies into content provision will cause undesirable favoritism of cable-company-owned channels. In contrast, the present system of providing bundles of channels, instead

of “a la carte” service, has cost-reducing effects that outweigh the presumed benefits of requiring all customers to choose only the channels they want. Crawford sees little need for new regulatory policies except those that would facilitate entry. His specifics range from the familiar one of reallocating the electromagnetic spectrum to the idea of national franchising standards, whatever that may mean.



Economic Regulation and Its Reform: What Have We Learned?

Edited by Nancy L. Rose

608 pp.; University of Chicago Press, 2014

Electricity/ Frank A. Wolak provides a too lengthy, sprawling examination of supposed problems arising from efforts to create an independent, competitive electricity generation sector. Difficulties arising from implementation of such a market cause him, in effect, to fear that others’ optimism about the vigor of competition in independent generation is misplaced.

A main defect of the chapter is Wolak’s undue concentration on limited experience and particularly his excessive reliance on the California electricity crisis of the early 2000s and his market-power explanation of that crisis. Similar problems did not arise from creating independent generation in other parts of the United States. Wolak is one of the authors who piously note the defects of regulation, but then ignore those defects.

The chapter also ignores that the main restructuring of the U.S. electric power industry over the past half-century was the creation, through mergers, of larger, vertically integrated electric utilities. Such mergers were widespread but diverse. Some new mega-companies arose, most notably First Energy, which grew out of a series of mergers with contiguous firms mostly in Ohio and Pennsylvania. However, the more typical route was that already-large generators like American Electric Power and Duke Energy simply became larger. This led to other, much more successful

reorganizations of regional power systems; Wolak barely notes that last point. One spectacular case involved the massive expansion of one of those systems to cover many companies and states without any major hitches.

The chapter starts with a breathless background section followed by multiple overly detailed views of the theory and practice of electricity wholesale-market design. The problem with the implementation of that market design in U.S. states that deregulated is obvious: the markets need to be as vigorously competitive as possible, and regulators failed to ensure sufficiently competitive markets. Wolak presents the traditional view that the transmission and distribution of electricity are natural monopolies whose performance can be improved by regulation and argues that regulation has a role in generation.

His too-short history section careens among many familiar subjects. A likewise too-short section tries to cover the high cost of storing electricity, the absence of time-of-use metering and pricing, the evidence that demand is responsive to price, a confused argument that short-term monopoly power exists in the electricity market but dissipates over time, that larger transmission networks facilitate competition among generators, and regulators must limit short-run power. Having made those points, he spends the rest of the chapter expanding on them in several different sections.

He starts with a bloated but still incomplete theoretical section on the comparative desirability of public ownership, unregulated private ownership, and regulated private ownership of electricity generation and delivery. His overly lengthy, disconnected treatment of the notorious defects of government ownership is particularly egregious. He presents a discussion of private monopoly that stresses simple monopoly behavior relating to a concept of residual demand. The problems with using regulation to address those issues are noted without resolution.

He then returns to the aspects of market design that he deems critical. He offers

IN REVIEW

a problematic argument that a residual wholesale supplier that knows its output is critical to meeting demand can benefit from restricting output, and he turns to a model of how suppliers with long-run contract obligations can profit from a strategy that lowers spot prices so much that buying spot is the cheapest way for the suppliers to fulfill the contracts. He explains that more responsive pricing for final consumers and a larger transmission network would help increase competition. He then provides banal suggestions to regulators for generating useful market data, better designing industry structure, and supervising problem areas.

The next section is a rambling discussion of how actual restructurings failed to meet his goals. His discussion of the U.S. experience with electricity market restructuring presents conjectures about the changing roles of federal and state regulation. He notes that U.S. restructuring produced less efficiency gains than other countries' restructurings because no inefficient publicly owned entities were divested, and inefficient new cost-recovery procedures were instead introduced. He then briefly notes a few improvements that did occur in U.S. restructuring.

Paul Joskow also contributes a paper on electricity market regulation, using it to examine the theory and practice of incentive regulation. He nicely summarizes the efforts to develop regulatory approaches that recognize that regulators have imperfect knowledge about the firms being regulated and sketches the practical issues of implementation such as best design, adequacy of cost information, and appropriate benchmarks. Joskow then presents a review of experience with incentive-based pricing. The general problem of establishing a rule is outlined with warnings that the key elements of base-line cost and an appropriate adjustment factor are difficult to derive. Taking advantage of an extensive historical record, he gives a detailed, thoughtful review of the effort in Great Britain to set price caps for electricity generation and transmission. He well shows the many

problems involved. A brief review of the limited information on outcomes suggests improvement resulted. He concludes with useful comments about the implications. He reiterates that implementation involves difficulties many enthusiasts ignored. He stresses problems of accounting for capital recovery but keeps tacit the basic problem that standard accounting techniques incorrectly measure economic profitability.

Telecommunications / Jerry Hausman and J. Gregory Sidak draw on the telecommunications regulation experiences in the United States, the United Kingdom, and New Zealand to sketch of relevant theory of that regulation. They conclude that rising competition from wireless and cable TV companies is superior to regulation in ensuring efficiency in land-line telecommunications. This paper is something of a mirror image of Crawford's review of cable television, which I discussed above.

The chapter's concern is the fixation of regulators on designing a policy for efficiently pricing the access of entrants to the lines of existing telephone companies. Regulators believed that price should encourage entrants to build competing facilities whenever the regulators believed competition would enhance efficiency. The authors' central premise is that setting such an efficient policy for access is far beyond the capability of regulators who have botched the effort.

Their introduction starts with their basic conclusion that while the federal government allowed enough cable TV entry into telecommunications to obviate regulation, many counties did not. Some generalizations about the problems of designing a sound regulatory price structure and the shifts from rate-of-return regulation to price caps and back are sketched. The ensuing analytic portion of the chapter nicely lays out the reasons why the cost of service cannot be defined independently of market conditions and discusses how regulation is distorted by neglect of this reality.

The desirability of entry requires exhaustion of economies of scale and

scope by local telephone companies. Hausman and Sidak eventually note that the rise of competition from cable TV companies suggests that such exhaustions have occurred. A further issue that is raised but cursorily treated is the high level of sunk costs for the network. In principle, a proposition from traditional single-product price theory generalizes to the multiproduct case that arises in practice: a sufficiently limited capacity level leads to excesses over variable costs that recover investment. Hausman and Sidak ignore that point and warn that regulators succumb to the temptation to set rates too low for investment recovery whatever the optimality of the past outlays.

The authors next examine the nature of and rationale for unbundling in the United States, review the U.S., UK, and New Zealand experiences with bundling and unbundling, and conclude by arguing that cable TV competition suffices to allow deregulation. The review starts with examination of U.S. policy, presents and indicates defects of the Federal Communication Commission's rationale for compulsory access, and moves to a discussion of why experiences in the United States, UK, and New Zealand failed to support the FCC case for access.

Pharmaceuticals / Patricia Danzon and Eric Keuffel grapple with the main issues arising with pharmaceuticals: product safety, optimal patenting, price regulation, and control of promotion. They start by sketching the familiar concerns about high research and development costs with low production costs, difficulties of verifying product characteristics, and the intricacies of balance among patent protection, drugs mainly purchased through insurance, and wealth differences among countries. A good review of U.S. drug-quality regulation and brief remarks on the rest of the world follow. The treatment of the benefits and costs of U.S. policy indicates high costs and low benefits, but the authors conclude with timid proposals driven by reiteration of the standard imperfect-information

excuse for intervention. The patent section starts with acceptance of the need for patent protection and a decision not to delve more deeply, provides a valuable review of how U.S. law facilitated the rise of generics, and outlines the problems of providing drugs to poor countries.

