

IN REVIEW

Health Care Incentives Matter

REVIEW BY DAVID R. HENDERSON

In 1963 the *American Economic Review* published “Uncertainty and the Welfare Economics of Medical Care” by economist—and later Nobel Prize winner—Kenneth Arrow. It became a classic. Much of the academic discussion of health care and health insurance since then has either built on or responded to one or more of his thoughts and insights in that article.

In 2012 Columbia University, where Arrow earned his doctorate in economics, decided to base that year’s Kenneth J. Arrow Lecture on his 1963 article. The invited lecturer, Amy Finkelstein of Harvard University, focused on one aspect of his work, the idea of “moral hazard.” Thus this book’s title. With an introduction by Harvard health care economist Joseph P. Newhouse, the book contains Finkelstein’s lecture and comments by Arrow (now at Stanford University), MIT’s Jonathan Gruber, and Columbia University’s Joseph E. Stiglitz, along with a reprint of Arrow’s original paper.

This short book is full of insights and useful information. The two most valuable parts are Arrow’s original paper and Finkelstein’s lecture.

Whereas many economists will say that Arrow’s paper made the case for a highly interventionist health care policy, it is more nuanced than that. Indeed, parts of it can be read as arguing against some of the main provisions of the 2010 Patient Protection and Affordable Care Act (ACA, better known as Obamacare).

Finkelstein’s insights on moral hazard, along with her discussion of the Oregon Medicaid experiment, are the highlights of

her chapter. She finds that, indeed, people do use more health care when they pay a lower price. She also makes a strong case for health savings accounts. The introduction by Newhouse points out that a low elasticity of demand for health care, which is what the famous RAND Health Insurance Experiment (HIE) found, can actually imply a high reduction in health care use in response to small price increases. In his comments, Stiglitz jumps from an assertion of market failure in health care to a presumption of government success.

Arrow’s original/ Let’s start, as much of the health economics discussion does, with Arrow’s 1963 paper. It is valuable on so many levels. Early in the piece, he writes, “The causal factors in health care are many and the provision of medical care is only one.” That is an obvious point, but it is one that many people even today fail to acknowledge.

Arrow also discusses the economics of vaccination. He notes that in “an ideal price system,” those who fail to be immunized against a communicable disease could be required to pay those whose health is thereby endangered by the non-vaccinated, or else the vaccinated could pay the non-vaccinated to “undergo the immunization procedure.” I wondered, when reading this, whether Arrow was influenced by the late Ronald Coase’s 1960 *Journal of Law and Economics* paper “The Problem of Social Cost,” which gave rise to the “Coase Theorem.” (See “The Power of Exchange: Ronald

Coase, 1910–2013,” Winter 2013–2014.)

Another interesting aspect of Arrow’s article is his view of the economics of information. He writes, “The value of information is frequently not known in any meaningful sense to the buyer; if, indeed, he knew enough to measure the value of information, he would know the information itself.” This quote reminded me of a similar insight from Austrian economist Israel Kirzner. This information problem, Arrow maintains, leads to market failure. He argues that we, as patients (buyers of medical care), don’t know enough to judge the experts (doctors) who provide it. Interestingly, though, he does not jump to the conclusion that the solution to this market failure is entirely governmental. He writes that the government is “usually implicitly or explicitly held to function as the agency which substitutes for the market’s failure.” He continues: “I am arguing here that in some circumstances other social institutions will step into the optimality gap.”

Particularly interesting is Arrow’s discussion of health insurance. He writes:

On a lifetime insurance basis, insurance against chronic illness makes sense, since this is both highly unpredictable and highly significant in costs. Among people who already have chronic illness, or symptoms which reliably indicate it, insurance in the strict sense is probably pointless.

He adds:

Hypothetically, insurance requires for its full social benefit a maximum possible discrimination of risks. Those in groups of higher incidence of illness should pay higher premiums.

Those quotes are simply sensible reasoning about insurance, and it is doubtful that Arrow was the first to come up with those ideas.

They are striking for a different reason, though: they completely undercut the case for laws against pricing insurance for pre-

DAVID R. HENDERSON is a research fellow with the Hoover Institution and professor of economics in the Graduate School of Business and Public Policy at the Naval Postgraduate School in Monterey, Calif. He was the senior economist for health policy with President Reagan’s Council of Economic Advisers. He is the editor of *The Concise Encyclopedia of Economics* (Liberty Fund, 2008). He blogs at www.econlog.econlib.org.

existing conditions, one of the key features of the ACA. That sensible reasoning was missing entirely from the arguments that proponents—and even many opponents—of the law made. Arrow also discusses the role of moral hazard in medical care: people with insurance have an incentive to use more medical care because the insurance company pays for most of it.

Elasticities / Finkelstein builds her lecture around this latter insight. In particular, she discusses the two most famous health insurance experiments in U.S. history: the mid-1970s RAND HIE and the Oregon Medicaid experiment of 2008. Finkelstein distinguishes between two kinds of moral hazard that health insurance can give rise to: ex ante moral hazard and ex post moral hazard. Ex ante moral hazard occurs if someone, knowing he is insured, takes worse care of himself by, say, smoking, drinking excessively, or not exercising. Ex post moral hazard occurs if someone, knowing he is insured, uses more medical care because he does not pay the full cost. Finkelstein's focus, like that of most other health economists who study the issue, is on the latter.

She finds strong evidence of ex post moral hazard in the Oregon experiment. Because of budget constraints, Oregon's state government was unwilling to cover all people who were "financially but not categorically eligible for Medicaid." Those people were financially eligible because their incomes put them below the poverty line, but categorically ineligible because they were able-bodied. The government held a lottery to choose 10,000 of those people—out of about 75,000 who applied—who would receive Medicaid coverage. She and other researchers then tracked the expenditures and health sta-

tus of both the people who got Medicaid through the lottery and those who did not. They found, not surprisingly, that people who were spending "other people's money" for health care spent more. Finkelstein writes, "Medicaid increases not only hospital admissions, as was just demonstrated, but also the probability of taking prescription drugs and of going to the doctor." She concludes, "Medicaid increases annual medical spending by about 25 percent." Interestingly, the main effect of the spending seems to have been on reducing depression rather than on improving physical health.

Finkelstein also argues that high-deductible insurance plans, which "were encouraged by the Health Savings Accounts Act of 2003," are "theoretically optimal" when "there are risk-averse individuals and concerns about moral hazard." She points out that this is an implication of Arrow's 1963 article.

