

IN REVIEW

Multiple Explanations for a Largely Invisible Crisis

REVIEW BY DWIGHT R. LEE

Like a lot of economists writing on political issues, American Enterprise Institute scholar Nicholas Eberstadt focuses attention in his new book, *Men Without Work*, on what he believes is an extremely serious but “largely invisible crisis,” and makes a case for government action to confront the problem. Unlike most such calls, however, instead of wanting government to do more, Eberstadt gently suggests that it do less. But his gentle suggestions are not gentle enough for two economists/policy analysts who respond to the arguments in the last part of his book.

The crisis that concerns Eberstadt is the relentless downward spiral of the labor force participation rate (LFPR) of prime-age American males between 1965 and 2015. He begins Chapter 1 by pointing out that so far in the 21st century we have seen three fundamental indicators of economic health that typically move together—wealth, output, and employment—lose their alignment. The growth in wealth as measured by net worth of U.S. households and nonprofit institutions has surged, almost doubling between early 2001 and late 2015. Yet, real per-capita output was barely 3% higher in the first quarter of 2016 than it was eight years earlier.

There are different explanations for this collapse in economic growth. A compelling (though partial) explanation is found in the labor market despite a steady stream of cheerful reports of a decreasing unemployment rate. Eberstadt points out, “If our nation’s work rate today were back to its start-of-the-century highs, approximately 10 million more Americans would currently have paying jobs.” The LFPR for prime-age males declined from 94.1% in

1948 to 84.1% in 2015, and almost all of that decline has taken place since 1965. The decline occurred as the LFPR for prime-age females more than doubled between 1948 and 2015.

Interesting details/ In his first three chapters, Eberstadt expands on numerous details concerning the real and troubling flight from work by U.S. men. Chapter 4 begins with the observation that as countries become wealthier, their citizens generally consume some of their additional wealth in leisure. The U.S. experience, however, differs from that in other modern Western economies in “peculiar, if not anomalous” ways. Working Americans “spend markedly longer hours on the job than their counterparts in affluent European countries and Japan.” Yet, in 2014 the United States ranked 22nd out of 23 countries in prime-age male LFPR, coming in ahead of only Italy.

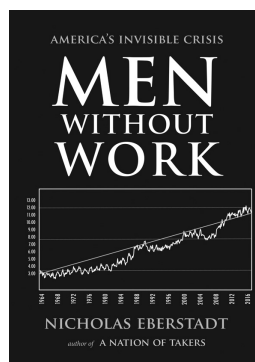
Chapter 5 contrasts men who are, and who are not, participating in the labor force. Prime-age men who are not in the labor force are apparently paying little attention to information provided by labor markets on job opportunities, since “fully two-thirds of [them] who were not in the labor force (NILF) for any part of 2014 were out of it for the entire year.” In terms of race,

By 1965, both prime-age work rates and LFPR were already substantially lower for black males than whites. They also dropped far more steeply for blacks than whites over the next 50 years. It is worth noting, however, that those rates were higher for black men in 1965 than they are for white men today.

The data Eberstadt uses are for non-institutionalized populations. The more education a man has, the more likely he is to be working. Also, being married or having been married increases the chances that a man will have a job or be actively looking for one. Finally, regardless of ethnicity, foreign-born men of prime-employment age are more likely to be employed or looking for a job than their ethnic counterparts born in America. In addition, immigrants have higher LFPR than native-born Americans over all educational levels except for college graduates.

In Chapter 6, after making the traditional distinction between leisure (which refines and elevates) and idleness (which corrupts), Eberstadt considers how prime-age NILF men use their time. According to the Census Bureau’s Annual Social and Economic Survey, when prime-age men who did not have a paying job at all in 1994 and 2014 were asked why they didn’t work, only 16% and 15%, respectively, answered, “The inability to find work.” Even at the bottom of the Great Recession in 2009, only 28% provided that answer.

So how are NILF men spending their day compared to employed men? Making use of the U.S. Department of Labor’s “American Time Use Survey,” Eberstadt finds that NILF men spend 1 hour and 16 minutes more than the latter on daily personal care, including sleeping; 31 minutes more on household care; the same amount of time on caring for household members; 5 hours and 54 minutes less on work—which means



Men Without Work: America's Invisible Crisis

By Nicholas Eberstadt
216 pp.; Templeton Press, 2016

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they worked just 7 minutes a day; 2 minutes less on eating and drinking; and 4 hours and 11 minutes more on socializing, relaxing, and leisure—which surely involved drinking not included in the “eating and drinking” category. Regarding the leisure-based activities of prime-age NILF men, Eberstadt tells us that in 2014 they spent more time than working men and women or unemployed men listening to radio, watching television, using tobacco and drugs, gambling, and (perhaps incongruously, according to Eberstadt) engaging in hobbies involving arts and crafts. This chapter clearly leaves the impression that NILF men are not, as a group, very productive.

Demand-side or supply-side? / Chapter 7 considers two types of explanations for the men without work problem: demand-side and supply-side. Eberstadt clearly recognizes the importance of both, but doubts that demand-side factors, such as international trade, technological and financial innovations, and outsourcing and temporary work dominate supply-side factors.

He cites from the *2016 Report of the President’s Council of Economic Advisers*:

A number of studies have identified declining labor market opportunities for low-skilled workers as the most likely explanation for the decline for prime-age male labor force participation, at least for the period in the mid-to-late 1970s and 1980s.

He then discusses five qualifications suggesting demand-side explanations are less compelling than commonly believed. First, there has been a steady decline in LFPR males since 1965. Second, work rates for women have been less affected by recessions than have the rates for men. Third, work rates are not typically reduced much by slow growth in affluent modern economies. Fourth, the LFPR for some less-educated prime-age American males (in particular, foreign-born and lower-skilled males) have increased since 1994. And fifth, if demand-side influences were the primary reasons for low male LFPR,

one would not expect the large regional differences in those rates to be more persistent than they would be with normal labor mobility. Long-term and large differences in male LFPR, even in adjacent states, indicate that workers are not moving in response to labor market opportunities. These qualifications suggest that it is supply-side influences that are reducing the LFPR of lower-skilled males, with dependence on government transfers an important influence by reducing the males’ labor mobility.

Welfare and the underground economy

How dependent are prime-age NILF men on government transfers, and what are their living standards? The data Eberstadt cites and discusses in Chapter 8 seem to support the view that these men have become increasingly dependent on government transfers and they live in low-income households, which strengthens the supply-side explanation for the declining LFPR for men. There is no doubt that he is correct that it has become easier for men to qualify for disability payments, with Social Security Disability Insurance being the main source of these payments. The number of men taking advantage of these payments has significantly increased over the last 50 years.

Without going into the details of the data, let me consider an omission in his discussion that could have important implications for the seriousness of the problem he is considering. He fails to consider an important source of income available to prime-age NILF men that could be reducing the social costs of men dropping out of the labor force.

Recall from my discussion of Chapter 6 that Eberstadt cites data showing NILF men work only 7 minutes a day on average. This estimate seems to ignore the possibility that many men recorded as NILF are actually working clandestinely in the underground economy (a possibility about which there is—understandably—little solid evidence), which is estimated to be contributing \$2 trillion, or a little over 12%, to U.S. GDP. Most of that contribution is believed to

come from the poorest households, which according to Chapter 8 are the households containing most of the NILF men. This suggests that the average productivity of NILF men—though not as high as it could be if they were formally employed—is not as small as Eberstadt indicates. This could mean that the problem of men without work is not as serious as he would have us believe, at least in terms of lost productivity. To the extent this is true, however, it strengthens his view that government support payments motivate lower-skilled men to leave formal employment. The income lost by doing so can be more than made up by earnings from less-productive employment in the underground economy.

Furthermore, ignoring the productivity that men classified as being “without work” may be contributing in the underground economy does not necessarily mean that Eberstadt has overstated the social loss from the decreased LFPR of prime-age men. Consider that in Chapter 9 on crime and the decline in work, he wants “to understand the impact of [the upsurge in arrests, felony convictions, and incarcerations] on male work patterns in modern America.” And he presents strong evidence that criminal activity and incarceration correlate with men becoming less employable, though he is careful not to make causal claims.

A plausible case can be made that welfare payments increase felony convictions and incarceration and therefore cause reductions in LFPR of prime-age males. That case goes as follows: As previously argued, the possibility of engaging in the underground economy adds to the incentive created by public assistance for less-educated men to drop out of the formal labor market. This likely increases the number of men who get involved in criminal behavior and end up doing time in prison, thus becoming a greater cost on society and less attractive as an employee. Even if not a major factor in employment trends, this could still explain how welfare assistance causes a long-term decline in LFPR for men by interacting with crime to generate that decline.

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Some solutions / In his closing chapter, Eberstadt offers some brief policy recommendations. While acknowledging that addressing the men without work problem requires action on many different fronts—and certainly not just government action—he suggests devoting closer attention to three broad objectives:

- Revitalize American business and its job-generating capacities.
- Reduce the immense and perverse disincentives against male work embedded in our social welfare programs.
- Come to terms with the enormous challenge of bringing convicts and felons back into our economy and society.

Taking appropriate government action on these issues would require undoing much that government currently does. For example, eliminating a lot of government regulations and scaling back the government wars on poverty and drugs would go a long way toward accomplishing each of the three objectives (respectively). Given the prevalence of poor education among NILF men, it is surprising that Eberstadt doesn't mention the importance of undoing the barriers that currently protect public K-12 schools against competition.

Addressing critics / *Men Without Work* ends with two dissenting points of view, followed by a response from Eberstadt. The first dissenter is Henry Olsen, a senior fellow at the Ethics & Public Policy Center. Olsen recognizes the negative consequences of men dropping out of the labor force, but believes Eberstadt “overestimates the causal effect of government safety net programs ... and underestimates the causal effect [of] a changing labor market.” Disappointingly, Olsen says nothing about the government policies that restrict the ability of men to prepare themselves educationally for productive employment or about the barriers that prevent them from getting entry-level jobs in which they could develop employment skills. He does recognize the disincentives of entitlements, but adds that “once men feel they cannot reenter the workforce,

they need something to live on.”