A price section tackles the rationale for layering price regulation on other controls. The authors begin by recognizing that monopolization is constrained by low concentration, ease of entry, and the ease with which an important new drug's patent protection is undermined by imitations. Then comes a reiteration of the tired arguments that doctor ignorance and the availability of insurance lessen price sensitivity. That insurance companies negotiate for lower prices is treated as a second-best response rather than an inherent advantage of pooled purchasing. It is quickly noted that foreign countries regulate prices and U.S. Medicare drug programs rely on the price bargaining of the plan providers, but other federal drug-purchase programs impose price limits based on prices paid elsewhere in the U.S. marketplace and thus produce higher prices to nonfederal buyers. Review follows of how imitation does lower prices before patents expire and how generics quickly take over after patents expire. The many approaches to direct price controls are reviewed. A useless section complains about problems of measuring the effects of such controls. Even worse is a discussion of what the authors consider the soundest evaluation of profitability and the authors cavalierly dismiss findings of unexceptional profitability. Similarly inconclusive finds on productivity ensue.

Then the classic issue of promotional activities is surveyed. The treatment rushes through the level and composition of promotional spending, U.S. regulation, the debate over whether advertising misleads or informs, the efforts to measure the (largely positive) effects, policies in other country, whether managed-care organizations properly evaluate drugs, and the curious conclusion that the U.S. Food and Drug Administration should spend more

to regulate promotion, even though there is little evidence that this is a problem.

Finance / Randall Krosner and Philip Strahan treat banking. They argue that the industry was long hobbled by regulatory measures that undesirably restrained competition, but changes arose to eliminate those restraints. The treatment begins with valuable introductory remarks that indicate that alternatives arose to overcome the restrictions on bank activity and some of those new methods may have contributed to the 2008 financial crisis.

A well-done overview of banking and the evolution of regulation follows. This starts with a terse review of the history of banking and its regulation, followed by examination of the key areas of restriction: the number of branches a given bank could own, required deposit-insurance restrictions, what activities a bank could undertake, limits on interest rates, and capital requirements. The authors note that deposit insurance was an unsatisfactory substitute for diversification arising from allowing multi-branch banks to arise.

The next section treats the consequences of financial regulation and its reform. The first key point is that many substitutes arose for banks as promoters of financing of firms. Elimination of barriers to branching produced fewer, stronger banks, but it also increased banking competition at the local level. Under the old system, the rents gained from protection from competition were an offset to the temptation for excessive risk-taking because of deposit insurance. Krosner and Strahan find it unclear whether removal of those rents had strong harmful effects. However, the consolidation clearly increased efficiency and lowered prices. They raise and dismiss fears that banks acquire inside information that they abuse. They also provide evidence of the overall beneficial effects on the rest of the economy and on macroeconomic stability. Then they argue that the political influence of small banks and insurance companies long perpetuated restrictions on branching, but the rise of automatic teller

machines, money-market mutual funds, more broadly available credit information, and increasing public awareness contributed to the end of the restrictions. A short update on post-2008 developments provides conjectures on whether the financial crisis can be linked to changes in financial markets to evade regulation and in response to deregulation, and discusses the likely effects of the Dodd-Frank financial reform legislation.

The book ends with Eric Zitewitz's particularly unsatisfactory effort to deal with securities regulation. It starts with an overblown discussion of the magnitude of fraud in the 1920s and then in the years before the Sarbanes-Oxley corporate governance legislation. That is followed by a rambling, pointless effort to show that the financial sector is large enough to be of policy relevance.

The next section unconvincingly presents the alleged market-failure justifications for intervention. The core predictably is imperfect information with consequences for the market for knowledge, including a curious variant on the hoary cream-skimming argument. The Vanguards of the industry supposedly attract the sophisticates and make the less knowledgeable more likely to pick inferior funds.

The next section is a rambling review of the history of securities regulation. It reluctantly recognizes the defects of Sarbanes-Oxley but glosses over them and makes Eliot Spitzer a hero for his state-level intervention into securities markets.

Two sections on mutual-fund fees and antitrust actions follow. Purely theoretic, familiar concerns about conflicts of interests between research and sales activities ensue. Zitewitz offers a wild conjecture, supported by only one example, that competition may entice firms to take unobservable excessive risks. The conclusions show that no clear reform path emerges. Briefly, an author who knew how to cite Stigler on the defects of regulation in general might also have considered Stigler (among many others) on why the deficiencies of securities markets do not justify the regulatory agencies that exist and are likely to emerge. R

Building Better Infrastructure

REVIEWED BY IKE BRANNON

A few years ago, I returned to my Central Illinois hometown to join in a homecoming party for a family friend who had been away for 30 years. As we men stood watch on the grill at the celebratory barbecue, our esteemed visitor remarked without irony that he noticed that work was still being done on the bridge that crosses the creek on the way to “town”—Peoria, in this instance—just as it was being done three decades ago when he left. There was a long pause before someone fully comprehended the context and informed him that we had, in fact, completed the original bridge replacement project not long after he left and that the current work was to rehab the bridge, as 30-year-old bridges sometimes require.

It is easy to see why he made the mistake he did, because the original rebuild back in the 1980s played havoc on many people’s lives. What had been promised to be a three-month job took nearly a year: The low-bid subcontractor assigned to build the approaches to the bridge found itself in over its head and eventually punted on the assignment. The main contractor then had to pay handsomely to get a team that would attempt to work through the winter—an effort that proved virtually useless owing to the particular severity of the season that year. The job ultimately cost much more than originally anticipated, an expense that was passed on to the citizens of our township, and left us forced to navigate a lengthy detour “to town” for much longer than was necessary.

I would like to say that the township board of trustees—who remember that episode quite well—came up with a different approach when it came time to improve the bridge, but they did not. Just as before, the township invited companies to bid on the job and awarded the contract to the lowest bidder. Fortunately, the second act played out much less eventfully, but there

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was no reason to think that the process in 2009 would necessarily result in a better conclusion than it did in the 1980s; we just had better luck.

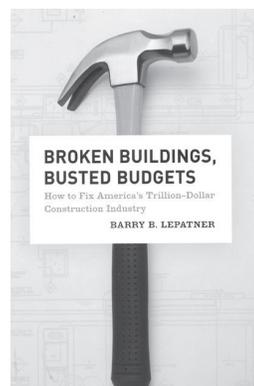
A better way/ The stasis in how we actually do road construction in this country is ripe for mockery. When Rep. Mark Kennedy (R-Minn.) made a quixotic effort to reform how we build and finance public infrastructure before the Great Recession—he would discover, during an ill-fated run for the U.S. Senate, that few people cared about this issue—he often quipped that an electrical engineer who fell asleep for 20 years would awake to find his entire field radically changed and would need to be completely retrained in order to pursue a job. A highway engineer who did likewise could awake and go right to work—probably on the same project he was on when he fell asleep.

Why is there so little discussion afoot about creating a new approach for building America’s transportation infrastructure? Since the Great Recession in 2008, there has been furious debate on the merits of spending more money to improve infrastructure—some of which we did, in fact, do as part of the 2009 stimulus package—but there has been little debate about whether we are getting enough bang for our buck from spending that money.

Those who complain about the poor state of infrastructure and want to spend more on it need to reconcile their urgency in doing so with the fact that it takes so long to disburse and spend public money on infrastructure, and that we can never be sure we are getting our money’s worth. There are funds allocated for infrastructure spending in the 2009 stimulus bill that have yet to be fully disbursed. Just one block from the White House sits a small federal office building that was included on the initial list of rebuilding projects in the stimulus bill. A scant 18 months after the bill’s passage, the building’s tenants were evicted, and 18 months after that, construction actually began, fitfully. As of early 2015—fully six years after the bill’s passage—construction had yet to be completed. It took less time to construct the Hoover Dam than it has to update this modest building.

Why it takes so long to build or improve public roads, bridges, and buildings these days owes to a multitude of factors. Barry LaPatner, a construction lawyer with a passion for fixing this broken system, argues convincingly in *Broken Buildings, Busted Budgets* that the very way we conceive of government contracts for infrastructure construction is amiss.