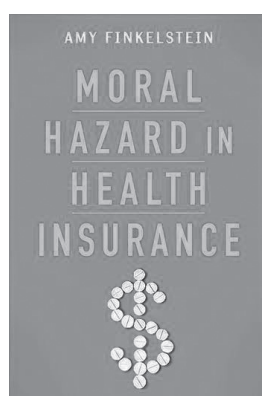
Newhouse's short introduction makes a very important point. The RAND HIE, in which he was a central player, found that the elasticity of demand for medical care is about 0.2. That doesn't sound large, implying

that a 10-percent increase in prices paid by patients will cause only a 2 percent decline in the amount of health care purchased. Newhouse, however, explains its significance is quite large. While his explanation is too involved to explain fully here, one example he gives will help relate his idea. Given that most insured people pay such a small amount of the bill (while insurance pays the rest), a small increase in the amount of the copay can be a large percentage increase of the copay. Consider an increase from a \$5 copay for a drug to a \$10 copay. That is a 100 percent increase and, with an elasticity of 0.2, the quantity of drugs demanded should fall by 20 percent.

Cost drivers / Unfortunately, Finkelstein, in referring to Newhouse's famous 1992 *Journal of Economic Perspectives* paper "Medical Care Costs: How Much Welfare Loss?" discussing the various factors behind the explosion in U.S. health care spending, repeats a mistake that Newhouse made in that paper. I hasten to add that the Newhouse paper is one of my 10 favorite health economics articles ever. Nevertheless, by not performing a simple multiplication, he minimizes the role of factors other than technology in driving spending.

In the 1992 article, Newhouse considers the role of population aging (older people use substantially more health care than younger people), increased insurance (the less people pay out of pocket, the more health care they buy), and increased income per capita (as people's income increases, their use of health care increases). He finds the effect of each of those factors to be low, but he doesn't consider them together. The correct way to consider the combined effects of those factors is to multiply them, not add them. So, for example, if aging causes a 15 percent increase in spending per capita, and increased insurance causes a 50 percent increase in per capita spending, the combined effect is not a 65 percent increase, but a 72.5 percent increase ($1.5 \times 1.15 - 1 = 0.725$.) Adding in the role of income means that the three factors together, using Newhouse's estimates, account for a 193 percent increase in health care spending per capita from 1950 to 1990. This is 39 percent of the overall increase in health care spending per capita.

Newhouse is probably still right that the most important factor in increased spending is increased technology. But most readers of his article would probably be surprised to learn that his own data imply that almost 40 percent of the increased health care spending is not due to increased technology. One such reader, I believe, is Finkelstein. When she writes, "Technological change in medicine is the driving force behind the growth in health care spending," she overstates. It is probably *the main* driving force, but it is not *the* driving force.



Moral Hazard in Health Insurance

By Amy Finkelstein,
with Kenneth J. Arrow,
Jonathan Gruber,
Joseph P. Newhouse,
and Joseph E. Stiglitz
146 pp.; Columbia
University Press, 2015

IN REVIEW

Other commenters / The main contribution of Gruber's comment is his pointing out that the change in the way Medicare paid hospitals—basing it on diagnosis rather than cost—reduced the average length of hospital stays of the elderly by a whopping 15 percent within a year. Gruber claims that this reduction had “no effect on elderly care.”

Stiglitz makes the strong claim that because of market failures in health care that result from asymmetries in information, “there are always interventions that could make some individuals better off without making others worse off.” Unfortunately, he does not tell us what those interventions are. “There is a need for government,” he writes, but he does not con-

sider how well or badly government works.

In discussing health maintenance organizations, he claims that although the reputation of HMOs is important, “we know that reputation mechanisms don’t work very well.” I don’t know that.

One thing that struck me in the 1963 Arrow paper is the good will he displays toward those with whom he disagrees. He thanks the University of Chicago’s Reuben Kessel, for example, for helpful comments and gives him credit in a footnote, even while fundamentally disagreeing with Kessel’s view of the American Medical Association as a monopoly creator. To her credit, Finkelstein also seems to have a generous view of those who might disagree with her. That is heartening. R

Although this mode of power is unrecognized by the Constitution, it has become the government’s primary mode of controlling Americans and it imposes profound restrictions on their liberty.

Quite so; very few among us are not affected by the numerous mandates, prohibitions, fees, and rulings made by agencies such as the EPA, Department of Health and Human Services, National Labor Relations Board, Internal Revenue Service, and many others.

Whether any or all of the voluminous administrative rules and regulations are wise is beside the legal point. Hamburger maintains that administrative law itself runs afoul of the Constitution’s separation of powers. If you read the reports from the Constitutional Convention of 1787, we see that the drafters were adamant that each branch of the new government be confined solely to its appropriate functions, without possibility of overlap or usurpation. They had good reasons for insisting on that, Hamburger argues; they wanted to eliminate any possibility of the kind of royal prerogative power that had existed in Europe ever emerging in the United States. Unfortunately, their handiwork was inadequate. Administrative law is a reemergence of prerogative power; much like a disease we thought we had eliminated, prerogative has come back and is spreading rapidly.

History of divided government / In the first part of the book, Hamburger covers the history of the battle against prerogative power going far back into British history. The Magna Carta was the opening battle in the war to put restraints on the king’s authority. Legal history buffs will savor Hamburger’s telling of the thrust and parry that went on for centuries between Crown and Parliament. Especially intriguing were the battles during the reign of James I, who insisted on nearly unlimited power to govern.

A pivotal consequence of his ambition was the 1610 Case of Proclamations, in which the Crown maintained that the King was entitled to rule through proc-

The Rise of Prerogative Power

◆ REVIEW BY GEORGE LEEF

Last February 4, the U.S. Congress held a rare joint committee hearing, bringing together the House Transportation and Infrastructure Committee and the Senate Environment and Public Works Committee. The hearing’s purpose was to take testimony on a proposed rule by the U.S. Environmental Protection Agency and the Army Corps of Engineers. The rule would expand the definition those agencies use in deciding what is to be regarded as a “navigable water,” thus subjecting the property to their control.

Spokesmen for organizations opposed to the proposed rule argued that it would give the agencies enormous new power, far beyond the scope of the Clean Water Act. The rule would enable them to interfere with the use of almost any piece of property that stays wet for more than a day or two.