The second dissenter is Jared Bernstein, formerly chief economist and adviser to Vice President Joe Biden and now with the Center on Budget and Policy Priorities. He agrees that men without work is a serious problem, but disagrees with Eberstadt that it is underappreciated. Bernstein mentions concerns about automation, immigration, and globalization—all demand-side influences on the declining percentage of prime-age men in the labor force.

His more important disagreement with Eberstadt concerns the latter's belief that the downward trend in men's LFPR is largely a supply-side problem, which Bernstein considers a serious misdiagnosis. Not surprisingly, his suggested solutions are limited to policies he must believe will increase the demand for workers otherwise likely to leave the workforce. I admit to being mildly surprised when he listed—no doubt with plenty of demand-side enthusiasm—raising minimum wages. Obviously, raising the wage floor is a tough way to address weak labor demand. I am

reminded of a man who responds to his boat taking on water by drilling a hole in the boat's bottom to let the water run out.

Ebersadt responds politely to these critics, pointing out that, except for a few labor economists at think tanks and universities, “men without work” remains largely ignored by almost everyone else in the country, including most policymakers in Washington. He also points out that he doesn't claim welfare and disability programs “caused the male flight from work, but rather *financed* it” (emphasis in original). As indicated earlier, I think Eberstadt is a little too reticent to assign causation, but his dissenters don't think he is reticent enough.

I strongly recommend *Men Without Work*. It is a well written and informative book on an important issue. I also recommend a previous book of Eberstadt's, *A Nation of Takers* (Templeton Press, 2012). That book considers the broad economic and social effects of public assistance programs. It exhibits less caution about causation, as indicated by its subtitle, *America's Entitlement Epidemic*. R

Finding the Money

◆ REVIEW BY GREG KAZA

Heather Boushey's new book, *Finding Time: The Economics of Work-Life Conflict*, is topical for one reason: presidential hopefuls Hillary Clinton and Donald Trump both supported taxpayer-subsidized child care.

Clinton proposed to make “preschool universal for every four-year-old in America” by spending more tax dollars to provide a “living wage” to “America's child care workforce.” Her goal was to “significantly increase” government expenditures, which she termed “investments,” so that “no family in America has to pay more than 10 percent of its income to afford high-quality child care.”

Trump called for “rewriting the tax code to allow working parents to deduct

from their income taxes child care expenses for up to four children and elderly dependents.” He would also “provide low-income households an expanded Earned Income Tax Credit—in the form of a childcare rebate—and a matching \$500 contribution for their savings accounts.”

Both wanted to expand the Family and Medical Leave Act of 1993, which requires employers with 50 or more employees to provide 12 weeks of *unpaid* leave. Trump proposed six weeks of paid maternity leave; Clinton would have required employers to pay for 12 weeks.

Boushey leads the Washington Center

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for Equitable Growth, a think tank founded by John Podesta, Clinton's campaign chair. Boushey was named chief economist of Clinton's presidential transition team in August. Her book can be summarized in one sentence: taxpayer-subsidized child care is a pressing economic issue.

She links taxpayer-subsidized child care to changes in the domestic economy. She argues:

American businesses used to have a silent partner. This partner never showed up at a board meeting to make a demand but was integral to profitability. That partner was the American Wife.

She goes on to note:

In 1960, two-thirds of children lived in a family where their parents were married and only their father worked outside the home. This kind of family was common across all income levels.

Today, women's greater labor force participation influences upper-, middle-, and lower-income household decisions, demanding "a rethinking of the social contract between governments, firms, and families."

Middle-class households, she contends, face lower expectations. "Most middle-class children now grow up in a dual-earner or a single-parent family," she writes, leading households to lower economic expectations, make "Mom the New Breadwinner," or increase debt loads. Low-income households face a "lack of income-mobility," their members confronted with "erratic and unpredictable schedules" that force them to turn to "extended kin networks" for support. Professionals also face challenges. For many of them, Boushey writes, "maintaining their place in the economic hierarchy requires a great deal of time and effort." This leads to "face time" demands at work and disregard for life outside the office. All three groups are affected by American businesses' loss of their silent partner.

She cites 1930s-era New Deal legislation as precedent to advance her case for policy changes in 2016. Among those prec-

edents are the 1935 Social Security and National Labor Relations acts, and the 1938 Fair Labor Standards Act. Clinton's policy agenda would have added taxpayer-subsidized child care as well as paid sick days, short-term time off, and "paid family and medical leave." Boushey wants to add greater scheduling predictability and a limit on what she calls "overwork."

"An option to telecommute may not help a working parent whose home office has been turned into a playroom or the receptionist and line workers who must physically be at work," she writes. "But better scheduling practices may be especially helpful to all these workers." Her arguments advance an ambitious agenda.

The most ambitious goal is universal child care. She links "early childhood education and the quality of care" to economic growth and argues for free or low-cost universal access to pre-kindergarten for all 3- and 4-year-olds. She notes approvingly that the U.S. Senate and House passed legislation in 1971 that would have "established a network of nationally funded, locally administered, comprehensive child-care centers." President Richard Nixon vetoed the measure, though today's Republicans might embrace the idea if they can be convinced to view the issue through the lens of economic, not social, policy.

How to pay for these programs? Boushey claims that "my proposals will cost taxpayers—and businesses—very little." Elsewhere, though, she concedes that "there are some added costs for businesses when implementing work-life policies," though they aren't quantified. She argues that "flexibility saves firms money" and that the stock market tends to respond positively when firms introduce workplace flexibility. She tries to persuade business, citing a 700-firm study that found employers consider adoption of workforce flexibility policies to be managerial common sense.

Some firms and the U.S. government provide care onsite or have flexible work schedules. "About eight in ten firms allow some employees some flexibility over when they start or end work." The problem? It's still "far from the norm in the workplace for all or even most." Boushey cites real-world examples: San Francisco and

Connecticut's paid sick-day policy; Alaska and Minnesota's prohibition on employment discrimination for family responsibilities; and paid family leave in California, New Jersey, and Rhode Island (financed by a tax on employees). Do these policies boost family incomes? Data through a complete economic cycle are not presented.

Unfortunately, she does not discuss a host of other important matters: firms' current economic incentive to be flexible in scheduling to retain skilled labor; federal economic policies' contribution to the weak jobs growth

described in the book; the role of churches, service clubs, and other voluntary organizations in providing support to families; and robots as household labor savers.

Interestingly, Arkansas—home of several real-world Clinton policy experiments involving labor and families—is not discussed. Arkansas per-capita personal income was stagnant from 1983 (when Clinton chaired the state's Educational Standards Committee) until a decade ago. In 1983, Arkansas' per-capita personal income was 75.4% of the nation's, and it hovered in the mid-70s through 2006, when it was 76.8%, according to the U.S. Bureau of Economic Analysis. In 2007, state lawmakers voted to reduce Arkansas' regressive grocery tax. That appears to have helped; in the last few years Arkansas' per-capita personal income has been around 80% of the nation's. Interestingly, Clinton's husband raised that tax when he was Arkansas governor.

My wife and I read Boushey's book and were left with the impression that the



**Finding Time:
The Economics of
Work-Life Conflict**

By Heather Boushey

**360 pp.; Harvard
University Press, 2016**

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author considers parents like us helpless to craft voluntary solutions to the time constraints we face balancing work and family life. These solutions range from voluntary decisions to reduce consumption in support of increased education spending, to

the use of time-saving technologies that increase efficiency and productivity at the household level. Parents seeking voluntary solutions that fit their unique situations will likely be disappointed by those important omissions. **R**

Banning Cash: This Time is Not Different

REVIEW BY PIERRE LEMIEUX

Ken Rogoff is a former chief economist at the International Monetary Fund and now professor of economics at Harvard University. Just after the recent recession, he published with Carmen Reinhart a best-seller entitled *This Time Is Different*, an ironic and iconic title pointing to the hubris of thinking that our times were different and immune to financial crises.

As we shall see, this general idea is not unrelated to Rogoff's latest book, *The Curse of Cash*, in which he proposes nothing less than a government prohibition, or near-prohibition, of cash in order to cripple the underground economy and promote monetary policy. He has been making this argument for two decades and has been joined by a few pundits, economists, and bankers.

The term "cash" has many meanings, all referring to liquid assets—that is, assets whose values can be realized rapidly. In its narrowest sense, cash refers to paper currency (dollar bills in the United States), which is what Rogoff and other proponents of abolition are referring to. Coins are typically not included in this definition of cash, and their value would add a mere 3% to paper currency anyway.

Paper currency makes up about 10% of the total stock of U.S. money (using the M2 measure of money). The rest is essentially electronic money represented by accounting entries in the computers of banks, transferable by check, debit cards, direct transfers, and similar means. If all

cash were abolished, only electronic money (and coins) would remain.

Rogoff claims to take a moderate stance. He stresses that cash would be phased out over 10 or 15 years. The largest denominations would go first, starting with \$100 and \$50 bills, and then the \$20. Smaller denominations (\$10 and lower) might be kept because they are useful for small transactions and for low-income people who may not have bank accounts and debit cards. But those bills might be banned too, and replaced by "equivalent-denomination coins of substantial weight." It's more difficult to become a criminal if you always have to push a wheelbarrow of money before you.

During the phase-out period, the government would replace paper currency with interest-bearing bonds, which could of course be cashed and converted to electronic money. There would be no overt confiscation, except for those who chose not to turn in their money earned illegally.

Whether the ban would be total or near-total, Rogoff's argument is that cash is bad because it facilitates crime and because it prevents monetary policy from pushing interest rates much below zero. The two main parts of *The Curse of Cash* explain these two reasons for considering cash a

curse to be eliminated.

Fighting crime/ Rogoff believes that reducing crime is the major reason for banning cash. He argues that cash is mostly used in criminal activities. Its advantage for criminals is that it is anonymous and that large denominations are relatively easy to transport and store.

Surveys suggest that American consumers hold less than 20% of the part of U.S. currency that circulates domestically. Moreover, 80% of the value of U.S. currency is made of \$100 notes, which ordinary consumers do not often use. ("Note" or "banknote" is the technical term for a paper currency bill.) It is inferred that a large part of cash must therefore be used in criminal activities: tax evasion (notably in small, cash-intensive retail businesses), drug transactions, and other illegal transactions in the underground economy. The same appears to be true in other countries with their own currencies.