The current process of contractors bidding on a project and then having their activities closely scrutinized or managed by government overseers leaves a lot to be desired, he argues. It is only natural that the low bidder for any government project may be affected by the “winner’s curse”—winning a contract at a price at which it is impossible to make a profit. Faced with that stark reality, he begins to cut corners wherever he can, and it becomes the job of the highway engineer to keep him from doing so. Many times the contractor turns to the government for more money after the project has started, and the original bidding process—designed to



Broken Buildings, Busted Budgets: How to Fix America’s Trillion-Dollar Construction Industry

By Barry LaPatner
240 pp.; University of Chicago Press, 2008

save taxpayers' money—turns out to be completely irrelevant to the ultimate cost and scope of the project. The incompetent subcontractor hired to help finish the approaches to the new bridge may end up slowing the project down, but the contractor gets his money nonetheless.

LePatner advocates for a design and build process for roads, bridges, and buildings that would essentially take the government middleman out of the process and give the contractor carte blanche in deciding how to build. The government would merely specify the quality of a road (or bridge or building) and a period of time after construction is complete that the contractor bears responsibility to maintain that quality level. In essence, the contractor would be asked to provide not a one-time good—building a road—but to deliver a service over time: a smooth road without potholes, cracks, or broken pavement for the next 20 years. How the road would be built would be of no concern to the government so long as the contractor guarantees to maintain the high quality of the road until the contract ends.

In one step, LePatner argues, such a change would alter the essential calculus by aligning the incentives of the general contractor and the government. There becomes no need for the government to specify how the road is built or to supervise each and every stage of the process and in so doing create a bureaucratic regime that throttles ingenuity and takes away any incentive to improve productivity.

For this to fully rein in costs we concomitantly would have to end the ability of contractors to kick all cost overruns to the customer. That it has become *de rigueur* for the customer to be responsible for those excess costs—and for the courts to allow this practice to become entrenched—makes little sense. It can only be justified by the assumption that moral hazard is so endemic in the contractor/client relationship that even the constant supervision and contractual obligations contained in the current structure of contracts are not enough to prevent the contractor from cutting corners and delivering a substandard project. A clearer delin-

ation of what is to be delivered, freeing the contractor to pursue ways to improve productivity without government getting in his way, could deliver radical gains in construction speed and the quality of our building projects, LePatner argues.

So why am I reviewing a book that came out six years ago? The sad fact of the matter is that we are currently bereft of ideas in the highway construction world. Congress will not increase gas taxes, the prospect of more toll roads is dead, and the vehicle-miles-fee approach has bitter enemies on

both sides of the aisle who are determined to keep it from ever happening.

If there is a need to do more infrastructure building, how can we do it? We are left with appealing to ways to increase productivity. *Broken Buildings, Busted Budgets* offers a blueprint to do so that remains as fresh today as it was in 2008—and more timely than ever.

And when Representative Kennedy's sleepy highway engineer wakes up 20 years from now, this book will no doubt still be relevant and a largely untried recipe for fixing a broken system. R

John Hicks and the Beauty of Logic

◆◆ REVIEW BY PIERRE LEMIEUX

Economics undergraduates often criticize the theory they are taught. In much of the world, that theory is neoclassical economics, the strand of thought that has been mainstream economics since the late 19th century. It is blamed as too abstract. Today, an international student movement critical of neoclassical theory's dominance, supported by some professors (including Joseph Stiglitz) and partly bankrolled by billionaire George Soros, is apparently having an effect as some universities try to bring more "diversity" to their economics curricula.

But in order to learn economics and economic reasoning, there is no shortcut around neoclassical thought. A good illustration of this can be found in the work of John Hicks, one of the major economists of the 20th century.

John Richard Hicks (1904–1989) was born and lived virtually all of his life in England. At a time predating diploma inflation, the B.A. Honors in "Philosophy, Politics and Economics" he earned from Oxford University was sufficient to launch him on an academic career in the most prestigious English universities. He made important contributions to many fields of economics,

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from microeconomic and macroeconomic theory to welfare economics and labor economics. In 1972, he and Kenneth Arrow were awarded a Nobel Prize in economics "for their contribution to general equilibrium theory and welfare theory."

Hicks was a master of pure economic theory—that is, the logical development of theorems from the starting point of clearly stated assumptions. He explained his theories mainly in plain English, although he was not afraid to use mathematics when necessary—to extend his results to more than two goods and two persons, for example. His book *Value and Capital*, which appeared 75 years ago, exemplifies pure economic theorizing. His later book *A Theory of Economic History*, which appeared 45 years ago, applies economic reasoning to history. Reviewing those two books on their anniversary will allow us to explore Hicks's development and use of economic theory.

Logic of history / How can one build a

IN REVIEW

theory of economic history? Theory is ahistorical and general; history is made of unique events. Because of particular events and the influence of individuals, history cannot be deterministic. Yet, Hicks explains, economic theory can help understand why, in its general features, history evolved as it did. It also helps the analyst to fill in the blanks when the historical or archeological records are missing or incomplete. Behind the way people act, “there is an economic logic.”

Economic reasoning is the use of logical theories based on individual self-interest, incentives, and related concepts. With economic reasoning, Hicks imagines how the market rose, from prehistoric times to our own. This theoretical reconstruction of history must not, of course, contradict the historical facts we know, but it can make them more intelligible.

The market rose in the interstices of, and against, the custom or command economies that characterized the first ages of mankind. Although humans have exchanged since the earliest of times, the crucial phenomenon in the rise of the market must have been the gradual appearance of specialized middlemen—traders or merchants—who made a living by buying goods only in order to resell them. Middlemen especially thrived in city-states, which from ancient Greece to medieval Italy provided merchant communities with a favorable economic and legal environment. Hicks sees in the rise of the merchant the first phase of the “Mercantile Economy,” a term perhaps not well chosen, which simply means the market economy.

The middle phase of the market economy came when the commercial ways of city-states started penetrating the rest of the world, often after the city-states themselves had been conquered *manu militari*. Money had been used for a long time, but its character changed in the middle phase. It started to be loaned for interest, even when interest was frowned upon or banned. Financial markets provided an essential tool for commerce, especially in more risky commercial ventures in foreign lands. Banking appeared in Florence in the 14th century. Insurance—

against the loss of cargo in transit—developed at roughly the same time.

Many other phenomena strengthened the middle phase. Partly because of the reduction of the labor supply by the Black Death in the 14th century, labor became dearer and peasants escaped servitude and their forced attachment to their lords’ lands. Land slowly became tradable on the market. For the farmers, this commodification was a liberation.

How could the early kings get the revenues they needed? Hicks, prefiguring Mancur Olson, pointed out, “One does not get a regular income by plunder.” Slavery is often not an efficient solution either. So the king will request that his subjects make contributions or pay taxes. He will soon discover that it is more efficient to let his local vassals collect taxes and send him a cut. That leads to a decentralization of power—typical of the Middle Ages—that threatens the king. Hence he will want a bureaucracy at his exclusive service. He will then have to make sure that his civil servants do not usurp his power. Public Choice in historical time, as it were!

Dark side / The third stage of the development of the market—the modern phase—continued the advance of trade. Finance developed further. The Amsterdam Bourse started trading in securities in the early 1630s. The law created limited liability companies. The abolition of the slave trade pushed up the price of slaves, contributing to the growth of a free labor market. In America, the availability of frontier land likewise tilted the balance of power to the laborer by increasing the relative wages of free labor, with dire consequences for black Americans.

But progress was continuing. The Industrial Revolution was made possible not only by technological developments (such as the steam engine), but also by the growth of finance, which reduced the risk of large capital projects. Such projects are, by their nature, sunk and illiquid. If you can’t borrow against your factory in case of need, chances are that you will not build it. Hicks contends that, for a time, labor-saving technologies created a

lag between investment and wage increases, but the lag did not last. Wage labor was a liberation. The Industrial Revolution ended the casual and irregular employment of previous times when, at the bottom of the social scale, poor and homeless people drifted in and out of temporary employment.

The modern phase, however, had a dark side. Governments vastly increased their taxing powers through the Administrative Revolution. While the first phase of the Mercantile Economy was “an escape from political authority,” the modern phase made control “immensely easier.” State power grew, especially with World War I. And the process continues: “The contribution of the computer to the mechanization of government,” Hicks wrote perceptively in 1969, “is only beginning to be seen.”