Putting aside the pros and cons of this as a policy matter, consider how odd this circumstance is under the U.S. Constitution. Article I vests “all legislative power” in Congress; the executive branch is only authorized to enforce the laws. But what

has emerged in the United States over the last 80 years or so is “administrative law,” under which executive agencies actually make law, enforce it, and adjudicate purported infractions. The drafters of the Constitution would be astounded at the spectacle of citizens pleading with Congress, as in that hearing, to stop parts of the executive branch from arrogating law-making power to themselves—but that’s where we are.

Why we should have never gotten into this fix is the subject of Philip Hamburger’s book *Is Administrative Law Unlawful?* Hamburger, a professor at Columbia Law School, argues with great force that it is unlawful. He immediately sets forth his challenge, writing,

Administrative law has transformed American government and society.

clamations and the nation's judges were obliged to show deference to them. Sir Edward Coke, chief justice of the Common Pleas, refused to be bullied into a decision his sovereign would smile upon. He ruled against James, observing that the law of England was "divided into three parts, common law, statute law, and local custom; but the king's proclamation is none of them." The notion that judges should give deference to the modern equivalent of proclamations—rules and edicts of administrative agencies—still resounds four centuries later, but Coke was made of sterner stuff than most of our modern jurists.

Moving ahead in time and across the Atlantic, the leaders of our revolution wanted to guard against concentrated governmental authority. Hamburger writes that the Americans

were very familiar with absolute power.

They feared this extra-legal, supra-legal, and consolidated power because they knew from English history that such power could evade the law and override all legal rights.

Their concerns gave rise to the Constitution's provisions that create a separation of powers and checks and balances intended to confine the three branches to distinct spheres. That worked for a while.

During the Progressive Era, however, Congress began establishing administrative agencies charged with implementing statutes it passed—the Interstate Commerce Commission leading the pack. No constitutional problem in doing that, but before long Congress sought to give such agencies *de facto* legislative power to make law through regulations. The Supreme Court repeatedly ruled against that on the grounds that Congress was not empowered to delegate its authority to other branches.

The non-delegation

doctrine held through 1936 and numerous New Deal statutes crashed and sank against it. But in 1937, the Court (shaken by Franklin Roosevelt's threat to pack it with new members sympathetic to his vision of executive power) chose to ignore the doctrine in the pivotal case *NLRB v. Jones & Laughlin Steel*. The Court gave lawmaking by bureaucratic fiat the green light. Ever since, it has mostly turned a blind eye to the exercise of legislative power by unelected administrators, although it sometimes strikes down administrative rules or decisions that go "too far."

Bureaucratic maze/ If pressed on the legitimacy of administrative law, most judges, lawyers, and legal scholars say that it's a kind of power implied by the Constitution. Hamburger argues that, quite the contrary, it is exactly the sort of extra-legal power that the Founders meant to prevent. The main line of defense for administrative law is that modern circumstances have made it necessary and hence constitutional. Hamburger devotes a chapter to refuting that claim.

Supposedly, the increasing complexity of society and the problems facing the government make it imperative that Congress turn over much of the essential lawmaking to agencies staffed with experts who can quickly react with new regulations as they're needed. In response, Hamburger argues that while society is different and more specialized than when the Constitution was written, it does not follow that we must cope with those changes by a growing maze of bureaucratic controls. Our technology is more complex, but that does not mean that our laws must change. Referring to Richard Epstein's book *Simple Rules for a Complex World*, Hamburger points out that simple, basic rules (such as those embodied in the common law) work as well or better than efforts by bureaucrats to write new

laws to deal with every problem they see developing.

Moreover, nothing prevents the legislature from doing its job when legal change is called for. He writes,

Even if regulatory complexity is generally needed, statutes can be just as complex and subtle as administrative rules. Both types of enactment can be highly detailed and both can be drafted by experts—the only difference being that statutes are adopted by Congress rather than by the heads of agencies.

Quite so, and if Congress had to write exact laws, it might forebear from venturing into areas of life that are best left up to common law and voluntary processes. Instead we get vague statutes (the 2010 Patient Protection and Affordable Care Act being a great example) that leave much of the hard, contentious decision-making to bureaucrats. In further support of Hamburger's position, I would point out that in the rare instances where we have abolished regulation and allowed the market to discover the best ways of dealing with problems, the results have been highly favorable—the elimination of the Civil Aeronautics Board to free the airlines to compete, for instance.

Echoing one of Alexis de Tocqueville's famous observations, Hamburger sees danger in the soft despotism of administrative law, writing,

In democratic circumstances, administrative power can be a benevolent version of absolute power, and it often seems more enervating than immediately threatening. What begins softly, however, is apt to become harsh.

In recent years, we've certainly witnessed harsh, arrogant, abusive behavior from regulators enforcing their whims. Remember the EPA official who was sacked for blurting out that his *modus operandi* was to "crucify" one business so others in the industry would become compliant?

After completing his alarming book, Hamburger does not conclude with an optimistic chapter outlining an antidote

Is Administrative Law Unlawful?

Philip Hamburger

Is Administrative Law Unlawful?

By Philip Hamburger
648 pp.; University of Chicago Press, 2014

IN REVIEW

for the legal poison of administrative law. I suspect that's because he knows that not one of the branches of the government is apt to take any action.

The U.S. Supreme Court could revive its precedents against the delegation of legislative authority, but currently only Justice Clarence Thomas might be willing to engage in so startling a constitutional U-turn. The rest of the Court and most future prospects probably regard it as "settled law" that administrative agencies may act the way they act.

Congress is also implicated here because lawmakers prefer to write vague statutes that delegate the hard decisions to executive branch bureaucrats who don't have to worry about elections. Will future congressional

leaders put an end to that practice? Perhaps, but that also seems unlikely.

That leaves the president. A future president might understand that the morass of administrative law is a problem that harms the country in numerous ways. He might order his cabinet officers to see to it that their departments stop adding pages to the Code of Federal Regulations and take serious violations into actual courts. That's less unlikely, but still the political hazards of "turning back the clock" would be severe.

In sum, Hamburger has told us that allowing administrative law to take root was a constitutional mistake of the first magnitude, and one from which there is no apparent escape. R

Ethics and Energy

REVIEWED BY DAVID R. HENDERSON

Alex Epstein's new book, *The Moral Case for Fossil Fuels*, needed to be written. He makes a powerful, practical case for using more, not less, fossil fuel, and his practical case is also his moral case. Thus the book's title.