Reducing tax evasion, Rogoff calculates, would produce government revenues that would more than compensate the loss of seigniorage. Seigniorage is the difference between the government's cost of printing dollar notes and their market value.

This argument underestimates the need of a free society for institutional constraints on state power. That these constraints often benefit criminals is not a sufficient argument for depriving others of that protection. Criminals are probably more likely than blameless citizens to invoke the Fifth Amendment against self-incrimination, or the Fourth Amendment against "unreasonable searches and seizures." The Eighth Amendment, against "cruel and unusual punishments," looks even more tailor-made for criminals. But limiting government power is necessary to protect the innocent. Even the prohibition of cruel and unusual punishments does, because many innocents would plead guilty to lesser charges if the alternative in the plea-bargain offer were excruciating torture.

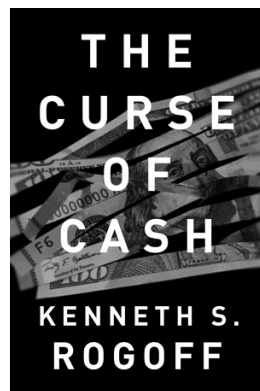
"It is no accident," Rogoff wrote in a *Wall Street Journal* op-ed previewing his book,

“that whenever there is a big-time drug bust, the authorities typically find wads of cash.” I suspect they also find cars. Suppose a law mandated that cars had to be equipped with factory-installed, non-removable GPS devices and airplane-like black boxes in order to combat their involvement in organized crime. As a consequence, criminals might switch to horses and the authorities would find horses at big-time drug busts. Could one then argue that horses—that inconvenient relic of the past, just like cash—should be prohibited for everybody?

At the margin, some cost-benefit guesses are unavoidable in legislation, but banning neutral things and exercising prior controls are generally shunned in a free society, and for very good reasons. For example, alcohol is involved in about a third of crimes (according to Department of Justice estimates), but that does not justify a new Prohibition. A similar argument can be made for cars, guns, and many other goods. Twitter is used by terrorists. But in a free society, deterrence through punishment is preferred to general prohibitions and prior controls.

Legitimate demand / There is obviously a legitimate demand for cash, which is used in some 60% of small purchases (up to \$10). Many find cash convenient, and not only for emergencies. Even for large purchases, some individuals may have a legitimate reason to protect their privacy. Ultimately, all preferences are subjective, and economic efficiency is defined in terms of what individuals want according to their own preferences.

Interestingly, cash is one of the few goods that government seems to be efficient at producing. Such has not always been the case and it is not true in all circumstances. Rogoff documents several historical cases when governments have debased paper currency by running the



The Curse of Cash

By **Kenneth S. Rogoff**
296 pp.; Princeton
University Press, 2016

printing press too fast. In today's rich countries, governments have more sophisticated ways than the printing press to debase money. So let's keep the focus on cash.

About one-half of U.S. paper currency circulates in foreign countries. In “dollarized” countries such as Panama or Ecuador, the U.S. dollar is the official currency. In other countries, people use dollar notes illegally (in view of local laws) to protect themselves against the debasement of their national currency by their own government. This happened in

Zimbabwe just a few years ago after the government had printed so many Zimbabwean dollars as to render them nearly worthless. Galloping inflation became so rapid that the Reserve Bank of Zimbabwe was printing notes in denominations of 100 trillion Zimbabwe dollars.

That the poor Zimbabweans had to use U.S. cash to protect themselves against their government's exactions reminds us that not all crimes are created equal, even in Western countries. There is certainly a big difference between terrorism (where the use of cash is only “a relatively minor factor”) on the one hand, and tax evasion or hiring an illegal immigrant for cash in the underground economy on the other.

On the benefit of a cash ban in fighting illegal immigration, Rogoff wrote in his *Wall Street Journal* piece that “it sure beats building walls.” I'm not so sure, if only because banning cash is a virtual wall that would also capture citizens. At any rate, the economist venturing into normative matters would normally attach the same weight to a foreigner's welfare as to a national's. This is what the individualist methodology of economics suggests.

Built-in constraint / Furthermore, Rogoff does not see that some actions legally defined as crimes constitute useful constraints on the state. He writes that “if

the government is able to collect more revenue from tax evaders, it will be in a position to collect less taxes from everyone else.” This common argument assumes an angelic government that dutifully raises the minimum amount of taxes necessary to produce the public goods that all individuals want. In the real world described by public choice theory, Leviathan always lurks behind government; it will be tempted to maximize its revenues, charging what the market will bear, in order to benefit its electoral clientele and enlarge the power and perks of politicians and bureaucrats. In this perspective, the built-in constraint of tax evasion prevents government from grabbing more money from all taxpayers.

We can extend this reasoning to the underground economy, which exists in large part because of both taxes and regulation, including prohibitions. When taxes or regulations reach a certain level, people start retreating into the underground economy, which provides a built-in brake on state encroachment. Harold Demsetz, the famed University of California, Los Angeles economist, hypothesized that as government expenditures reach 25% of gross national product (a concept closely related to gross domestic product), “the feedback system of underground transactions starts to become significant.” He continued, “The feedback becomes more forceful as the government sector increases beyond 30%, making the size of that sector difficult to push much beyond 45% of real GNP in a democracy.”

Writing in 1982, Demsetz may have been too optimistic about where exactly the built-in constraints of tax evasion and the underground economy stop the state's voracity. But these constraints are certainly stronger in a freer country, and that is a benefit, not a cost.

Negative interest rates / The second broad argument that Rogoff invokes against cash is that it prevents monetary policy from pushing interest rates far into negative territory, which he thinks is sometimes required. To understand this argu-

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ment, a little detour into monetary theory is necessary.

Keynesian-inspired macroeconomic theory holds that recessions or slow recoveries (like the current one) are due to a deficiency of “aggregate demand.” Government has to boost aggregate demand by either fiscal or monetary policy. Keynes preferred fiscal policy—increasing government spending or reducing the tax burden—but monetary policy has been fashionable lately. Monetary policy is supposed to work through the central bank pushing down interest rates and thus stimulating investment and consumption expenditures. (Real and nominal interest rates are the same if expected inflation or deflation is zero; otherwise they differ. To simplify this brief summary of the argument for negative interest rates, I assume no expected inflation or deflation, except otherwise specified.)

Pushing down interest rates will not work when they are already at zero. In theory, the central bank could continue buying bonds for more than their price at maturity, thereby pushing their yields into negative territory. It could also charge a negative rate to the banks that deposit money with it. But as interest rates go below zero, it becomes less onerous for savers and banks to keep their money in cash—that is, in dollar notes—because at least then they don’t lose the negative interest. The existence of cash prevents the central bank from pushing interest rate below the zero bound constraint.

In reality, the “zero bound” constraint is not at zero, but slightly below. Storing cash is risky: it can be stolen or destroyed by fire. Secure storage, including insurance, costs something, especially for large volumes of cash—perhaps between 0.5% and 1% of the value stored. So interest rates can be pushed down to –0.5% or –1%, but not further.

A negative interest rate looks like a strange creature. It means that lenders (including holders of bank deposits) must pay to lend, and borrowers get paid to borrow. Lenders will accept this only if they think that their savings are otherwise threatened with even larger depreciation.

Note that real interest rates can be temporarily negative if nominal interest rates, although positive, are lower than the inflation rate; but inflation expectations would soon push up nominal rates and correct the situation. A negative nominal interest is a new phenomenon.

During the past few years, central banks have run “quantitative easing” programs whereby they purchased bonds on the open market, bidding up their prices and pushing down their yield. Recently, they have pushed them slightly below zero in some European countries and Japan. These negative rates have not yet been passed on to bank depositors except for some large corporate deposits. In America, short-term interest rates are still positive but close to zero. If cash did not exist, the argument

It would be tempting for government to push interest rates far below zero and keep them there for long periods of time to reduce government borrowing costs.

goes, the central bank could decisively push interest rates below zero.

Hubristic risk / There are many arguments against central banks pushing (or trying to push) interest rates below zero.

For one thing, it overestimates the state of economic knowledge. Our very imperfect knowledge of the nature of the business cycle is illustrated by the fact that economists still debate the causes of the Great Depression and even of the 2008–2009 recession. Politicians and the general public don’t know more. The power of monetary (or fiscal) policy to manipulate aggregate demand is limited. We don’t really know the consequences of monetary policies, especially unconventional ones like negative interest rates—except that they don’t seem to show much success in Europe and Japan thus far. As *The Economist* observes, “Each new round of central-bank action seems to bring less stimulus and more side effects.”

The argument for a policy of negative interest rates may also overestimate the influence of central banks, which is debated among economists. Do central banks exert a determining influence on interest rates or do they mainly follow broader market trends? There is no agreement on whether the currently low interest rates are a continuation of a downward market trend that started in the 1980s, an effect of monetary policy, or a joint effect of both factors. It can be argued that central banks are just accentuating the downward trend. There is much that we don’t understand.

Rogoff underestimates the economic and political risk of negative interest rates. It would be too tempting for government to push rates further below zero and keep them there for longer periods in order

to reduce its own borrowing costs. Exporters would exert pressure for more negative interest rates, as this should lead to a lower exchange rate and higher exports. (The lower interest rates are, the less foreign investors

will want the currency.) This way, the world could end up in a protectionist race to the bottom. Negative interest rates would prove detrimental to savers, future retirees, and insurance companies.

Even if politicians and bureaucrats become saints and only manipulate interest rates in the public interest (assuming we can agree on a definition of this elusive concept), they may unintentionally generate bubbles in other markets such as commercial real estate or stocks.

Rogoff recognizes these dangers, but he has faith in government. He admits that monetary policy is plagued by ignorance and uncertainty, but he thinks that proceeding cautiously would be safe. He seems to think that, in case of ignorance, government should intervene.

It is safer to assume that politicians and bureaucrats will not become saints, so it’s wise to constrain their power in the field of economic policy as in other areas. Cash provides individuals with a

measure of protection against their own governments. If it becomes necessary, they can move their money over borders in cash form. If cash can facilitate private crime, it also renders government crime (by confiscation) more difficult.