Of course, political authority was not absent before the modern phase. Money had been spontaneously created on the market, but the authorities did not leave it alone. Kings helped the circulation of international coins by stamping them. Those rulers soon yielded to the temptation of debasing money, especially local currencies. Some companies were given trading privileges. Colonization was not always profitable for everybody. Banks were put at the service of public finances.

Celebration of exchange / *A Theory of Economic History* is a continuous celebration of exchange and its liberating power. “So long as trade is voluntary, it must confer an All-round Advantage,” wrote Hicks. Exchange leads to economic growth, which is what people generally want:

It is easy to be sentimental, or romantic, about the beauties of primitive societies; but it remains true that when people are offered a genuine opportunity for economic growth ... they are generally glad to take it.

Trade, especially when combined with technological innovation, can create much disruption. As a welfare economist, Hicks could not ignore that in all big shifts, “there are gains as well as losses,” and that “the gains and losses accrue to different

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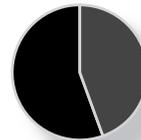
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people, so that we cannot easily set one against the other.” Yet, he concluded, “there is a sense, which is recognizable when we look at the matter from a distance..., in which the gains must be dominant.”

Hicks was not blind to the fact that “mercantilism,” as the term is generally used, “marks the discovery that economic growth can be *in the national interest*,” which he (correctly) viewed as a danger:

The name “mercantilist” is only appropriate when we are looking at history the other way, from the standpoint of the State, from the standpoint of the rulers. They become “mercantilist” when they begin to realize that the merchants can be used as an instrument for their primary non-mercantile purposes.

When, at the end of the book, Hicks expressed his opinion about the problems of underdeveloped countries, he seemed unduly pessimistic of the possibilities of the free market. And he was a bit too optimistic on the positive role that governments can play: “Whatever its motives,” he correctly wrote, “protectionism is an obstacle,” but he accepted (mistakenly, in my opinion) the use of temporary protectionist measures “for the easing of transitions.”

A Theory of Economic History is a delicious book. It is understandable why Hicks later said that it is the book he would most like to be known for, and that he would have preferred that he had received his Nobel Prize for it.

End of marginal utility / As a pure “theory of economic choice,” *Value and Capital* is a very different book. It is widely recognized as Hicks’s main book and as one of the economics classics of the 20th century. The first part of the book is, in my opinion, the essential one. It proposed what was, at the time, a revolutionary reformulation of the theory of utility and demand, and it rapidly passed into mainstream economics. Hicks showed how the

Value and Capital

By John Hicks

340 pp.; Oxford University Press, 1939, 1946

A Theory of Economic History

By John Hicks

181 pp.; Oxford University Press, 1969

theory could be rebuilt—and refined—without any concept of measurable utility.

Following Alfred Marshall (1842–1924), neoclassical economists had theorized that value comes from the “utility,” or satisfaction, that a good or service provides to individuals. Every individual was supposed to have a certain intensity of desire for goods and services. Although subjective, utility was conceptually measurable,

like distances. In other words, it could be represented by cardinal numbers. As one geographical landmark can be, say, twice as far as another one, a certain quantity of a certain good could give an individual twice as much utility as a different quantity of that or another good.

The marginal (or additional) utility that successive units of a good give to a consumer was assumed to be decreasing. In a given period of time, one gets more pleasure from his first glass of wine than from the second, from the first cigar than from the second, and so forth. A consumer maximizes his utility by distributing his budget among goods in such a way that the marginal utility of any good (per dollar spent) is equal to the marginal utility of any other good.

From this, it seemed that interpersonal comparisons of utility were possible. Since the marginal utility of money diminishes (like for any other good), it was argued that income redistribution increases net utility in society.

Many economists, like Carl Menger (1840–1921), one of the founders of the Austrian school of economics, had expressed doubts about this conception of utility. They argued that marginal utility could only be measured (even conceptually) in an ordinal manner, that is, by way of rankings. Ordinal utility was still quantitative utility, and it was not clear how marginal utility could be purely ordinal. If you can carve marginal units out of a total, doesn’t that imply that the total has a cardinal value?

Scale of preferences / In the crucial first chapter of *Value and Capital*, Hicks shoved away any idea that utility could be measured and cut in tranches.

For that purpose, he borrowed the concept of indifference curves from two economists of his times, Vilfredo Pareto (1848–1923) and Francis Y. Edgeworth (1845–1926). An indifference curve is a geometrical (or algebraic) device showing all bundles of goods that give a certain consumer the same utility, however one cares to measure it. Indifference curves are similar to level contours on a map, but without any significance attached to the distance between them. If we have all the indifference curves of an individual (his “indifference map”), each one corresponding to a certain level of utility, we can theoretically calculate which bundle of goods that consumer will choose, given his budget and the prices of the goods, in order to maximize his utility.

Hicks explained that, in this way, we can totally separate the consumer’s indifference map from any quantitative concept of utility, thereby eliminating any backdoor to cardinal utility. The only necessary assumption is that an individual has a “scale of preferences” on which he subjectively ranks different bundles of goods. Because the quantitative concept of utility is not necessary, “on the principle of Occam’s razor, it is better to do without it.” The scale of preferences replaces the “utility function” (even if the latter’s label is retained).

“If total utility is arbitrary,” Hicks added even more radically, “so is marginal utility.” So marginal utility is gone, too. For example, your second cigar could provide more marginal utility if smoked with the second glass of wine, but it does not matter anyway because there is a better and simpler assumption available than diminishing marginal utility.

Hicks replaced the principle of diminishing marginal utility with a diminishing marginal rate of substitution: at a given level in his scale of preference, a consumer is willing to give up less and less of one good in order to consume more of another; one unit of the new good can be substituted for less and less of the previous one.

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In order to increase your consumption of cigars, you will be willing to give up less and less wine—otherwise you would fall on your scale of preferences. The condition of equilibrium for a consumer becomes that his marginal rate of substitution of one good for another must be equal to the ratio of the two goods' prices.

Rabbit in the hat / How do we know that a diminishing marginal rate of substitution is a better assumption than diminishing marginal utility? As Hicks put the question, how did the rabbit get in the hat before the magician released it? The answer is that it is a simpler assumption than diminishing marginal utility, and it allows the development of a richer theory. Hicks's theory of utility has proven more useful than alternative theories, if only because it decomposes the effect of a price change into a substitution and an income effect.

The marginal rate of substitution *can* be interpreted as the ratio of the marginal utilities (as some economists continue to do for ease of exposition), but it *does not need to be* interpreted that way. We can totally dispense with marginal utility to build a theory of consumer behavior.

Theoretical explorations / Part II of *Value and Capital* extends the partial-equilibrium analysis of Part I into a general-equilibrium system. General-equilibrium analysis connects all markets and follows their indirect effects on each other. Equilibrium means a situation where individual expectations are fulfilled and plans are consistent. Hicks's analysis incorporated firms and their production functions in a way that still forms the backbone of microeconomics. His conclusion was that a free-market system will likely be in a stable equilibrium.

Part III of the book tries to recast the basics of economic dynamics. Hicks began his dynamic analysis by saying, in typical discovery mode, "Let us proceed to see how it all works out." The dynamic problem is that the economy does not stay in static equilibrium, partly because lending and money create shifts through time. Another way to look at this is to realize that capital—goods

that serve to produce consumer goods and must be financed—changes over the long run. That is the "capital" part in *Value and Capital*. Hicks readily admitted with Eugen Böhm-Bawerk (1851–1914), a major Austrian precursor in the theory of capital, that the economic system must be conceived as "a process in time," but he applied the same tools of analysis to a dynamic economy that he used for a static economy.

His dynamic analysis is not satisfactory for today's economists. Hicks tried to overcome what he saw as the Austrian economists' shortcomings, such as their neglect of price expectations and their focus on stationary conditions. But his own dynamic theory does not look very dynamic. His conception of interest is also unsatisfactory because it focuses exclusively on risk and excludes time preference (the hypothesis that, other things equal, an individual prefers consuming now rather than later).