How can a practical case also be a moral case? Simple: if one's standard of value is human life, as Epstein says his is, then whatever enhances human life is moral. There are some problems around the edges of his argument, but in a big-picture sense it holds up.

The best way to see this is to consider a true story he retells about Gambia, a tiny country in West Africa. In 2006, Kathryn Hall, founder of the energy charity Power Up Gambia, observed an emergency cesarean section in that country. The baby died only minutes after birth. The doctor explained that if he had had enough electric power, he would have been able to use an ultrasound machine and plan the C-section rather than do it as an emergency

surgery. Hall also observed the birth of a full-term baby weighing only 3.5 pounds. In the United States, the infant would have been put in an incubator. But the hospital managers, knowing they did not have a reliable energy supply, did not bother wasting money on an incubator. The baby died.

This story drives home the importance of a stable energy supply. Our lives literally depend on it.

Of course, we could still live our lives with much less energy. It's just that our lives would be less full, we would be able to do fewer things, and we would be less wealthy. So it's not just our lives that are Epstein's standard, but a certain kind of life. Unfortunately he never makes that point explicit.

Fortunately, that shortcoming does not badly damage his argument. The vast major-

ity of us want to have more wealth, more things, more leisure, more of the "good life." Epstein does a tremendous job of showing how getting more of those things will require copious amounts of energy. For example, he quotes a passage from Milton and Rose Friedman's *Free to Choose* in which they write, "The rich in ancient Greece would have benefited hardly at all from modern plumbing—running servants replaced running water." The vast majority of us benefit greatly because we don't have servants. And running water, of course, requires pumps, which require energy.

Cost / Epstein argues that fossil fuels are "cheap, plentiful, reliable, and scalable," and he justifies each of those claims. He does so by relating facts about the fuels and by contrasting them with solar energy and wind power. Neither solar nor wind, he notes, is cheap and both are unreliable. Consider solar. The top five countries ranked by solar energy consumption, he writes, "are Germany, Italy, Spain, Japan, and China." But the percentage of those countries' electricity from solar energy is tiny: "0.5 percent, 6.3 percent, 4.0 percent, 0.09 percent, and 0.6 percent."

Why so low? Epstein argues that it is because solar is so expensive. He reminds us that we need to judge various energy sources by the cost of *all* the resources used to produce energy. Sure, rays from the sun are free, but the various materials used to convert those rays into a usable energy form are very expensive, requiring many other materials per unit of energy produced. Referencing a U.S. Department of Energy report, he notes that such materials "can include highly purified silicon, phosphorus, boron, and compounds like titanium dioxide, cadmium telluride, and copper indium gallium selenide." The story for wind power is similar. He points out that generating one megawatt of electricity with wind power requires 542.3 tons of iron and steel, compared to only 5.2 tons to get the same amount of electricity using coal.

Moreover, both wind and solar energy are unreliable, for what should be obvious reasons: try getting solar energy at 8 p.m.

DAVID R. HENDERSON is a research fellow with the Hoover Institution and professor of economics in the Graduate School of Business and Public Policy at the Naval Postgraduate School in Monterey, Calif. He was previously the senior economist for energy policy with President Reagan's Council of Economic Advisers. He is the editor of *The Concise Encyclopedia of Economics* (Liberty Fund, 2008). He blogs at www.econlog.econlib.org.

in the winter or wind energy on a windless day. Epstein's critique is more devastating than this, but at least you get the flavor.

Fossil fuels, by contrast, are much cheaper and much more reliable. Coal, which, Epstein points out, produced 41 percent of the world's electricity in 2011, "is plentiful, widely distributed, and relatively easy to extract." Unlike most mine products, he notes, "coal requires relatively little processing." The big virtue of natural gas, besides the fact that it pollutes relatively little, is that it is very useful for producing peak power—that is, power during times of heavy usage.

In one section, Epstein absolutely devastates the idea of biofuels, pointing out how absurd it is to use large amounts of energy to produce biofuels, and then convert those biofuels back into energy. He writes, "If we could eat oil or electricity, we would, because it's much cheaper [than food] per unit of energy. Why should we feed human food to machines with hundreds of times our appetites?"

Climate change/ What about one potential downside to using more fossil fuels, all of which are carbon-based: namely, climate change? Epstein discusses this extensively. He points out that increased carbon dioxide affects climate in at least two ways: "as a greenhouse gas with a warming impact" and "as plant food with a fertilizing impact."

On the "fertilizer effect," Epstein references research by climate scientist Craig Idso showing that more carbon dioxide in the atmosphere results in greater plant growth. Epstein cautions that this one effect does not prove "that there will be overwhelmingly positive climatological effects from" increasing carbon dioxide. That's not his point. Rather, he points out that these positive effects on plants are "*scientifically uncontroversial yet practically never*

mentioned" (italics his). This, he charges, is "a dereliction of duty" by commentators. He writes, "It is our responsibility to look at the big picture, all positives and negatives, without prejudice." That is really the theme of the book.

But isn't the "warming effect" of increased carbon dioxide a problem? It would be, he argues, only if it is catastrophic. Epstein gives evidence that the effect of increased carbon dioxide is logarithmic. In other words, if carbon dioxide increased by, say, 10 percent, the temperature would increase by much less than 10 percent.

Epstein produces a figure that purports to show this, but instead of giving the temperature increase as a result of more carbon dioxide, his figure gives something called "net downward forcing." Presumably, there's a relationship between this variable and temperature, but that relationship—while it might be obvious to climate scientists—is not obvious to this

lay reader. Fortunately, his other graphs are more informative. One important graph, in particular, shows predictions for increases in the earth's temperature made in 1988 by James Hansen, whom some people consider the world's leading climate scientist. In the same graph, Epstein shows that the actual increases in the earth's temperature as of 2013 were well below the numbers that Hansen predicted. Score one for Epstein's logarithmic point.

Here's how Epstein summarizes the record: "Since the industrial revolution, we've increased carbon dioxide in the atmosphere from 0.03 percent to 0.04 percent, and temperatures have gone up less than a degree Celsius, a rate of increase that has occurred at many points in history." That appears to be accurate.