Regulatory state / As Rogoff admits, a total or partial ban on cash would necessarily be accompanied by a new crop of regulations and controls. As cash is being phased out, restrictions on the maximum size of cash payments (like in some European countries) could be required. Other measures would be needed; for example, government would have to subsidize the provision of debit cards to low-income people—or supply them itself—in order for people without them to be able to use money. The spread of foreign cash would have to be prevented. Cryptocurrencies, which now provide a refuge for anonymity and privacy, would have to be regulated, perhaps with backdoors for regulators. Prepaid cards would be “discouraged,” to use Rogoff’s mild term. Fees on withdrawals and deposits of any remaining cash may be required. With negative interest rates, prepayment of taxes would have to be controlled and banks may need bail-outs. Many savers would no doubt ask for state help. Other regulations would be adopted to close newly discovered loopholes.

Cash hoarders would be shamed and bullied. Rogoff suggests that, after U.S. cash has been abolished, any business “that comes to the bank each week with a pile of euros might as well have ‘money laundering operation’ emblazoned on its stationery.” He praises a British police agency that bullied banks into restricting the supply of €500 notes. As he says, government always wins anyway: “It is hard to stay on top of the government indefinitely in a game where the latter can keep adjusting the rules until he wins.” Many people get the word: submit! And the rule of law rides away into the setting sun of liberty.

Welcome to the brave new world of the regulatory state. With due respect to Rogoff, his plea smacks of a naive trust of the state and a dangerous elitism or paternal-

ism toward ordinary people who want to use cash and escape the clutches of the regulatory state.

The real question is very different from the one Rogoff considers. It is not whether government should prohibit cash, but why it supplies cash in the first place. Consider this intriguing fact: government-supplied cash helps individuals escape intrusive surveillance by government.

Supplying cash is a rather minor intervention provided that competition is not forbidden. In the United States and many other countries, legal tender laws are dead-letter. Individuals or corporations may in theory agree to deal in other currencies and use other forms of cash, although I suspect that a host of indirect regulations and bullying kill any competitive temptation. To paraphrase Rogoff, the users of other currencies would have a money laundering target painted on their backs.

Better alternative / A world where government does not supply cash and prevents anybody else from doing so—which is close to what Rogoff recommends—would be as dangerous as a world where government supplies cash and forces everybody to use it. But between these two extremes (cash ban or cash monopoly), there is a third alternative: economic freedom.

Let each individual choose whether he wants to use cash or not and in which currency, and give suppliers the freedom to respond to this demand (short of counterfeiting somebody else’s currency), whether they be governments—foreign or domestic—or private suppliers, and whether their offerings are fiat money or commodity-based money (such as gold). Following Friedrich Hayek, an economics Nobel Prize winner, many contemporary economists have presented cogent arguments for allowing competition in the field of money as in other areas of life.

One thing is sure: we need another prohibition like we need another Berlin Wall.

As Rogoff would say in another context, this time is not different. Human nature has not changed, knowledge has not attained perfection, politicians and bureaucrats have

not become angels, Leviathan is still lurking, and public policies can wreak havoc. Abolishing cash would increase government power, undermine the rule of law, facilitate risky monetary policies, start a cascade of new regulations, and negate individual choices and the legitimate demand for cash. It would bring another brick to the construction of the police state.

Steve Ambler, a professor of economics at the University of Québec in Montréal’s business school, says about the proposal of banning cash, “I think that the proposal is strongly tied to the desire to control, track, and tax any and all forms of expenditure.” (The recent cancellation of cash and confiscation of part of it by the Indian government confirms such suspicions.)

Citizens would be well advised not to trust the state, but a state that claims to be democratic should trust its citizens. Switzerland is one of the economically freest countries in the world: in the latest ranking of the Economic Freedom of the World index, it comes in fourth (compared to the United States’ 16th). It is probably significant that Switzerland has one of the largest banknote denominations in the world: 1,000 Swiss francs—equivalent to about \$1,000 at the time of this writing. *That is a beacon of liberty.*

The Curse of Cash is a well-argued book and Rogoff is a good economist. If it were possible to prove that government should abolish cash, he would have done it. But his demonstration is not conclusive because this time is not different. R

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Down the Memory Hole

REVIEW BY DAVID R. HENDERSON

Ask any American born before 1960 for an example of corporate greed resulting in environmental disaster and the odds are good that he or she will name Love Canal. Love Canal, for readers who don't know, is a neighborhood in the city of Niagara Falls, N.Y. that was once a chemical waste dump. The dump became a major news story in the late 1970s, including sensational articles in the *Niagara Falls Gazette* by registered nurse turned reporter Michael Brown, who would later write the book *Laying Waste: The Poisoning of America by Toxic Chemicals* (Pantheon, 1980). The incident led to passage of the so-called Superfund legislation of 1980, which imposed a tax on petroleum and chemical companies to generate revenue for government-directed cleanup of toxic chemical sites.

But the real story of Love Canal isn't the "corporate guys: bad; government guys and community activists: good" tale that many people believe. In its February 1981 issue, *Reason* magazine published an exhaustive, fact-filled, 13,000-word article on Love Canal written by independent investigative reporter Eric Zuesse. The article dramatically recast many of the characters in Brown's reports, including Brown himself. I recently asked *Reason's* longtime science writer, Ron Bailey, whether further information in subsequent years had led him to doubt any important factual claims in Zuesse's piece and he replied, "I am not aware that his article has been contradicted or found deficient in any important way."

When I read about Love Canal, I do so with an eye on two topics: (1) Does the work discuss Zuesse's version of the story? (2) Does it challenge his claims? Those questions were on my mind as I read historian Richard Newman's new book *Love Canal*. Newman does not mention Zuesse, but he does raise some of the issues that Zuesse did. Disappointingly, Newman ulti-

mately ignores those issues and adopts much of the story that Brown presented.

Backstory / Before diving into the book, some backstory is needed. In the 1890s, an entrepreneur named William Love proposed to build a canal bypassing the falls on the Niagara River, which would allow shipping between Lake Erie and Lake Ontario. As part of his vision, Love proposed a planned community along the waterway. His project ultimately was dashed by the Panic of 1893 and a congressional prohibition on diverting water from the Niagara River, resulting in the abandoning of the partially dug canal. However, some of the residential development Love envisioned did become reality.

Decades later, the unfinished canal, which had become filled with water, became a dumpsite for the city of Niagara Falls' municipal waste. During World War II, a city-based chemical company, Hooker Electrochemical Company (later Hooker Chemical) received permission to dispose of chemical waste in the canal. Late in the decade, Hooker drained it, lined it with clay, and began depositing drums of chemicals at the site. Dumping continued through the early 1950s, when Hooker capped the site with clay.

Development / But the site was soon disturbed. The Niagara Falls City School District wanted the property

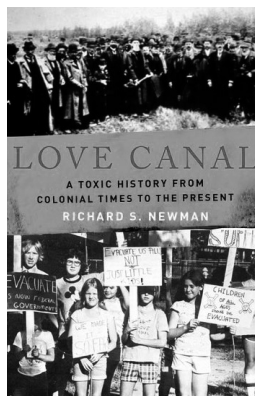
for a school and threatened to use eminent domain to gain the land. Rather than fight the action, Hooker offered to sell the property to the school board for \$1. The school board agreed, even though it was aware of the site's history.

In the deed of sale, Hooker included the following closing paragraph:

Prior to the delivery of this instrument of conveyance, the grantee herein has been advised by the grantor that the premises above described have been filled, in whole or in part, to the present grade level thereof with waste products resulting from the manufacturing of chemicals by the grantor at its plant in the City of Niagara Falls, New York, and the grantee assumes all risk and liability incident to the use thereof. It is therefore understood and agreed that, as a part of the consideration for this conveyance and as a condition thereof, no claim, suit, action or demand of any nature whatsoever shall ever be made by the grantee, its successors or assigns, for injury to a person or persons, including death resulting therefrom, or loss of or damage to property caused by, in connection with or by reason of the presence of said industrial wastes. It is further agreed as a condition hereof that each subsequent conveyance

of the aforesaid lands shall be made subject to the foregoing provisions and conditions.

The new owner of the land automatically became liable for any damage done by toxic waste on the land, making such a clause legally unnecessary. Why, then, did Hooker insert the clause? Zuesse's explanation is that Hooker wanted to underscore that the chemicals could be dangerous and should not be disturbed. Consider that in March 1952, a Hooker official escorted school board officials to the site and, with them present, made test borings into the protective clay



Love Canal: A Toxic History from Colonial Times to the Present

By Richard S. Newman
306 pp.; Oxford
University Press, 2016

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cover to convince the school board officials that the potentially dangerous chemicals were there. Yet, in August 1953, the school board unanimously voted to remove 4,000 cubic yards of fill from the waste site to complete the grading at another school site. The school board then began building the school on the Love Canal site, and that school opened in February 1955.

In 1957, the school board considered trading part of the property to two developers in exchange for other land and \$11,000 in cash. Hooker executives, upon hearing about the proposal, sent company attorney Arthur Chambers to attend the board meeting where the proposal was discussed. Chambers reminded the board members that chemicals were buried under the land's surface and pleaded with them not to let houses be built on the land. The board deadlocked 4-4, with the result that the resolution to sell the land failed.

Unfortunately, at the same time, city workmen, while constructing a sewer, punctured the walls of the site and its clay cover. They did this even though articles in the local paper at the time regularly warned that the construction was "dangerous" and "injurious."

In short, Hooker Chemical tried on several occasions to warn people about the dangers of the buried chemicals, and the irresponsible players in the drama were government officials. Two decades later, as groundwater tests began finding toxic chemicals and assertions were made that the chemicals were causing birth defects, Brown began writing his articles.

Newman's version / Newman tells some of this story. But at some points, he undercuts it with doubts about Hooker's actions. He writes, for example:

Hooker later claimed that developers removed the [clay] cap when building new homes and streets. But subsequent investigations doubted that the company had actually capped the entire dump (perhaps only part of it). ... In short, the Love Canal dump may never have been completely contained.

Here's the problem: In a 306-page book with 32 pages of footnotes, this very important claim is not footnoted. So either Newman has failed to back up a correct claim, or he's simply stating some unspecified person's opinion. The way to plant credible doubt is to show, not just assert, that there is doubt.