Part IV of *Value and Capital* is also disappointing and has not aged well. The main question was whether the dynamic general equilibrium system is stable, and the stability issue was very important in the wake of the Great Depression. Hicks argued that a free-market system is "imperfectly stable"—that is, generally stable, but not always—once we take into account the accumulation of capital, inflation or deflation, speculation, and self-fulfilling expectations.

Efficient government? / This last part of the book shows how Hicks had already been influenced by Keynes, whose *General Theory of Employment, Interest and Money* had been published a few years earlier. However, the influence in the other direction was probably greater: Hicks' "IS–LM" curves, with which any student of economics is familiar, reformulated Keynesian theory—or one version of it—in a more intelligible manner. At any rate, Hicks seemed more optimistic than Keynes on the stability of the economy. And he later distanced himself from Keynes.

Hicks sometimes appears naive toward the efficiency of government intervention and the possibility of central planning, but probably less so than Keynes. In the

conclusion of *Value and Capital*, he suggests that government should use its power of control over investment and its monetary policy to dampen economic fluctuations. "Whether capitalism is less or more efficient than socialism depends very much on the efficiency of socialism," he wrote. "That is still rather an open question." He duly recognized, however, how sticky wages (perhaps caused by minimum wage laws) contribute to unemployment.

Other criticisms can be directed at *Value and Capital*, but Hicks's formidable logic remains impressive, and his contribution to the development of economic theory (especially in the first two parts of the book) is unquestionable.

Irregular and defective Austrian? / What was Hicks's philosophy? An analyst must always distinguish facts (*what is*) from values (*what ought to be*), the positive from the normative. A nearly parallel distinction runs between the results of economic analysis and the moral judgments brought to bear on them. Hicks was conscious of those distinctions and tried to avoid interjecting value judgments in his analysis. He believed that it is necessary to distinguish mere opinions from "those things which are the fruit of pure logic," that which we are "compelled to believe."

Hicks was generally recognized as a classical liberal. His mild classical-liberal values were consistent with his theoretical work, which emphasized the general efficiency of markets but harbored no a priori refusal of government intervention when needed. Yet, his political views changed over his career.

In a September 2013 *Econ Journal Watch* paper, Daniel Klein and Ryan Daza traced Hicks's ideological evolution. A temporary appointment in South Africa around 1927–1928 showed him how, contrary to the racist trade unions, a free labor market would advance the progress of blacks. "So I became a free market man," he wrote. He was then influenced by Hayek: "I fell rather easily into the ultraliberal line which became dominant in the economics section of [the London School of Economics]." By 1935, however, he had lost his "old

faith” in the free market, a new ideological period that coincided with his work on *Value and Capital*. But starting in the 1960s or 1970s, he seemed to have come back to classical liberalism and became more suspicious of government.

In the 1970s, he also seemed to return to his original Austrian influences, claiming to develop a “neo-Austrian” theory of capital. In 1979, paraphrasing poet John Milton who confessed to being an irregular and defective Baptist, Hicks described himself as an “‘irregular and defective’ Austrian.”

Critical theorist / That Hicks would not have bought any ideology in bulk, nor sold his soul to any school of economic analysis, that he would always be “irregular and defective,” is not surprising. He was a critical theorist who would follow the logic of his models wherever it would take him. He did not hesitate to criticize his own previous theories.

But he was not blinded by the formal beauty of pure theory. In 1979 he wrote that “theory gives one no right to pronounce on practical problems unless one has been through the labour, so often the

formidable labour, of mastering the relevant facts.” He said he “felt little sympathy with the theory for theory’s sake, which has been characteristic of one strand in American economics,” and “had little faith in econometrics, on which [those economists] have so largely relied to make their contact with reality.”

Perhaps he had epistemologically mellowed. Economics, he wrote in 1983, is a discipline, not a science. He warned economists against conceit:

I do think it is a besetting vice of economists to over-play their hands, to claim more for their subject than they should. As will have been seen, I have on occasion fallen into that vice myself; but I think, or hope, that as the years have gone by, I have learned more wisdom.

Yet, he should not have apologized for the beauty of his logic. His conclusions, often surprising and iconoclastic, were always compelling (in the context of his models). He was also an extraordinary writer. Those qualities are obvious in *A Theory of Economic History* and in *Value and Capital*, however different those two books are. **R**

political science at Chapman University, in his new book, *The Evangelical Origins of the Living Constitution*. Compton argues that the “living Constitution” idea arose much earlier in our history, an outgrowth of the moral reform movement that swept across the United States from the 1820s until the early decades of the 20th century.

Alcohol and lotteries / Zealous champions of moral reform, then as today, thought that a proper function of the law was to eradicate vice and immorality. They were stymied, however, by the Constitution’s limits on governmental power. Compton explains, “For while the designers of the American constitutional order did not set out with the aim of inhibiting the moral development of future generations, they did envision a republic whose fundamental law would hinder efforts to interfere with settled property rights or restrict the flow of goods in interstate markets.” But that was exactly what anti-liquor and anti-lottery forces wanted—for the law to declare that there could be no legitimate property rights in alcoholic beverages or lottery tickets and to block their flow in markets altogether.

Compton’s history is compelling. The tension between moral reformers, who insisted on a virtually unlimited view of the “police powers” of government (i.e., to regulate in ways intended to protect the health and morals of the citizenry), and the Constitution’s framers, who feared the results of allowing factions to use government power for their ends, was crucial in shaping constitutional law during the 19th and early 20th centuries.

The book shows that by the time the New Deal’s aggressive expansions of federal power came before the Supreme Court, its earlier decisions approving legislation against liquor and lotteries had so undermined the defenses of property rights, contract, and federalism that it was nearly inevitable that the Court would cave in. Progressives argued that if the Court could interpret the Constitution to allow federal legislation when it came to the alleged harms of alcohol and gambling, it should do the same with regard to child labor laws,

How We Got a ‘Living’ Constitution

REVIEWED BY GEORGE LEEF

A constant, sometimes acrimonious source of debate in America is over the right approach for applying the Constitution to today’s governance issues. Essentially, there are two camps: the originalists who insist that the Constitution’s meaning as it was understood by those who wrote it (and its amendments) must guide the courts, and the advocates of a “living Constitution” who say the document must be interpreted in light of contemporary conditions and beliefs.

I put myself in the former camp, but had never given much thought to the genesis of the “living Constitution” theory.

When and how did it arise? My supposition had been that it was a creation of the “progressives” in our legal system early in the last century, exemplified by Justice Oliver Wendell Holmes and liberal intellectuals who favored Franklin D. Roosevelt’s vast expansion of federal authority.

That view is not exactly right, argues John Compton, assistant professor of

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unionization, wage and price controls, and similar issues. Eventually, they prevailed.

In Compton's well-researched narrative, the young American nation was one of rather relaxed religious and moral sensibilities. Church affiliation was in decline and few people saw the consumption of alcoholic drink to be a vice in and of itself. One fascinating detail Compton mentions is that Post Office employees had to work on Sundays. That brought down the wrath of many religiously minded people, but judges blocked every effort at halting this violation of the Sabbath.

Beginning in the 1820s, however, a wave of religious fervor spread across the nation. While some reformers were content just to denounce what they viewed as immorality and persuade people to give up their vices, others insisted on employing government power. In 1851, Maine became the first state to enact a prohibition against the production and sale of alcoholic beverages, and by 1856 a dozen states had such laws. In some states they were struck down by the courts, but in others they were upheld on the grounds that individuals' property rights had to fall before "the greater right of the community."

Easing the shoe / After the Civil War, litigation over the banning of liquor continued, but the biggest legal cases involved gambling. In early America, lotteries had been viewed benignly. By the 1860s, however, campaigns to stop them were alive in every state. Particularly interesting—even amusing—were the efforts against the Louisiana Lottery, a company that earned good profits in the lottery business. The battle between the company and its opponents went on for decades, culminating in the U.S. Supreme Court's 1903 decision in *Champion v. Ames*.