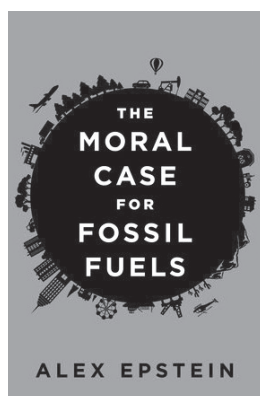
In considering the effect of changes in climate, Epstein brings to bear his moral

standard: its effect on human life. He shows that even as fuel usage and carbon dioxide concentrations have increased, climate-related deaths have plunged. Is there a connection? He makes a strong case that there is. Consider deaths from drought, which, he writes, are "the most common form of climate-related death." The number of drought-related deaths has fallen. He points out that more use of fossil fuels has improved both agriculture and transportation to drought-affected areas and has facilitated modern irrigation.

Other pollution/ What about other forms of pollution from fossil fuels? Epstein admits that this could be a problem, and his solution is unclear. He starts out with a property rights approach to controlling pollution and criticizes a "common good" approach. Yet, as my Econlog co-blogger Bryan Caplan has pointed out, Epstein slips the common good approach in through the back door. He shows no awareness of the usual way economists address this issue if they believe in a role for government (which most do): tax pollution or have tradable pollution permits.

Consider Epstein's claim that we need more energy, a claim that he appears to regard as obvious. What he actually has shown is that energy, in total, is wonderful. That refutes the more extreme environmentalists who would dramatically curtail fossil fuel use. But economists, who are used to thinking on the margin, would point out that some of that energy might cause pollution that harms people. So the marginal uses of energy might be inefficient. It's possible, therefore, that we should use *slightly* less energy.

I'll close on a positive note. Epstein's last chapter is his best and should have been his first chapter. In it, he tells how he paid famous environmentalist Bill McKibben \$10,000 to debate him. That alone impressed me. Epstein tells the story in such a dramatic way that it almost gave me chills. I recommend reading it first; you will likely then be motivated to read the rest of the book. R



**The Moral Case
for Fossil Fuels**

By Alex Epstein

248 pp.; Portfolio/
Penguin, 2014

Defending Sweatshops

✦ BY PIERRE LEMIEUX

It should be a no-brainer: it would be better for the poor to have more, rather than fewer, economic opportunities. But many people disagree with that idea; consider the common opinion of “sweatshops.”

In *Out of Poverty*, Benjamin Powell, a young economics professor at Texas Tech University, provides a comprehensive analysis of sweat-

shops. He carefully presents the anti-sweatshop arguments and the counter-arguments provided by economic and philosophical analysis. He uses economic reasoning to analyze the facts.

Sweatshops are Third-World manufacturing plants where employees—sometimes children—work in rough and often unsafe conditions for wages equivalent to a few dollars a day. Sweatshops are found mainly in Southeast Asia and South America, often in the textile industry.

Since the 1990s, a movement has developed in rich countries (mainly the United States and Europe) against sweatshops. The movement is made of the usual dogooders of the poverty industry, including trade unionists and student activists. Powell considers their arguments seriously; his reader may be less tolerant. A supporter of the United Students against Sweatshops (USAS) opines: “Everybody wants to have a living wage. ... Everybody wants to retire and feel good, enjoy life. Breathe. Live. Eat.” How can one argue against that? Why can’t rich Westerners decide what is good for foreign sweatshop workers and call for laws to bring that about?

Alternatives and revealed preference / The book’s central argument is that sweatshop workers are paid poorly because their productivity is low and their alternatives are even worse. Wages are determined by the demand and supply of labor. Demand is based on the workers’ productivity; supply reflects what workers, according to their

preferences, could do with their time if they did not work in a given market. The crucial fact is that, in poor countries, the alternative to sweatshop work is not a Western-type job or the *dolce vita* on the beach; the alternative is even lower earnings in farming jobs and menial tasks in domestic work—if not scavenging in garbage dumps, prostitution, or starving to death.

Imposing a minimum wage in sweatshops will create unemployment if the producer cannot adjust other margins—by reducing safety, for example. A mandated improvement in working conditions or other benefits amounts to the same outcome if the money wage is not reduced accordingly. What the vast majority of sweatshop workers want, as shown by interviews, is more money, not better working conditions. Economic theory reaches the same conclusion: “the mix of compensation is really driven by employee preferences”; the employer only cares about the total cost. A higher compensation package means that some workers will be let go.

Powell reviews the objections to standard labor market theory. He also offers many examples of how the standard labor market model applies to poor countries. For instance, in 2003 American activists helped in forcing BJ&B, a Dominican Republic sweatshop, to recognize a union, which rapidly obtained dramatically better conditions for its members. But the company’s workforce fell from 2,000 employees to just 234—and ultimately the firm closed in 2007. In response to an ultimately failed proposal by then-senator Tom Harkin (D-Iowa) to ban imports from countries where children work in sweatshops, Bangladeshi firms laid

off 50,000 children, many of whom ended up in worse jobs or on the street. “A significant number were forced into prostitution,” noted Paul Krugman in a 2001 *New York Times* column, citing Oxfam.

As poet Friedrich Hölderlin wrote, “What has always made the state a hell on earth has been precisely that man has tried to make it his heaven.”

The revealed preference argument is a good illustration of economic reasoning: “Because workers choose to work at these firms,” Powell writes, “we know that the workers believe the jobs are the best alternative for them.” This reminded me of a remark by Marxist economist Joan Robinson in her 1962 book *Economic Philosophy* (C.A. Watts): “As we see nowadays in South-East Asia or the Caribbean, the misery of being exploited by capitalists is nothing compared to the misery of not being exploited at all.”

With a database he created, Powell compares the wages paid in sweatshops with the average wage in the relevant countries. Sweatshop pay ranges from 6 cents an hour in Bangladesh to \$1.12 in Costa Rica. Those are miserable wages, for sure. But here is the catch: “Sweatshop jobs are not just better when compared to scavenging in trash dumps. They are better than many jobs in the countries where they are located.” Powell’s research suggests that most sweatshop jobs pay over \$2 a day (and sometimes much more) and that these wages amount to at least 50 percent of the average income in most of the countries covered. In Cambodia, sweatshop wages translate into earnings 50 percent higher than the average income. In Haiti, Honduras, and Nicaragua, they amount to twice the average income. No wonder many workers want these jobs.

New York Times columnist Nicholas Kristof, in a Jan. 15, 2009 column, wrote of a 19-year-old Cambodian woman he interviewed who was scavenging in a Phnom Penh dump, a “Dante-like vision of hell,” as he described it. “I’d love to get a job in a factory,” she told him. “At least that work is in the shade. Here is where it is hot.” Another scavenger, age 13, said, “It’s dirty, hot, and smelly here. A factory is better.”