Newman quotes much-celebrated Love Canal activist Lois Gibbs' claim that "residents of this blue-collar community have come to see that corporate power and influence are what dictated the actions at Love Canal, not the health and welfare of its citizens." Yet, if Zuesse's version of the story is correct, then it was a major corporation that *warned against* various politicians' plans to cut through the cover over the toxic dump. Perhaps Hooker Chemical was truly wor-

Hooker Chemical tried to warn people about the dangers of the buried chemicals, while the irresponsible players in the drama were government officials.

ried about "the health and welfare" of Love Canal's citizens. Perhaps it merely wanted to avoid adverse publicity and possible legal action (despite the legal protections in the deed). Regardless, the problem was not corporate power and influence but corporate *impotence*. The politicians had their narrow goal—building a school over a potentially toxic dump—and they were not about to be stopped by a mere corporation. Of course, the quote is from Gibbs, not from Newman, but Newman does not even attempt to gainsay her strong claim.

This failure is not just a careless slip. In one section, for example, Newman writes, "It all came back to the concept of justice, for Love Canal families felt that they had been sacrificed on the altar of profit and power." It seems far more accurate to say that they were sacrificed on the altar of the local school board's power; the idea that for-profit Hooker sacrificed them is hard to maintain in light of Hooker's warnings not to disturb

the site. Moreover, elsewhere in the book, Newman refers to Hooker's "newfound concern" in 1980 with the "public's health and safety." Newfound? As documented above, Hooker stated and, more important, acted on its concern in the 1950s.

And what were the chemicals' health consequences for Love Canal residents? One would think that a 2016 book would at least partially answer that question. But even though Newman refers to bad health consequences, he is disturbingly vague about their nature. He refers, for example, to some blood tests of young children living in the area without even giving a hint about what those blood tests found. Elsewhere he refers to a "much debated genetic test showing that roughly one-third of the thirty-six people sampled

may have suffered chromosome damage." One-third is high. What, then, was debated? Only when you actually read a 1983 *New York Times* article referenced in the footnote do you find the following: "Residents and former

residents at the Love Canal toxic-waste site in Niagara Falls, N.Y., are no more likely to have suffered chromosomal damage than residents elsewhere in the city, a Government study concluded today." The study was conducted by the Centers for Disease Control. Note the asymmetry: Newman puts the horrific claim about genetic tests in the body, references a *New York Times* study in a footnote, and doesn't even hint in the footnote either what the study found or that it was conducted by the Centers for Disease Control.

At one point, Newman refers to reporter Brown's being driven "by an old-fashioned sense of justice." I beg to differ. Consider, for example, Brown's claim, which Zuesse highlights: "At that time [1953], the company issued no detailed warnings about the chemicals; a brief paragraph in the quitclaim document disclaimed company liability for any injuries or deaths that might occur at the site." A brief paragraph? As Zuesse points out, this paragraph,

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quoted above, is the longest paragraph in the whole deed. Newman's idea of an old-fashioned sense of justice is certainly not mine.

Conclusion / It's usually a good idea to revisit important historical issues in light of new information. Unfortunately, Newman's revisit of the Love Canal story omits much of what Zuesse discovered 35 years

earlier. People who read it will get many of the apparently false impressions produced by Brown's original reports.

If you want to know the history of Love Canal in the 19th century and first half of the 20th century, Part One of Newman's book is for you. But if you want to really understand the key events from the early 1950s to 1980, Zuesse's 1981 article is the place to look. R

Restoring Checks and Balances

◆ REVIEW BY GEORGE LEEF

America's constitutional structure, too few people today understand, was crafted for a good purpose: to disperse governmental power. It was dispersed *vertically* (little allocated to the national level and most to the states) and *horizontally* within the national government, where the three branches were assigned specific areas of authority and expected to check and balance each other. The Founders had experienced life under the British Crown with its concentration of power in the monarchy and so disliked it that they risked their lives in a rebellion against it.

The United States prospered under that dispersion of power, but the system began to break down a century ago. The Progressives and especially President Woodrow Wilson believed that the nation would be better off if governmental authority were concentrated in Washington, D.C., primarily exercised by enlightened administrators working in the executive branch. Ever since then, our constitutional structure has been under siege with the dispersion of power steadily giving way. It isn't an exaggeration to say that today's presidency wields more power than King George III ever imagined.

Why and how all of that matters is the subject of *Liberty's Nemesis*, a superb collection of 26 essays exploring different facets of our increasing concentration of power. Edited by Dean Reuter (a senior staff member at the Federalist Society) and John Yoo (a law professor at the University

of California, Berkeley), the essays cover the range of federal action (and sometimes inaction) that is giving us, as the subtitle says, the unchecked expansion of the state.

Readers will probably be at least passingly familiar with most of the topics covered, including the legal wrangling over the 2010 Affordable Care Act, the Obama administration's efforts at preventing people from acquiring guns and ammunition, the unprecedented aggression of the National Labor Relations Board in pushing unionism, Operation Choke Point's illegal strangling of lawful businesses through abusive banking regulation, federal interference in state voting laws, the Internal Revenue Service's targeting of groups that oppose the president's agenda, and much more. Seeing all of these perversions of the rule of law discussed in one place gives readers a heightened sense of anxiety over the nation's future.

In his introduction, Reuter maintains that we are "dangerously near a tipping point" in that the balance of power is so eroded in favor of the president that the very concept of checks and balances may be irretrievably lost. Preserving that concept, he writes, "requires a certain faith-

fulness by all." The problem is that many politicians today do not act in good faith toward the Constitution they are sworn to uphold. The balance of power inhibits them because it makes governing slow and deliberate, requiring compromise and the willingness to take "no" for an answer. But they are impatient to get things done and happy with the breezy idea expressed by Democratic consultant Paul Begala, "Stroke of the pen—law of the land. Kind of cool." That, however, is not how our government is supposed to work.

Abuses of power / It isn't possible to do justice to each of these meaty essays in a short review, so I will concentrate on just a few that I think readers will find the most troubling.

Consider the much debated Second Amendment. The political left loathes the idea that citizens have the right to keep and bear arms and has engaged in a fierce campaign against it. In his contribution, former congressman Bob Barr details the non-legislative, extra-legal means employed by the Obama administration to undermine that right.

One of them was "Operation Fast and Furious," a gambit undertaken by the Department of Justice to sell firearms to Mexican drug cartel figures with the intention of demonstrating the supposed need for a greater crackdown on arms sales. Some of the weapons involved in this rogue plan were used in a 2010 gun battle that cost a border patrol agent his life. But when Congress investigated and sought information about Fast and Furious, then-attorney general Eric Holder refused to turn over documents and was held in contempt of Congress.

Another abuse of power is Operation Choke Point, which targets legitimate businesses that sell guns and ammunition (as well as other activities deemed unsavory, such as payday lending and coin sales). The operation directs the Federal Deposit Insurance Corporation to pressure banks into refusing to continue to deal with these kinds of businesses because they are "high risk" as declared by the Obama administra-

tion. No law authorizes this operation and when Congress attempted to investigate it, Attorney General Loretta Lynch dismissively promised to “look into it.”

Another instance where the executive branch operated without congressional sanction is the Education Department’s directive for how colleges and universities are to handle allegations of sexual assault on campus. No statute gives the department that authority, but under its “interpretation” of the law and a rule promulgated without adhering to the Administrative Procedure Act, department officials decreed that colleges must follow their dictates.

In their essay on this, Greg Lukianoff and Samantha Harris of the Foundation for Individual Rights in Education show how the vague language of Title IX of the Education Amendments of 1972 was twisted to mean not just that schools receiving federal student aid money could not discriminate against women (the statute’s clear intention), but to give the Education Department carte blanche to dictate every aspect of school policy having anything to do with sex. Under a 2011 department “guidance letter,” colleges risk the loss of government funds unless they do their utmost to prevent and punish all conduct that could be deemed harassment.

This has First Amendment implications, the authors note. “If a listener takes offense to sex- or gender-related speech for any reason, no matter how irrationally or unreasonably, the speaker has engaged in sexual harassment,” they explain. So we now have college officials frantically monitoring speech that might lead to an investigation by federal bureaucrats. Moreover, a substantial number of male students have been punished or expelled as a result of the blatantly one-sided, quasi-judicial procedures demanded by the department. Thus, both free speech and due process of

law have become victims of the Education Department’s overreaching officials.

Neglect of law/ Not only does the executive branch make up new laws on its own, but it also neglects to enforce laws it decides don’t fit with its agenda. Several essays deal with that problem, including the administration’s decision not to defend the Defense of Marriage Act when it was challenged in court, its decision to ignore the law on the deportation of illegal immigrants, and its decision to ignore the law requiring states to clean up their voter lists. Since the first two examples are fairly well known, I’ll discuss the third.

In his essay, “Unilateral Actions of President Obama in Voting and Elections,” Heritage Foundation legal scholar Hans von Spakovsky examines the various ways the current administration has intervened to improve the chances that Democratic candidates will win elections. This has been accomplished through litigation to block state efforts at making their elections less prone to fraud and by ignoring existing laws when enforcing them would work against Democratic prospects.

Particularly important here is the 1993 National Voter Registration Act, which requires the states to undertake “a reasonable effort to remove the names of ineligible voters from official lists.” There is evidence that in many if not most states, the rolls are laden with the names of people who have died or moved away. Inaccurate lists make vote fraud much easier. But the Obama administration chose to ignore this law, a Justice Department official calling it “uncongenial” because it did not fit in with the political goal of increasing voter turnout.

Similarly, von Spakovsky charges, the Obama administration was not interested in pursuing cases of voter suppression

and intimidation that may have helped its political allies, such as reports of Black Panther Party toughs patrolling Philadelphia precincts to frighten away voters.

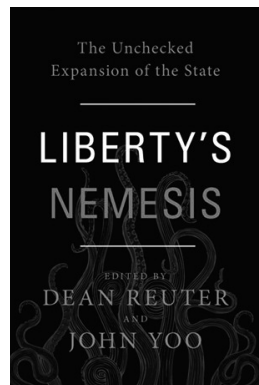
Von Spakovsky sums up, writing:

What appears clear is that the administration has misused its authority under various federal voting rights laws to advance its own ideological agenda, and to help ensure the election of candidates of the president’s political party. This is an abuse of executive power delegated to the president by the Constitution to “take Care that the Laws be faithfully executed.” ... This administration has failed that obligation.