At issue was the constitutionality of a federal statute prohibiting the interstate transportation of lottery tickets. Counsel

for the lottery industry argued that the law obliterated the longstanding distinction between interstate commerce, which pertained to the movement of tangible goods, and "police power" measures intended to regulate morals. Congress had never been thought to possess authority of the latter kind and therefore it seemed the statute would be declared unconstitutional.

Champion was vigorously contested. The Court heard arguments three times before a majority emerged in favor of upholding the statute. Justice John Marshall Harlan declared that because "lotteries were offensive to the entire people of the Nation," the statute should be allowed to stand. And even if the anti-lottery statute might be a surreptitious expansion of federal authority into an area traditionally reserved to the states, he wrote that the Court must not inquire into the motives of the legislators. The "living Constitution" concept had triumphed.

The dissenters, led by Chief Justice Melville Fuller, saw ominous implications in the decision. Simply to accommodate public opinion, the Court had illegitimately expanded the scope of federal power. Having once given in to the idea that America's "fundamental law is flexible," Fuller foresaw that the Court would succumb to the same pressure again and again. If the Court bowed to demands "to ease the shoe where it pinches," he argued, then eventually nothing but the shell of the Constitution's limitations on governmental power would remain.

Breaking the firewalls / Events would prove Fuller right, although not immediately. For quite a few years, the Court held to pre-*Champion* concepts about the boundaries of state and federal authority when it came to business and economic issues. In the famous 1905 case *Lochner v. New York*, for example, the Court struck down a statute that limited the number of hours

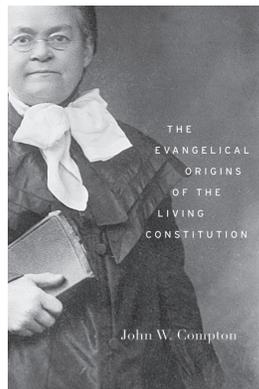
a baker could work, despite a vigorous dissent from Justice Holmes that state governments should be able to act for the public good and put a ceiling on the number of hours a person could work. In *Adair v. U.S.* in 1908, the Court, per Justice Harlan, declared that Congress had no authority to enact a law against "yellow dog contracts"—that is, contracts whereby employees agreed not to join a labor union. And in 1918, *Hammer v. Dagenhart* struck down the federal statute prohibiting items produced with child labor from moving in interstate commerce.

Those decisions and others that said "no" to progressive social and economic legislation were vociferously denounced as hypocritical by many legal and economic commentators. How could the Court side with business in cases like *Lochner*, *Adair*, and *Hammer* after conceding that government has the power to ban the evils of lottery tickets and demon rum?

The Court's "firewalls" against letting its pro-regulation rulings in liquor and lottery cases spill over into economic controversies held through the 1920s. But once the nation was mired in the Depression, the pressure on them became too great. The breakthrough case was *Blaisdell v. Savings and Loan* in 1934. Minnesota's legislature had enacted a moratorium on mortgage foreclosures, a populist measure that reflected the "little guy versus moneyed interests" spirit of the times. The problem was that it ran straight into the Constitution's prohibition against laws impairing the obligation of contracts.

Just a few years earlier, such a law would have never been suggested and, had one passed, the Court would have had no trouble invalidating it. In 1934, however, things were different. Would the Court find a way of upholding a law that was so clearly at odds with anything resembling an originalist reading?

It did. Citing the earlier lottery decision, Chief Justice Charles Evans Hughes wrote that the Contracts Clause could be "qualified" when a state needed to "safeguard the interests of its people." He acknowledged that the ruling might not fit with the



The Evangelical Origins of the Living Constitution

By John W. Compton
261 pp.; Harvard University Press, 2014

original intent of the clause, but was consonant with the Constitution’s “essential spirit.” Thus, with some verbal arabesques, Hughes sanctified the “living Constitution” approach in economic and business issues.

Until this point, Compton gives his readers scarcely a hint whether he is sympathetic to one side or the other. Here he drops the veil of objectivity, writing in defense of the *Blaisdell* decision that Hughes “was actually attempting to provide a new theoretical foundation for a clause that had long ago been severed from its original purposes.” I cannot agree. The Chief Justice was not looking for anything other than an excuse for avoiding a very unpopular decision. *Blaisdell* only meant that the Court would turn a blind eye to the plain meaning of the Contracts Clause if a large majority wanted government to favor debtors over creditors.

In 1935 and 1936, the Court held fast to the “un-living” concepts of federalism in striking down some major New Deal laws. In 1937, however, the dam broke when the Court upheld the National Labor Relations Act in a decision that eviscerated the distinction between intrastate and interstate commerce. Subsequently, the Court rubber-stamped the Fair Labor Standards Act, the Agricultural Adjustment Act, and other pillars of the New Deal.

Conclusion / Fuller’s concern in his *Champion* dissent has been amply borne out. “Living Constitution” jurisprudence has led to almost unchecked growth of government power. Ironically, while America is back to our early indifference toward liquor and gambling, we are caught fast in the web of economic regulation that was made possible by the precedents estab-

lished in the “morals” cases.

Perhaps Compton overplays his argument that the tension between the Court’s permissive liquor and lottery decisions on the one hand and the Constitution’s limits on government power on the other made it inevitable that the latter would eventually yield. After all, the justices continued to strike down interventionist legislation throughout the 1920s, ignoring the “hypocrisy!” criticism from the progressives when they did so. It was not until the Depression that the Court began retreating from its property rights, contract, and federalism defenses against legislation like that at issue in *Blaisdell*. If not for the Depression, those defenses might still stand.

Nevertheless, this is a fascinating book that sheds much light on how our views on the proper scope of government have changed. R

Working Papers BY PETER VAN DOREN

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

Oil Markets

“The Changing Face of World Oil Markets,” by James D. Hamilton.
July 2014. NBER #20355.

Crude oil prices, as measured by the U.S. Energy Information Administration’s domestic first-purchase price, increased from an average low of \$15.37 a barrel in 1970 (in inflation-adjusted second-quarter 2014 dollars) to an average high of \$71.48 in 1981. By 1988, prices had decreased to \$22.06, and by 1998 to \$14.94—lower than the price in 1970. By 2008, the price had risen to \$101.15. As I write this in October 2014, the price is around \$82.

Will oil prices ever return to their 1998 and 1970 levels? James Hamilton of the University of California, San Diego argues no. The current historically high price level is the result of an extraordinary increase in demand for oil from the developing world and stagnating conventional supply.

Developing countries accounted for one-third of the world’s oil consumption in 1980, but they consume 55 percent now. And their consumption growth since 2005 has been way above their 1980–2005 trend; China alone accounts for 57 percent of the global increase in consumption since 2005.

Consumption trends in the developed world have been the opposite. During the low-price era from 1984 to 2005, oil consumption in the United States, Canada, Japan, and Europe grew

linearly at an annual rate of 400,000 barrels a day. Since 2005, consumption has fallen at an annual rate of 700,000 barrels a day. Oil consumption in the developed world was 8 million barrels per day (mbd) less at the end of 2012 than one would have predicted from the 1984–2005 trend.

That reduction was the result of higher oil prices and not simply a fall in demand because of the Great Recession. Since 2009, U.S. gross domestic product has grown at about the same rate it did before the recession, but U.S. oil consumption continues to decline.

Crude oil production is accompanied by natural gas. The aggregate oil production data include “natural gas liquids” or NGL (these are ethane and propane, which are not liquids at normal pressures and temperatures, but are called liquids because they can be liquefied at low cost relative to methane). In 2005, NGL made up only 9 percent of total oil supply; since 2005, they have made up 29 percent of the increase in total supply. That is important because, though NGL adds to total supply, it cannot be easily converted to gasoline, jet fuel, or diesel fuel. Thus, there is an increasing mismatch between the characteristics of crude oil at the margin and its primary use as transportation fuel. This is reflected in the price of natural gas versus crude oil; we pay four times as much per British Thermal Unit for crude oil as for natural gas.