Economic growth/ Powell's demonstration that sweatshop employees would be worse off without the sweatshops is so convincing that one wonders how activists and the scholars who support them can take the opposite view. One reason must be a disagreement about facts. But ignorance of the facts will be less of an excuse after Powell's book.

A whole chapter is devoted to defending the work of children in sweatshops. As with their elders, it is the least bad alternative for those children. In many underdeveloped countries, 10–20 percent of children ages 10–14 have to work, often in places where conditions are worse than in sweatshops. Of course, a child may not know what is best for him, so the revealed-preference argument does not apply directly. The child's parents, however, are quite likely the most competent to decide what is best for him. To physically survive, poor families often need their children to work. The alternative to the sweatshop for these children is not school or Disneyland, but a fate far worse than sweatshops: living on the street, prostitution, or starvation. Only economic growth can eventually produce better alternatives.

Today's developed countries experienced a sweatshop phase one or two centuries ago. Massachusetts's textile factories in the 19th century were sweatshops. This was a required stage in economic development. While it lasted 150 years in England and 100 years in the United States, this difficult phase now seems to have shrunk to less than two generations, as evidenced by the experiences of South Korea, Taiwan, Hong Kong, and Singapore—and now China. But this stage remains impossible to avoid. You cannot go from poverty to riches overnight. You need some capitalist "exploitation."

A country cannot legislate its way out of poverty. "If the United States had adopted

more stringent standards when it was as poor as the sweatshop countries today," Powell observes, "it would never have grown to be as rich as it is now." Perhaps the United States would now resemble a typical South American country.

In today's poor countries, only economic growth can solve the sweatshop problem, which is a poverty problem. Sweatshops represent "the first rung on the ladder out of extreme poverty," wrote Columbia University's Jeffrey Sachs in his 2005 book *The End of Poverty* (Penguin Press). "Sweatshops themselves are part of the very process of development that will lead to their own elimination," adds Powell. Economic growth raises workers' productivity and thus their remuneration. Economic growth, in turn, requires private property rights and economic freedom, as demonstrated by much research. A whole chapter of *Out of Poverty* deals with economic development.

Ethics and interests/ Another reason why some people fight against sweatshops

may be a disagreement on ethical values. What values would the anti-sweatshop crowd espouse? There is an understandable impulse to not support a system that seems to provide laborers poor wages and conditions. But Powell shows that if people value the welfare of sweatshop workers, there is no reason to oppose sweatshops—quite the contrary.

He analyzes the philosophical arguments about sweatshops in the chapter, "Is It Ethical to Buy Sweatshop Products?" The answer is a resounding yes. The higher the sweatshop sales, the more the remuneration of sweatshop workers will be bid up, fueling the process of economic development.

Like anti-sweatshop activists, Powell opposes slave labor: "Sweatshops that coerce their workers with the threat of violence or use the local government to do it

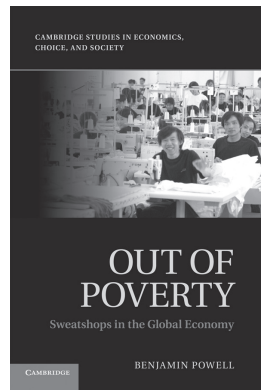
for them are the only type of sweatshop I condemn." But the typical sweatshop does not resort to violence. Employees work there voluntarily. And they are happy to have a job there, as interviews by Powell and others show. Voluntary work in poor conditions is not slave labor.

Opposing slave labor suggests also opposing government regulations that prevent voluntary labor. On this point, Powell debunks the easy and fallacious argument that multinationals must obey local laws. It depends on which laws, he argues. Coercive injustices in poor countries are usually committed by their own governments.

Self-interest is another reason for anti-sweatshop sentiments. Many activists hide their interests behind moral high horses. American trade unions defend their members against competition from poorer workers. Supporting another failed bill that would prohibit the import and sale of sweatshop products, the AFL-CIO hailed the legislation as "a powerful vehicle ... to take back our economy"—that is, to protect its members against poor foreign workers who offer a better deal to American consumers. The trade unions, Powell observes, "intentionally advocate policies that will harm those very workers and naive young activists end up acting as tools to help the unions achieve their protectionist goals."

Among those who don't have direct interests in closing down Third-World businesses, the disagreement about sweatshops may boil down to an ignorance of economics. Even value judgments, as long as they have some consequentialist element, require some knowledge of economics. It is difficult to offer a serious opinion about sweatshops if one does not understand how wages are determined, how increasing work amenities implies a lower wage or the unemployment of some current employees, or how economic development is the only solution to sweatshops and other manifestations of poverty.

The last chapter of *Out of Poverty* gives useful advice to anti-sweatshop activists if they really want to help sweatshop



**Out of Poverty:
Sweatshops in the
Global Economy**

By Benjamin Powell
198 pp.; Cambridge
University Press, 2014

IN REVIEW

workers. Powell recommends that activists specifically target the rare instances of slave labor, launch “Buy from the Third World” campaigns, fund programs to pay poor Third-World children to go to school, promote economic development through economic freedom and free trade, and advocate relaxed immigration restrictions in the United States.

A no-sweat book / I do have a few quibbles with the book. None are worth developing here, except about economic efficiency. Powell stresses that his argument has nothing to do with economic efficiency, but only with the welfare of sweatshop workers. “Nowhere do I advocate ‘economic efficiency’ as my ethical standard,” he writes. “The welfare of the worker is the end.” This focus may be rhetorically necessary to counter the anti-sweatshop crowd’s simplistic morals, but I think it is misleading.

The first problem is that the concept of economic efficiency is all about social welfare—that is, the welfare of all individuals—and nothing else. Powell does admit at some point that we should be concerned

with the welfare of all people in Third-World countries. One may choose to focus on the welfare of a limited group of individuals, but this must be part of a general framework of economic efficiency.

The second problem is that one must be careful about how social welfare is conceptually measured. The notion of economic efficiency that Powell pushes aside is the cost-benefit concept (following Alfred Marshall), where the benefits of poor sweatshop workers should be weighed against (say) the losses of unionized workers in the rich world. If one adopts, instead, a Pareto concept of efficiency, where social welfare cannot increase if any individual loses out, it becomes easier to pinpoint the value judgments that the policy analyst cannot avoid making—in favor of Third-World workers in the case of Powell. Once everything in production is narrowly efficient, the broader concept of economic efficiency requires a value judgment about how the benefits of exchange are distributed.