Indeed so. When a political leader decides not to enforce the laws impartially, but instead to pick and choose which ones to enforce for partisan advantage, a crucial element of democracy’s social contract has been violated.

Yoo’s conclusion/ Yoo ends the book with a sobering conclusion. The administrative state that was supposed to make everything more efficient has merely “eased the way for special interests” because they need only to capture the heads of federal agencies rather than the far more difficult task for persuading majorities in both the House and Senate to adopt whatever policies they desire. There is no consent of the governed when the laws are made by unaccountable bureaucrats.

What is to be done? Yoo argues that it is time to “disable and hobble” the administrative state. He would like to see the courts resuscitate the old “non-delegation doctrine” that used to keep Congress from handing its authority over to agencies. He also wants the courts to abandon their position of deference toward most agency actions and their statutory “interpretations.” And he favors a conservative offensive to restore the old concepts of individual rights, going so far as to say that the almost universally reviled decision in *Lochner v. New York* (1905) was actually correct in that it protected the worker’s freedom to contract as he thinks best.



**Liberty's Nemesis:
The Unchecked
Expansion of the State**

**Edited by Dean Reuter
and John Yoo**

**584 pp.; Encounter
Books, 2016**

IN REVIEW

That Yoo argues for such controls on executive power may seem ironic, given that some have charged him with helping to expand the chief executive's power while head of the Office of Legal Counsel in the George W. Bush administration. Nonetheless, the ideas he offers in this essay are good ones. However, the judiciary is mostly in the hands of people who see only good in the administrative state and

who often have disdain for claims of individual rights.

Reading *Liberty's Nemesis* is like going to see your doctor over what you think is a minor problem, only to learn that you have an aggressive, fast-spreading cancer. You might survive it, but the odds aren't good. The unchecked expansion of the state has ruined many other nations and our case is advancing rapidly. R

Centrally Planning Fuel Economy

◆ REVIEW BY DAVID R. HENDERSON

In the next few years, companies that sell cars and light trucks in the United States will have to comply with increasingly stringent federal regulations on fuel economy. The government's regulations call for a required average of 54.5 miles per gallon on new cars and trucks by 2025. The requirement will vary with the size of the car or truck, so each company will face a different required fuel economy average that varies with the size-mix of its sales. This is after the Obama administration had already raised the overall required average to 34.1 mpg for 2016.

On its face, such mandates would seem unnecessary. Auto consumers have ample reason to want fuel economy (balanced against other desirable traits such as safety, performance, and comfort), and car makers have ample reason to supply it. And, as *Regulation* has repeatedly documented, there is plenty of evidence that the market operates well in this regard. (See, e.g., "Do Consumers Value Fuel Economy?" Winter 2005-2006; "Working Papers: CAFE Standards," Winter 2015-2016.)

How did such a large increase in required fuel economy happen? Margo Oge, former director of the Office of Transportation and Air Quality in the

U.S. Environmental Protection Agency, tells the story in her book, *Driving the Future*. Oge had a large role in designing these regulations and negotiating for them within the Obama administration and with the auto makers, both foreign and domestic. Her book helps readers understand how this extreme regulatory requirement came about.

She argues for the regulations, basing her case on the climate change that she fears would occur without a large reduction in the carbon footprint of cars and trucks. She takes for granted that there would be catastrophic global warming without such regulations. She does not consider other ways that economists have conceived for reducing carbon dioxide emissions, such as cap-and-trade or taxes on carbon use or CO₂ emissions. She also ignores or fails to understand any unintended consequences of the regulations she favors.

the various criticisms of this view more seriously. At one point she refers to "climate change deniers," although there are a number of climatologists at good universities, none of whom deny climate change, but all of whom are skeptical of current professions of certain doom. She is having none of it, insisting that "the cause of these earth-changing deviations should no longer be subject to debate."

But *should* there be some debate? She has so much trouble granting that there might be a debate that at one point she refers to former President George H.W. Bush's chief of staff John Sununu's "effort to undermine the credibility of climate science." How did Sununu undermine it? She writes: "Sununu ran computer models that he claimed showed uncertainties clouding the understanding of global warming." What she misses is that undermining scientists' conclusions with computer models is—unless the models are dishonestly or inappropriately programmed—*part* of the scientific method.

She also criticizes Sherwood Idso, whom she calls, correctly, "a respected scientist." In his book *Carbon Dioxide: Friend or Foe?* Idso argues that increased greenhouse gas emissions "would actually increase food yield and provide other benefits." Oge admits that this is "true for some parts of the planet for short periods of time." But she writes that, overall, "Idso's arguments gave a false impression of the future impacts that climate change would have on agriculture." Unfortunately, she doesn't bother to explain precisely why this "impression" is false, instead dismissing Idso's book as being "popular and controversial" and, therefore, "exactly what industry interests wanted." We can't have that.

But let's assume, as she does, that without a large cut in CO₂ emissions, global warming would continue. What would the consequences be? There is a large, serious economics literature on this, written by people who share her concerns. I have in mind people like Yale economist William Nordhaus. But she doesn't reference his work, settling instead for a report by three people who are neither

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Climate change debate / Given how heavily Oge leans on climate science to make a case that the world is dangerously warming, it would have been nice had she taken

economists nor climate scientists: former treasury secretary Henry Paulson, former New York mayor Michael Bloomberg, and wealthy investor Tom Steyer. She cites a claim from their study that by 2050, if current trends continue, “up to \$106 billion of the nation’s coastal property will likely be below sea level.” Put aside the important hedges “up to” and “likely”; does Oge realize how relatively small a \$106 billion loss is? In 2013, according to the Federal Reserve’s Flow of Funds data, the value of all privately owned land and property in the United States was about \$21.6 trillion. It’s almost certainly higher now. That \$106 billion loss, therefore, though large in absolute value, would be less than 0.5% of the total.

Misunderstanding markets / To her credit, Oge understands why it would be a bad idea to require auto companies to use specific methods for reaching the ambitious regulatory mpg goals. She writes:

The EPA didn’t tell automakers what technology they had to use to make the improvements [in fuel economy]. It didn’t pick winners and losers. Instead, the mandate created a huge market for whatever new technology could get the job done. Private industry would have to figure out the rest.

Implicit in this passage is the idea that firms given a mandate will figure out the least-cost way of complying with the mandate. It’s good that she acknowledges this.

But once you understand why it would be a bad idea to require a particular technology, it’s pretty easy to see why it’s a bad idea to require a particular fuel economy for cars and trucks. Remember that Oge’s and others’ ultimate goal is not better fuel economy per se but, rather, lower CO₂ emissions. The least-cost way to get lower emissions is not to single out a particular sector

of the economy—in this case, new cars and trucks—and require a minimum number of mpg. Instead, it is to have people cut the uses of CO₂ that have the least value for a given amount of emission.

How would government do this? Economists offer two answers: a cap-and-trade system or a tax on CO₂ emissions. I note parenthetically that even economists have gone a little astray in talking about *carbon* taxes. If global warming is a real threat, then the enemy is not carbon but CO₂. Equating a tax on carbon with a tax on CO₂ implicitly assumes that one could not use a given amount of carbon in a way that produces less CO₂. (There might even be a cheaper way to deal with future CO₂ emissions: geo-engineering. But Oge does

not consider this.)

With a tax on CO₂ or a cap-and-trade system, everyone who uses carbon has an incentive to economize on emissions. So not only new car buyers, but also users of old cars would economize. Outside the auto sector, barbecue users, people heating their homes, manufacturers using fuel, and electric utilities—to name just a few—would economize. Yet Oge does not consider the option of cap-and-trade or a tax on CO₂ emissions. This omission is quite striking given how vocal economists have been in recent years about a tax or cap-and-trade.

It’s not as if she had no discussions with economists; she did, in both the George W. Bush and Obama administrations. She tells of one interaction with Michael Greenstone, chief economist on the Obama White House’s Council of Economic Advisers. In her telling, she had reported a finding that the higher price of the more fuel-efficient car would be more than offset by the savings in fuel expenditures. Greenstone challenged her. She quotes him as saying, “The consumer won’t fully value these fuel economy benefits, so we should discount them by 50 to 80 percent.”

Oge doesn’t say why he believed this. So I called him at the University of Chicago, where he is an economics professor, and asked him. He explained to me that if car buyers were not already demanding cars that had the fuel efficiency she was trying to achieve, it must be because there were other negatives besides the higher upfront price of the car. Those negatives might be the cars’ performance, esthetics, safety, or other features.

Oge writes, “Academics like Greenstone would still worry that we are messing with the magic of the market.” He explained to me that consumers know what they want better than central planners do. Summarizing her interaction with Greenstone, Oge writes, “The idea that the market functions perfectly is a powerful political and theoretical obstacle to fuel economy regulations.” The idea that economists think that the market functions perfectly is a caricature that many non-economists share. You don’t have to think that markets function perfectly—whatever that means—to think that they function well or, at least, better than government.

If one sentence crystallizes the problems caused by Oge’s lack of understanding of economics, it is this one, written about the then-freshly formed Obama administration: “There will be others, even within the new administration, who are ideologically opposed to the regulations—as is almost inevitable in any room filled with Washington lawyers and academic economists.” She, in short, sees economists—even ones in the Obama administration—as being ideologically opposed to regulation rather than being opposed because of their understanding of both markets and regulation.

Her lack of understanding of markets also leads her to miss a basic fact about the 1973 Arab oil embargo on the United States. The embargo, by itself, had no effect on the United States because oil is fungible. In a world market, selective embargoes against particular countries cannot work because buyers who get the oil from the embargoing countries can resell it. What hurt us and other oil-



**Driving the Future:
Combating Climate
Change with Cleaner,
Smarter Cars**

By Margo T. Oge
351 pp.; Arcade, 2015

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consuming countries in 1973 was not the embargo. At the time world demand was growing but world production was growing more slowly, pushing prices up. Oge attributes the gasoline lines of 1973 to the embargo, but that is wrong. The villain behind the gasoline lines was the one for whom she later worked: the U.S. government with its price controls on oil and gas. Countries whose governments avoided price controls, such as Switzerland, also avoided gasoline lines.