Not only is the composition of oil increasingly mismatched with transportation market needs, but the total production of crude oil is relatively stagnant. If one linearly extrapolates the pre-2005 production trend, one would project that oil production

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would have grown by 8.7 mbd between 2005 and 2013, but it only grew 2.2 mbd over that time.

Why has world oil production not increased? Libya, Iran, Iraq, and Nigeria have been affected by regime instability or international sanctions. Saudi production has been almost flat since 2005, averaging 9.6 mbd in 2005, 9.7 mbd in 2013, and 9.8 mbd so far in 2014. Major international companies have had increasing capital expenditures and decreasing production since 2005. U.S. production in the “Lower 48” states from conventional production is 5.5 mbd lower in 2013 than in 1970. This decline has been partially offset by Alaska and offshore production, but those sources peaked in 1988 and 2003, respectively. Recent oil shale production, which is 2.9 mbd more than in 2005, has offset the 0.6 mbd decline in conventional production in the Lower 48. More importantly, the net 2.3 mbd increase in production from oil shale in the United States is the entire increase for the world since 2005. Thus, the current historically high price of oil is not likely to decrease dramatically because of the apparent limits on conventional sources and the tremendous increase in developing world demand.

Payment Card Regulation

“The Impact of the U.S. Debit Card Interchange Fee Regulation on Consumer Welfare: An Event Study Analysis,” by David S. Evans, Howard Chang, and Steven Joyce. October 2013. SSRN #2342593.

“Regulating Consumer Financial Products: Evidence from Credit Cards,” by Sumit Agarwal, Souphala Chomsisengphet, Neale Mahoney, and Johannes Stroebel. September 2013. NBER #19484.

In payment card markets, banks create gains to trade between consumers and firms by facilitating transactions in which cards substitute for cash or checks. Banks have to decide how much to charge consumers and how much to charge merchants for that service. Because cash and checks have very low or zero marginal costs for consumers, banks have concluded that, to induce consumers to switch to cards from the other two payment forms, most of the costs of payment cards must be placed on merchants rather than consumers.

Merchants reacted to this politically by seeking the aid of Congress in reducing their charges. The Durbin Amendment to the 2010 Dodd-Frank Act instructed the Federal Reserve to issue rules limiting the level of debit card interchange fees to the costs of authorization, clearing, and settling debit card transactions, thus eliminating the fees as a source of profits for banks. In December 2010, the Fed proposed a rule that reduced charges a surprisingly large amount, to 12 cents per transaction from the approximately 44 cents unregulated rate. The final rule in June 2011, which gave unexpected relief to the banks, limited the charges to 24 cents. Still, in 2012, banks received an estimated \$7.3 billion less in debit card processing revenue because of the fee reduction.

How were the benefits and costs of this fee reduction distrib-

uted? David Evans et al. use the initial surprise of the 12-cent fee proposal and the subsequent surprise of the much higher 24-cent limit as the basis for designing a study to examine how bank and retailer stock values changed. They conduct a traditional stock price event study in which changes in the value of stocks of banks and retailers relative to all other stocks just after the surprise events are attributed to those events.

The event study consisted of the 66 largest publicly traded retail firms in the United States and 57 publicly traded financial firms with the largest debit card transaction volume. The draft rule created a capitalization gain of between \$2.5 and \$5.3 billion for retailers and capitalization loss of \$9.7–\$10.8 billion for banks. The final rule resulted in retailers losing \$6.2–\$8.6 billion and banks gaining \$9.4–\$11.2 billion. Scaling the results up so they represent all banks and merchants, the net effect of the final rule was to increase merchant profits by \$38.1–\$41.1 billion and decrease bank profits by \$15.9–\$16.4 billion. The decrease in bank profits is exceeded by the increase in merchant profits. Thus consumers are worse off by the \$22–\$25 billion difference because retailers are expected by investors to keep more of the interchange fee reduction in profits than banks are expected to take as losses.

Consumer groups and some economists, particularly those whose research falls into the “behavioral” rather than “neoclassical” tradition, favor regulation of financial transactions to aid unsophisticated consumers in their dealings with banks. They especially have in mind fees and other charges that are less than transparent and require diligence to understand. Banks and more traditional economists argue there is no free lunch and attempts to regulate fees will result in increased consumer costs in other unregulated dimensions. For government regulation to be effective, credit card markets must not be fully competitive and consumers must not be equally responsive to different types of charges and fees.

Sumit Agarwal et al. examine how credit card charges reacted to the Credit CARD Act of 2009. The act, relying on behavioral economics thinking, requires that consumers be notified and explicitly approve transactions over their credit limit, including notification of resulting extra fees. The status quo before the act allowed consumers to opt for a simple transaction denial once their credit limit was reached—an option that few consumers exercised. The CARD Act also requires that credit limit exceedance fees occur only once in a billing cycle rather than for each transaction, because many consumers did not realize they had exceeded their limit until they received their account statements and observed hundreds of dollars in extra fees. Finally, the act requires monthly statements to contain explicit information about how long it would take to pay off a balance if only the minimum payment were made and how large the payment would have to be to pay off the balance in 36 months.

Agarwal et al. studied the effects of the CARD Act on the “near universe” of credit card accounts of the eight largest banks. Before the provisions of the act took effect (from April 2008 to January 2010), consumers as a group paid 21.9 percent in interest payments and fees, cost the bank 15.6 percent in charge-offs, and

generated a net bank profit of 1.6 percent. Consumers with FICO scores—a measure of creditworthiness—lower than 620 (considered a bad score) paid 43.9 percent per dollar borrowed in interest and fees and generated net profits of 7.9 percent.

The regulations to limit fees had large effects on the behavior of consumers with low credit scores. Late fees and over-limit fees dropped by 2.8 percent of borrowing volume (\$744 billion in 2010), or \$20.8 billion. For those with FICO scores lower than 620, fees dropped from 23 percent to 9 percent of average daily balance. The authors found no change in interest rates or credit limits in response.

Because interest rates were declining in general during this period, some have argued that no change in interest rate charges to consumers is evidence that banks did “increase” interest rates relative to the counterfactual lowering that did not occur. To test this argument, the authors conducted a difference-in-differences analysis comparing interest rate changes for those with low and high FICO scores. They found no difference even though the low FICO score accounts generated much less fee revenue while the high FICO score accounts had little change in revenue generation. Thus, one would predict interest rates would have increased on the low FICO score accounts or decreased on the high FICO score accounts.

The authors find that the regulation that mandated information about length of time to full balance repayment had little effect. The number of accounts repaying at a rate that would extinguish balances within 36 months increased by a mere 0.5 percentage points.

Risk Retention by Mortgage Securitizers

“Qualified Residential Mortgages and Default Risk,” by Ioannis Floros and Joshua T. White. August 2014. SSRN #2480579.

In late October, federal regulators issued final rules required by the Dodd-Frank Act defining the characteristics of mortgages that are deemed risky enough to require the originator to retain at least a 5 percent stake in the mortgages. The original proposed rule in 2011 defined a “Qualified Residential Mortgage” (QRM), which would not require risk retention by the originator, as having at least a 20 percent down payment. The proposed rule exempted mortgages with an explicit government guarantee, including those sold to Fannie Mae and Freddie Mac as long as they remained under government conservatorship.

Liberal community housing groups, mortgage bankers, and home builders lobbied extensively for the last three years against the down payment requirements. The final adopted rule contained no down payment requirement and exempted mortgages sold to Fannie and Freddie as long as the firms remain under federal conservatorship with explicit government backing.

The reaction to the final rule from commentators has been negative. Barney Frank, former chairman of the House Financial Services Committee, said, “The loophole has eaten the rule, and there is no residential mortgage risk retention.”