Out of Poverty is not a very politically correct book. In the Acknowledgments section, Powell wishes to “thank two of

the three anonymous Cambridge University Press referees for valuable feedback.” I assume the third one could not swallow the economic truth the book contains—that is, you don’t help poor workers by restricting their alternatives.

Anybody who does care about the welfare of sweatshop workers and is not close-minded to the evidence will cringe at the testimonies of sweatshop workers happy to work there and to be paid in money instead of safety or other amenities. An anti-sweatshop activist, Joshua Samuel Brown, reported (quite honestly) what a worker told him: “I don’t want to tell you anything because you’ll close my factory and ruin any chances I have at having a better life one day.” Powell quotes Frank Knight: “It is hard to believe in the utility of trying to teach what men refuse to learn or even seriously listen to.” Brown did not change his mind.

For the general reader, *Out of Poverty* is instructive from the first page to the last. It is a short, no-sweat, yet deep book, with good economic reasoning and enlightening data. Even the seasoned economist will find in it much to think about. R

Working Papers ♦ BY PETER VAN DOREN

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

Climate and the Economy

“Does the Environment Still Matter? Daily Temperature and Income in the United States,” by Tatyana Deryugina and Solomon M. Hsiang. December 2014. NBER #20750.

“Will Adaptation to Climate Change be Slow and Costly?” by Alan Barreca, Karen Clay, Olivier Deschenes, Michael Greenstone, and Joseph S. Shapiro. January 2015. SSRN #2552786.

For an economist, the relevant question about climate change resulting from increased carbon concentrations in the atmosphere is whether there are negative economic consequences on net. In 1992, Nobel economics laureate Thomas Schelling argued in the *American Economic Review* that, for developed countries, “the impact [of climate change] on economic

output will be negligible and unlikely to be noticed.”

Since Schelling’s observation, some economists have tried to argue that developed countries would suffer net costs that were more than negligible. To buttress their arguments, they’ve developed Integrated Assessment Models (IAMs) that combine climate modeling with the modeling of future economic outcomes as a result of climate change. These IAMs can produce estimates of the damages from specific levels of carbon emissions, and thus can be used to calculate appropriate Pigovian taxes. Rather than negligible economic effects for developed nations, these models typically estimate damages in the order of about \$20 per ton of carbon air emissions.

But IAMs are subject to intense criticism. MIT economist Robert Pindyck, writing in these pages (“Pricing Carbon When We Don’t Know the Right Price,” Summer 2013), states:

The typical IAM has a loss function that relates temperature increases to reductions in GDP. But there is no economic

theory behind the loss function; it is simply made up. Nor is there data on which to base the parameters of the function; instead the parameters are simply chosen to yield moderate losses that seem “reasonable” (e.g., 1 or 2 percent of GDP) from moderate temperature increases (e.g., 2° or 3°C).

More recent papers attempt to improve upon the lack of knowledge in conventional IAMs. The paper by Tatyana Deryugina and Solomon Hsiang considers whether small variations in weather outcomes at the U.S. county level actually affect economic outcomes. It examines daily temperature variation and per-capita income from 1969 through 2011. The possible range of average temperatures is divided into “bins” with a 3 degree Celsius range. The regressions include year and county fixed effects and the distribution of rainfall; thus the effect of temperature on income is the result of an increase in the number of days a county is in a higher-temperature “bin” in some years relative to others.

The results show that personal income per capita “increases slightly as temperatures rise from cool to moderate,” and then decreases “linearly at temperatures above 59 degrees F.” Each 1 degree centigrade increase in daily average temperature above 59 degrees Fahrenheit reduces average daily income by 1.7 percent over the period 1969–2011.

The authors use the coefficients estimated from the 1969–2011 temperature data to conduct 20-year simulations using 44 different temperature projections for the period 2080–2099 under “business-as-usual” (that is, no policy change) assumptions. They determine that increased temperatures at the end of the 21st century would reduce average incomes by 2.31 percent at the end of 2099. The authors don’t say whether they consider that loss to be negligible, nor do they stipulate what carbon tax would be appropriate to avert that loss.

The second paper, by Alan Barreca et al., examines the effect of the adoption of air conditioning on mortality to provide insight into the effects of possible future adaptations to higher temperatures. It analyzes monthly mortality rates and daily temperature from 1900 to 2004 and finds that the effect of extreme heat on mortality is smaller in generally hotter areas.

Extreme heat is defined as the number of days in a month (each year) that a state experiences an average temperature above 90 degrees F. The regressions include state-month fixed effects so the effect of extreme heat stems from the variation in the number of above-90 days around its long-term average. In the 10 percent of states with the highest above-90 frequency, the mortality effect of one day above 90 is only a 0.68 percent increase, while in the coldest 10 percent of states the effect of a 90 degree day is a 31 percent increase in mortality.

This evidence is consistent with long-term adaptation. People

People who live in areas with the largest number of hot days have a much lower mortality rate from hot days than people who live in areas with fewer hot days.

who live in areas with the largest number of hot days have a much lower mortality rate from hot days.

The authors then estimate the effect on the data pre- and post-1960, when the diffusion

of residential air conditioning started. The effect of above-90 degree days on mortality declined 90 percent in both hot and cold states from the earlier era to the latter. Thus the effect of heat on mortality in cold states is still 10 times the effect in hot states after 1960. The effect of an additional 90-degree day in cold states from 1980 to 2004 is the same as it was in the hottest 10 percent of states from 1900 to 1939. Adaptation does happen, but it is slow and costly.

Command and Control Versus Externality Taxes

“Toward a Pigovian State,” by Jonathan S. Masur and Eric A. Posner. February 2015. SSRN #2559393.

Why don’t government agencies use Pigovian taxes to remedy externality problems? The conventional wisdom is that they are not permitted to do so by the statutes that govern their actions. In this paper, Jonathan Masur and Eric Posner argue that, to the contrary, current laws *do* allow agencies to do this.

An agency like the U.S. Environmental Protection Agency could levy a tax in the following way: Set an emissions limitation at zero. Set the fine for emitting a unit of pollution equal to the appropriate Pigovian tax. Initiate an administrative proceeding against all polluters to collect the fines. Voilà—the fines would work exactly like a Pigovian tax.