She is not alone in this basic misunderstanding. She tells of a conversation she had in the summer of 2013 with James Woolsey, a director of the Central Intelligence Agency during Bill Clinton's presidency. In October 1973, when he was

general counsel for the Senate Armed Services Committee, he had planned to run a congressional hearing on the Yom Kippur War. Instead, he "missed most of the hearing waiting in the long line at the pumps." Oge quotes Woolsey, "I turned pretty hostile to oil then, and that was forty years ago." Wow! One wonders what important decisions he made because he lacked this basic understanding of microeconomics.

Oge seems to be someone who tried to do what she thought was the right thing. It's too bad that she didn't have more understanding of economics. If she had, then we might not be contending in a few years with cars that get much higher fuel economy but suffer on yet unknown other dimensions. R

Peter Conti-Brown is an assistant professor of legal studies and business ethics at the University of Pennsylvania's Wharton School. He has also held positions as a fellow at Stanford Law and in the history department at Princeton, as well as at a law firm and as a law clerk. He has never worked at the Fed or one of the other financial agencies, or at a commercial bank for that matter. But he just seems genuinely fascinated with how this strange animal known as "the Fed" works in practice and he has apparently dedicated a large portion of the last five years thinking about how it has evolved over time and if it indeed works well overall. Conti-Brown highlights the dearth of quality legal and historical scholarship on the Fed (beyond the point of its creation) and he intends to fill that void.

The Ulysses/Punch Bowl View of the Fed

◆ REVIEW BY VERN MCKINLEY

A decade or so ago the Federal Reserve was riding high. In the midst of what was called the "Great Moderation," a 20-year run during which inflation was under control and two quite mild recessions graced us with their fleeting presence, things were looking good for the Fed. The tables had been turned on the stagflation of the 1970s and the Fed was getting much of the credit.

In a speech on this phenomenon titled with the same moniker as the period itself, then-governor Ben Bernanke of the Federal Reserve extolled his colleagues, gushing that their conduct of monetary policy, in contrast to the bleak memories of the 1970s, "makes me optimistic for the future." Overall there was little public consideration or appetite for revisiting the core idea of deference to the Fed on its management of the economy and the financial system.

What a difference a decade makes.

The Power and Independence of the Federal

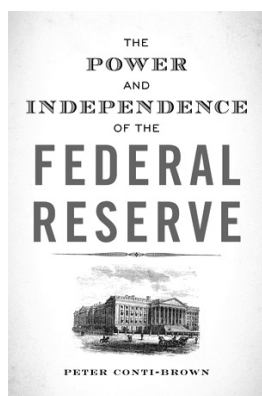
Reserve is a timely primer on how the Federal Reserve has evolved in its structure and functions in its century of existence. The book is timely because all manner of commenters—some qualified, others not—have provided a range of views since the onset of the financial crisis on: (1) why the Fed needs additional powers, or why it does not need to exist at all; (2) why the Fed needs to reduce its dual mandate of price stability and low unemployment to a single mandate of price stability, or why it needs to expand its mandate to include financial stability; or (3) why the Fed needs to go through a regular policy audit of monetary policy by the Government Accountability Office, or why it can get by with its current financial statement audit and other data releases.

Independence for whom and from what?

As implied by the title, the focus of Conti-Brown's book is on how the Fed's Byzantine structure affects its power and independence. He uses a generalized definition of power to mean simple influence on the global financial system. He then cobbles together, based on his review of the literature, a very Fed-specific definition of independence as the "separation, by statute, of the central bankers (specifically the Fed chair) and the politicians (specifically the president) for purposes of maintaining low inflation."

Conti-Brown puts the definition of independence in the context of the blended metaphors of the "Ulysses/punch bowl view of Fed Independence," to which he refers often throughout the book. Ulysses is a metaphor for a system where "we write central banking laws that lash us (and our politicians) to the mast and stuff beeswax in the ears of ... technocratic central bankers [who] guide the ship of the economy to the land of prosperity and low inflation." The punch bowl refers to the oft-told quote of former Fed chairman William McChesney Martin of how central bankers are "in the position of chaperone who has ordered the punch bowl removed just when the party was really warming up."

Conti-Brown claims that this widely held view of the Fed in fact “doesn’t work” and is actually “wrong,” which leads into the substance of his analysis of the Fed’s structure and history. However, Conti-Brown tips his hand that he judges that the Fed ultimately “did the right thing” during the last decade’s financial crisis when he states (without much supporting detail), “As we all saw in the 2008 financial crisis, policy failures and triumphs within the Federal Reserve stirred financial havoc but likely spared us from financial cataclysm.”



The Power and Independence of the Federal Reserve

By Peter Conti-Brown
354 pp.; Princeton University Press, 2016

Covering all the bases/ Conti-Brown’s historical and legal analysis of the Fed largely breaks down into four major questions (which by the way do not precisely cross-walk to the four parts of *The Power and Independence of the Federal Reserve*):

- “How is the Fed governed?” traces the evolution of the governance through what he calls the “three foundings of the Federal Reserve” in 1913 (Federal Reserve Act), in 1935 (Banking Act of 1935), and 1951 (Fed-Treasury Accord). Those developments evolved the Fed from the “institutional chaos” of its early days to its current position of pursuing “institutionally separate” sets of economic and monetary policies. He applies legal scrutiny to what he calls the “unconstitutional” Federal Reserve Banks.
- “What functions does the Fed perform?” contemplates the strange brew of technical functions the Fed is responsible for from monetary policy, to lender, to supervisor and regulator.
- “What people at the Fed have stood out over time and influenced its development?” delves not only into the specialists who comprise the leadership, but also the economists, lawyers, and international specialists. It also

takes on case studies of the expected comparisons of major chairmen of the Fed: the Martins, the Volckers and the Greenspans that the man on the street is familiar with. But it also scrutinizes the Tarullos, the Alvarezes and the Blinders, names that are mostly just familiar to hard-core, Fed-obsessed geeks.

■ “What major interactions does the Fed have outside its walls?” scrutinizes the Fed’s relationship with the president as implied by the Fed-specific definition of independence, and also Congress and bank-

ers (including international banks and central banks). This includes a thoughtful section on regulatory capture at the Federal Reserve Bank of New York.

What he gets wrong/ Near the end of the book, Conti-Brown advances case studies to apply his detailed framework for the Fed. He turns to an assessment of two current proposed legislative amendments to the Federal Reserve Act: a policy audit of monetary policy (“Audit the Fed”) and a mandate for a rules-based methodology for monetary policy. Conti-Brown concludes that both are unnecessary. He starts off by making an excellent case to justify a policy audit, one that I have advanced myself:

The public audit part of the proposal is consistent with an essential component of this book’s argument, that we cannot understand what the Fed is, what it does, and who on the outside influences Fed behavior without knowing more about how the Fed operates.

So far so good. He then turns the discussion on its head and ultimately concludes that the audit effort is “motivated by a desire to punish specific Fed actions” and therefore is not a good idea. Where did

the valid concerns about making the Fed more transparent go in this analysis? His argument is not convincing.

The second proposed legislative amendment that Conti-Brown assesses is the simple idea of requiring the Fed to adopt a rule to guide its implementation of monetary policy. This is as opposed to the current practice of vesting plenary discretion in the Fed to conduct monetary policy as the voting members see fit, unhinged from a logical, consistent monetary rule. Based on what I know about the legislative proposals on Capitol Hill (primarily sponsored by House Financial Services Committee Chairman Jeb Hensarling), Conti-Brown misstates the proposed legislation when he says that the “rule selected and written into the Federal Reserve Act is the so-called Taylor Rule.” In fact, Hensarling in multiple press releases has explained that there is no such mandate that the Taylor Rule be used, that the rule would be “of the Fed’s own choosing with the power to amend it or deviate from it at the Fed’s own choosing.”

I should also point out that Conti-Brown makes a few factual mistakes in the book—mostly mistakes your typical policy reader would not catch. For example, he speaks of Continental Illinois and the unprecedented \$3.6 billion bailout provided to it in 1984, then states, “It wasn’t enough; the bank failed anyway.” Advocates of bailouts called Continental “too big to fail” for a reason. The bailout meant it did not ultimately fail and it lived on to become part of Bank of America in the early 1990s. Additionally, he states that the last decade’s financial crisis was focused in the “uninsured investment banks, insurance companies, money market funds, and other uninsured financial institutions” because they lacked deposit insurance, which mitigates such panics. Yet he fails to explain why massive Citibank—a subsidiary of Citigroup, which is a Fed-regulated entity—had a run on its deposits, notwithstanding the fact that it was a good old-fashioned commercial bank with FDIC insurance. But misstatements and omissions like these are few and far between

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and he mostly gets his facts right in this detailed analysis of Fed operations.

Conclusion / Despite these stumbles that this Fed critic latches onto, Conti-Brown's book provides a thorough history and legal analysis. I agree with his characterization that it fills a large void in the literature. My favorite find that Conti-Brown mined as part of his research is a 1914 quote from Sen. Carter Glass about how the Fed would not issue "fiat money":

Fiat money is an irredeemable paper money with no specie basis, with no gold reserve, but the value of which depends solely upon the taxing power of the Government emitting it. This Federal Reserve Note has 40 percent gold reserve behind it, has 100 percent short-term, gilt-edge commercial paper behind it.

I think we know how Federal Reserve Notes "evolved" in the ensuing century. R

Should We Want More Government?

◆ REVIEW BY PHIL R. MURRAY

The title of this book, *How Big Should Our Government Be?* by Jon Bakija, Lane Kenworthy, Peter Lindert, and Jeff Madrick, raises an interesting question. The authors' goal is "to broaden the nation's understanding of how big government actually should be by presenting the best research on the subject." They claim to shun "ideology and politics." Their question in general is, "Will bigger government hurt the economy?" They reason it will not.

Social transfers / Lindert, an economics professor at the University of California, Davis, opens his contribution deftly with rhetorical support from Adam Smith. In Smith's *Lectures on Jurisprudence*, Lindert reminds us, the founder of economics refers to the "many expences necessary in a civilized country." Lindert equates those necessary expenses to government spending on "infrastructure." In his *Wealth of Nations*, Smith refers to "publick works which are beneficial to the whole society" that may need to be financed by "the general contribution of the whole society." Lindert's take is that Smith "clearly understood that external benefits could justify tax-based social expenditure." He then moves from economic literature to an empirical investigation

of how transfer payments affect macroeconomic performance.