How important are down payments and other characteristics in predicting mortgage delinquency? Ioannis Floros and Joshua White examine the performance through the end of 2012 of private label (non-government agency) loans securitized from 1997 to 2009 (about 2.7 million loans). The percentage of loans that became seriously delinquent (defined as 90 days or more in arrears or in foreclosure) in the entire sample is 44.6 percent, ranging from a low of 13.7 percent in 1998 to a high of 57.8 percent in 2006. That compares to a “serious delinquent” (SDQ) rate of only 5.3 percent over the same time period for agency loans. Higher FICO scores have lower delinquency, but 26.8 percent of SDQ loans have a score greater than or equal to 720 (considered a good score). If one restricts the sample to qualified mortgages (QM—those exclude loans that are negative-amortization, interest-only, involve balloon payments, or require no income or asset documentation), the SDQ rate decreases from 44.6 percent to 33.8 percent. If one excludes loans with a FICO score below 690 and a loan-to-value ratio of greater than 90 percent (less than 10 percent down), then the SDQ rate drops from 33.8 percent to 10.7 percent. Thus, loans meeting the QM definition plus only two additional components of the proposed 2011 QRM definition (FICO above 690 and 10 percent down payment) would be more than four times less likely to be SDQ.

Down payments and FICO scores predict bad loans. So why were those provisions not included in the final definition of QRM, while the QM rules (negative amortization, interest only, balloon payments, and documentation) that were not very predictive were included? The simple explanation is that the more stringent rules would have shut down the private market. Members of Congress made it clear that they did not want that to happen. Less than 2 percent of the loans in the data had loan-to-value ratios of less than 80 percent (at least 20 percent down) and FICO scores above 690.

Risk Analysis

“Pricing Lives for Corporate Risk Decisions,” by W. Kip Viscusi. September 2014. SSRN #2491735.

In 2014, General Motors was fined \$35 million by the National Highway Traffic Safety Administration (NHTSA), the maximum allowed under the law, for failure to report safety problems related to ignition switches. Those problems were associated with 13 fatalities. The consent decree released by NHTSA also revealed that GM had no internal systematic discussion of risk versus cost in the design of the switch.

For Vanderbilt economist Kip Viscusi, that fine is too low. NHTSA is permitted a fine of only \$7,000 per violation and the total fine for a related series of violations is limited to \$35 million. The value of a statistical life (VSL) used by the U.S. Department of Transportation (in which NHTSA exists administratively) to govern its decisions on the cost effectiveness of regulatory rules is \$9.1 million. Thus, the 13 lives lost have an aggregate value of \$118 million, which should have been the amount GM was fined. The

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estimated cost of the GM recall was about \$100 million in 2007. If GM decisionmakers had faced the prospect of a \$118 million fine or a \$100 million recall, they would have chosen the recall to minimize the company's costs.

GM had no internal discussion of the costs and benefits of risk reduction because explicit discussions by auto companies in the past (e.g., Ford's infamous decision to adopt a less costly gasoline tank design for its Pinto subcompact) led to vilification by the press as well as punitive judgments by juries. To be sure, Ford's Pinto discussions were flawed because they used only lost earnings (\$40,000 a year for 40 years would equal only \$1.6 million) as a measure of the price of a life rather than the much higher VSL. If they had used the higher VSL, they probably would have concluded the safer design was cost effective.

Juries do not confront the *ex ante* choice of expenditures to save statistical lives. Instead, they confront the loss of an explicit life versus a trivial expenditure per car rather than the aggregate expenditure for an entire model run. In the case of the Pinto gasoline tank fires, the jury weighed the \$11 extra expenditure per car versus the loss of a life. This framing effect makes juries very sympathetic to plaintiffs and very unsympathetic to companies that engage in explicit risk reduction tradeoff discussions.

Viscusi has conducted studies of jury behavior using random samples of ordinary people given various VSL estimates who then vote on damage awards in hypothetical cases. In the hypothetical cases, if a company conducted explicit cost-benefit analysis, the jury award was higher. Viscusi proposes that there be a safe harbor for any corporate analyses conducted correctly using the DOT VSL number.

Financial Market Regulation

"Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications," by John C. Coates IV. January 2014. SSRN #2375396.

"Towards Better Cost-Benefit Analysis: An Essay on Regulatory Management," by John C. Coates IV. July 2014. SSRN #2471682.

In 2011, the D.C. Circuit Court of Appeals struck down a Securities and Exchange Commission regulation because the agency failed to provide an adequate cost-benefit analysis (CBA) for the regulation. In Congress, Sens. Mike Crapo (R-Idaho) and Richard Shelby (R-Ala.) have introduced a bill that would require the financial regulators to conduct CBA of all future proposed regulations.

In a previous issue of *Regulation*, University of Chicago professors Eric Posner and Glen Weyl argue that the time has come to require CBA by the independent financial regulatory agencies ("The Case for Cost-Benefit Analysis of Financial Regulation," Winter 2013–2014).

In an earlier issue, Richard Zerbo and two of his doctoral students at the University of Washington examined CBA as conducted by an actual government agency ("Benefit-Cost Analysis in the Chehalis Basin," Summer 2013). He concluded that

the results of bureaucratic [CBA] reflect costs and benefits that are readily countable, rather than a careful consideration of economic standing or economically significant cost or benefit flows. ... Bureaucratic [CBA] tends to find positive net benefits for a given alternative when conducted or commissioned by project supporters, and negative net benefits when conducted or commissioned by project detractors. Both positions may be supported by legitimate bodies of credible evidence.

John Coates IV has written two papers in the same vein as Zerbo, arguing that the proponents of CBA of financial regulations (CBA/FR) have oversold its capabilities. In the first paper, he conducts a hypothetical CBA of the monetary policy known as the "Taylor rule," proposed by Stanford economics professor John Taylor. The rule would set the federal funds rate at $1 + 1.5 \times$ the inflation rate $+ 0.5 \times$ the "output gap," defined as the percentage deviation of actual GDP from "potential" GDP. Coates argues that the capacity of anyone to conduct qualified CBA with any real precision or confidence does not exist for important financial regulations like a Taylor rule. The data are not available and analysis often involves the use of contested macroeconomic analysis. He even quotes Taylor himself at a 2013 congressional hearing as saying "while discretion [by the Federal Reserve] would be constrained [by the rule], it would not be eliminated." Coates rhetorically asks how would anyone evaluate such a regulation?

In the second paper, Coates argues that it "is CBA supporters themselves who need to show that CBA is anything different than judgment in drag." "Any guestimates that emerge from superficial CBA/FR will only reflect crude assumptions based on the prior judgmental beliefs (i.e., theoretical guesses, informed by experience and ideology) of researchers about the value of regulation."

He spends the remainder of the paper suggesting how we should encourage regulators to engage in meaningful "conceptual" CBA (that is, do not regulate unless real market failures exist and be careful about reducing competition, etc.) to encourage the development of actual quantitative CBA. His recommendations include giving agencies deference and restricting court review to those cases in which an agency is expanding its jurisdiction (or at least some people think it is) and using "bad" CBA to cover up that fact; appoint more economically literate regulatory commissioners so that the staff know that CBA is really important; allow CBA to be released by staff without commissioner approval, like inspector general reports; and use the equivalent of clinical trials to develop true knowledge about effects.

Some of these recommendations have as much "assume-a-can-opener" feel to them as the CBA recommendations Coates criticizes. In the end, I am reminded of Bill Niskanen's thoughts on the struggle over the proper role of economically informed analysis in policy decisions ("More Lonely Numbers," Fall 2003), which are worth repeating: "If lawmakers want more or better regulatory analysis, then [such analysis] would be valuable.... But it is not at all evident that Congress wants better regulatory analysis." 

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The John William Pope Center for Higher Education Policy is a nonprofit institute dedicated to improving the nation's colleges and universities.

Concerns

We are concerned that:

- The intellectual life on campus is narrow, rejects traditional Western ideas, and belittles inquiry
- Faculty pay is rising, but faculty teaching workloads are declining
- Accountability is inadequate
- Taxpayers may be paying for inefficiency

Goals

Our goals for U.S. universities are to:

- Increase the diversity of ideas
- Encourage respect for freedom
- Improve students' learning
- Cut costs

To achieve these goals we:

- Inform the public about actual learning
- Promote classic texts and traditional curricula
- Tell taxpayers where their funds are going
- Make policymakers aware of our feelings



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