The remainder of the paper explores regulatory law in a variety of policy areas to convince the reader that command-and-control regulation could be replaced by externality prices, and such actions would be upheld by the courts.

Shale Gas Development and Housing Values

“Shale Gas Development and Housing Values over a Decade: Evidence from the Barnett Shale,” by Jeremy G. Weber, J. Wesley Burnett, and Irene M. Xiarchos. July 2014. SSRN #2467622.

Most discussions of the costs and benefits of shale gas development describe diffuse benefits for consumers and concentrated costs for the producing areas. Those costs result in externalities from “industrial” development in

IN REVIEW

areas that have not typically experienced them. That tradeoff influences policymakers' decisions on whether to allow shale oil extraction. For instance, an evaluation indicating high localized costs led New York Gov. Andrew Cuomo (D) to ban horizontal fracturing shale drilling in the state in December 2014.

But do producing areas actually experience net costs? In Texas the value of oil and gas rights is part of the local property tax base. Thus localities receive tax revenues from oil and gas development and can finance local public amenities without increasing property taxes.

How large are those benefits? House values include all public and private costs and benefits that flow from occupancy of a particular home. The Barnett shale area splits the Dallas–Fort Worth area in half; all of the wells are in the western part of the metro area. The authors of this paper seize on that geological accident to determine whether shale development produces net benefits and thus increases housing values.

Over the entire 1997–2013 period, shale ZIP codes in the Dallas–Fort Worth area appreciated 5 to 6 percentage points more than non-shale ZIP codes. By 2012 the local tax base of ZIP codes with shale had expanded by \$82,000 per public school student. However, within shale ZIP codes, greater well density was associated with less appreciation, indicating some local disamenities. Nonetheless, these results suggest that improved local finances have more than offset whatever disamenities result from shale development for the typical homeowner.

E-Cigarette Taxation

“Should E-Cigarettes Be Taxed?” by Alex Brill, Sally Satel, and Alan D. Viard. October 2014. SSRN #2515026.

In these pages, Jonathan Adler et al. recently argued that, for political reasons, heavy taxation of electronic cigarette is forthcoming (“Bootleggers, Baptists, and E-Cigs,” Spring 2015). This paper, by Alex Brill et al., considers these taxes from a public policy perspective and finds the economic case for such taxation to be lacking.

The federal cigarette tax (currently about \$1 a pack) is now five times higher in real terms than it was 32 years ago. Federal revenue from the tax in 2013 was \$16 billion, or 0.6 percent of all federal revenue. State taxes range from 17 cents per pack in Missouri to \$4.35 in New York. Combined taxes in Chicago are now \$7.17 per pack, the highest in the country.

The original rationale for tobacco taxation was that it was a luxury good (rather than for health reasons). But today, tobacco use is inversely related to income, which contradicts the notion of cigarettes as a “luxury.” In fact, cigarette taxes are regressive; 3.2 percent of household income is spent on tobacco in the lowest quarter of the income distribution while only 0.4 percent is spent in the highest quarter.

Both the externality and paternalism rationales now used to justify tobacco taxation depend on adverse health effects, but e-cigarettes don't have such effects. There are no carcinogenic combustion gases or particles inhaled either by the consumer or second-hand by other people. The only recognized health concern for e-cigarettes is that the consumer inhales nicotine, but, in the words of Mitch Zeller, the head of the U.S. Food and Drug Administration's tobacco division, “I'm not saying nicotine is benign, but compared to the risk from regular tobacco it pales.”

According to the authors,

It would make sense to tax e-cigarettes if they pose serious health risks or lead to an increase in smoking. As discussed, however, the evidence does not point to serious health risks or to e-cigarettes serving as a gateway to smoking. Therefore e-cigarettes should not be taxed at this time.

Effects of Extended Unemployment Insurance

“The Effect of Extended Unemployment Insurance Benefits: Evidence from the 2012–2013 Phase-Out,” by Henry S. Farber, Jesse Rothstein, and Robert G. Valletta. January 2015. SSRN #2558363.

The spike in unemployment during the last recession rekindled the debate over disincentives from unemployment insurance. On one side, people argue that the duration of unemployment benefits should be extended in recessions because of the moribund jobs market. On the other side, people argue that extending the benefits would reduce the incentive for the unemployed to find jobs, which would perpetuate their unemployment.

This paper, by Henry Farber, Jesse Rothstein, and Robert Valletta, attempts to determine how severe was the employment disincentive effect of unemployment insurance in the wake of the last recession. The authors find that the availability of extended benefits *did* reduce the monthly exit rate from the program (which is normally around 20 percent) to about 17 percent. But the decline did not adversely affect exit due to employment; rather, it affected exit due to the beneficiary dropping out of the labor force. That is, when extended benefits are ended, people do not increasingly find work; they increasingly drop out of the labor force.

According to the authors,

UI extensions have not had large moral hazard effects on recipients' job-finding rates, either during the worst period of the Great Recession or during the subsequent recovery.... UI extensions around the Great Recession had very limited impacts on labor market efficiency.

the CATO JOURNAL

AN INTERDISCIPLINARY JOURNAL OF PUBLIC POLICY ANALYSIS

“Exceptional in consistently publishing articles that combine scholarly excellence with policy relevance.”

— MILTON FRIEDMAN

Cato Journal is America's leading free-market public policy journal. Every issue is a valuable resource for scholars concerned with questions of public policy, yet it is written and edited to be accessible to the interested lay reader. Clive Crook of *The Economist* has called it “the most consistently interesting and provocative journal of its kind.”

Cato Journal's stable of writers constitutes a veritable Who's Who in business, government, and academia. Contributors have included James M. Buchanan, Richard Epstein, Kristin J. Forbes, Milton Friedman, Robert Higgs, Vaclav Klaus, Justin Yifu Lin, Allan H. Meltzer, Charles Murray, William Niskanen, Douglass C. North, José Piñera, Anna J. Schwartz, and Lawrence H. White.

Three times a year, *Cato Journal* provides you with solid interdisciplinary analysis of a wide range of public policy issues. An individual subscription is only \$22 per year. *Subscribe today!*

SUBSCRIBE TODAY— BY PHONE OR ONLINE

For more information call (800)767-1241 or
visit www.cato.org/cato-journal

Save more with multiple years	1 YEAR	2 YEARS	3 YEARS
Individuals	\$22	\$38	\$55
Institutions	\$50	\$85	\$125