His first piece of evidence is a graph that shows real gross domestic product per capita and "social transfers as a % of [gross domestic product]" for "four of Smith's civilized countries—the United Kingdom, the United States, Sweden, and Japan." The graph shows that both real GDP per capita and social transfers as a percentage of GDP have increased over the long run. One interpretation is that standards of living in those four countries have increased despite more government spending on public pensions, health care, unemployment benefits, etc. Another interpretation is that the welfare state is compatible with a high standard of living. Lindert prefers the latter. He recognizes that reverse causality might be at work: "Perhaps the prosperity bred the wasteful social spending." He responds, "Yet if the social spending is nothing but a rich country's bad habit, like obesity or recreational drugs, why don't we see any easy evidence of it dragging down

GDP per capita?" Perhaps observing just four high-income countries isn't enough to respond to that question.

The next piece of evidence is a table that shows correlations between transfer payments and economic performance among a greater number of countries in the Organisation for Economic Co-operation and Development over several decades. Lindert straightforwardly calculates a correlation coefficient between "initial share of social transfers in GDP" with the growth rate of GDP per capita during each decade for all the countries. It is unclear, though, exactly how he did this; did he use average GDP per capita for each decade? Nevertheless, he concludes, "History again shows no significantly negative relationship between the start-of-decade public social spending share and either the growth or the level of GDP per capita." At this point, he encourages neither advocates of the welfare state nor advocates of limited government. "From all the correlations," he declares, "we cannot infer a positive causal influence of social spending on economic growth, yet any claim of a negative historical relationship is easy to doubt." He adds:

I have surveyed the econometric studies available as of a decade ago. None has found a significant negative effect of the whole welfare state package on GDP, at least not any study that has used sound econometric techniques and has made its underlying data available to others. Even the few that announced negative effects but hide their data have failed to show negative effects large enough to imply the major economic damage claimed by some theorists, journalists, and politicians.

And with that, Lindert vigorously advocates for the welfare state. Taxing and transferring income will not, according to him, reduce the standard of living or its rate of growth. He invites us, moreover, to expect these bonuses from the welfare state: less income inequality, reduced poverty, increased longevity, honest government officials, small budget deficits, and even happier people.

He knows that some readers will be skeptical, so he offers justification. Successful welfare states rely on “the broader kinds of taxes that economists consider more efficient.” These include “broad consumption taxes and sin taxes on harmful and addictive products such as tobacco, alcohol, and gasoline.” Bureaucrats that administer successful welfare states spend efficiently too: “Universalist public transfers and services, those to which everybody is entitled, are cheaper to administer because there is less bureaucratic need to investigate who should be excluded from the benefits.”

The efficacy of welfare state spending on health care, “skills accumulation for mothers,” and “social programs for children and those of working age” apparently overcomes any deleterious effect of the welfare state on productive effort. That’s why we don’t observe a negative correlation between welfare spending and GDP. Lindert boldly proclaims, “No welfare state has become poor.” Not even the example of Greece contradicts his findings, according to him, because “Greece has never had a true welfare state and, compared to other rich nations, it does little for the poor.” Yet the author defines a welfare state as “any democratic country for which public social transfers, and the taxes implicitly paying for them, exceed 20 percent of GDP.” The book’s Figure 2.6 shows “public social expenditure as a % of GDP” beyond 20 percent in Greece, which seems to satisfy his definition of a welfare state. The same figure also shows that Greece’s welfare state exhibits “elderly bias,” which may be why Lindert rejects it as “true.” Perhaps we may draw the lesson that the best intentions of a welfare state may be thwarted by special interest groups in the political process.

Size of government / The authors of *How Big Should Our Government Be?* do not only

argue that generous welfare spending is compatible with high standards of living and growth. Bakija, an economist at Williams College, argues at length that government officials can purchase a larger share of all goods and services as well as increase taxes, and there will be no decrease in economic well-being. His first piece of evidence is a graph showing that “across all countries in the world for which data are available, there is a strong *positive* correlation between taxes as a share of GDP and real GDP per person.” He acknowledges that higher real GDP per person might be causing higher taxes as a share of GDP, but he does not concede that this possibility refutes his finding.

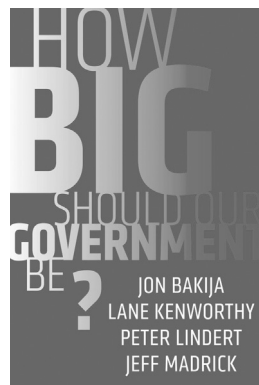
His next piece of evidence is a group of graphs showing the evolution of real GDP per person and the size of government (specifically, government spending as a percentage of GDP) for 12 successful economies over a 100-year period. Each country has a bigger government today than it did about a century ago, and each has a higher standard of living. Bakija emphasizes that “there is no evidence of a slowdown in the long-run economic growth rate in the era of big government.” The case is not closed, however. There is a possibility that bigger government reduces the standard of living without reducing its trend rate of growth. In order to see whether this happens, the author charts the percentage-point change in the ratio of government spending to GDP from 1913 to 2013 ver-

sus the average annual percentage change in real GDP per capita over that period for 13 countries. Even if real GDP grew at the same rate almost every year, say 1.75 percent, occasional decreases in real GDP per person because of bigger government will reduce the average annual growth rate over all the years. Bakija’s figure shows that standards of living evidently did not grow

at slower rates on average as governments grew larger. But the case is still not closed, as he admits: “A potential confounding factor arises because economic theory suggests that countries starting at lower levels of GDP per person might find it easier to grow quickly.” Even when holding constant this effect of “catch-up growth,” there is “no significant association between increase in size of government and economic growth, despite enormous differences in the magnitude of changes in the size of government.”

Econometric methods might clarify our understanding of the relationship between size of government, economic well-being, and the “many other confounding factors.” Bakija reviews the literature. These number-crunching exercises appear thorough and sophisticated. Although econometric studies don’t resolve the debate over what happens in the economy when the government gets larger, they create what the author calls a “common ground.” Some researchers accept Lindert’s point that efficacious government spending is sufficient to counteract the adverse effects of taxes. Some imply that policies consistent with greater economic freedom—such as free trade, low inflation, and the absence of employment protection laws—offset taxes and government spending. Those economists, according to Bakija, “are essentially arguing that the Nordic countries could have even higher economic growth if they maintained all their market-friendly policies but scaled back on their taxes and social welfare policies.” He admits that this view is possible, even “plausible,” but not “convincingly demonstrated.” He suggests that citizens in a democracy might be more willing to accept the uncertainty that accompanies global capitalism if they get a welfare state along with it.

Which programs and taxes? / Given their evidence that bigger government does not reduce economic growth, Kenworthy and Madrick (the former a sociologist and political scientist at the University of Arizona, the latter a senior fellow at the Century Foundation) call for increasing taxes



How Big Should Our Government Be?

**By Jon Bakija,
Lane Kenworthy,
Peter Lindert, and
Jeff Madrick**

**207 pp.; University of
California Press, 2016**

IN REVIEW

and government spending by 10 percentage points of GDP. In general, they recommend spending on “infrastructure, economic security, equality of opportunity, and fairly shared prosperity.” In particular, they propose: “universal health care,” “one-year paid parental leave,” “universal early education,” and 13 more programs. The authors do not itch to regulate every aspect of economic life. “Indeed,” Kenworthy and Madrick grant, “the country would be better off if the degree of government intervention in some areas were to shrink.” The areas they have in mind include patents on pharmaceutical drugs, occupational licenses, and land use.

In order to finance bigger government, Kenworthy and Madrick recommend a federal consumption tax, a higher “effective income tax rate for the top 1 percent of households,” “a carbon tax and a small financial transactions tax,” and a higher “earnings threshold for the payroll tax.” In the chapter he contributed, Bakija “dug a little deeper” into the question of whether higher taxes would diminish the incentive to work. The data show that as the highest marginal income tax rate paid by “people in the top 0.1 percent of the distribution of pre-tax income” fell from 70 percent in 1960 to about 40 percent in 2014, their share of the income zoomed over 200 percent. We may not, Bakija cautions, take this to mean that the supply of labor is sensitive to the tax rate on income, and thereby fear that reduced work effort would result from the authors’ plans to increase taxes.

Bakija presents cross-country evidence over the long run that shows no relationship between reductions in marginal income tax rates and growth rates in real GDP per person. He gives reasons why countries do not experience accelerated growth rates in their standards of living along with lower marginal income tax rates. He wants to shed light on what will happen to the standard of living following an increase in marginal tax rates. “The important point for our purposes,” he summarizes, “is that none of the alternative explanations—rent-seeking,

technological change and globalization, or shifting of reported income between personal and corporate tax bases—implies that increasing tax rates on high-income people involves large costs in terms of economic efficiency.” Expand government, increase taxes to pay for it, and expect, in the authors’ words, a “free lunch.”

If, a century ago, a progressive proposed increasing taxes and government spending from around 10 percent of U.S. GDP to around 40 percent today, an advocate of limited government would have predicted economic stagnation. Such an expansion of government is now historical fact, and today’s advocate of limited government cannot deny that growth has occurred. He might argue that growth could have been brisker, but he probably boasts of the standard of living we have today.

Yet Bakija, Kenworthy, Lindert, and

Madrick face their own paradox. Bigger government is what their intellectual ancestors wanted, and it is what we have today, but the authors still want more government. They thereby admit that today’s size of government is inadequate to maintain infrastructure and solve social problems. How do they know that increasing taxes and spending another 10 percentage points of GDP will upgrade infrastructure and relieve social problems? Would a bigger American welfare state show outcomes similar to Nordic welfare states?

This book will challenge readers wary of big government. Both they and those who embrace big government may look forward to the next round of this debate in the new book by Centre for Policy Studies research fellow Nima Sanandaji, *Debunking Utopia: Exposing the Myth of Nordic Socialism* (WND Books, 2016). R

What You Always Wanted to Know about GDP But Were Afraid to Ask

◆ REVIEW BY PIERRE LEMIEUX

Gross domestic product (GDP) pops up everywhere in the news. Last summer, for example, the news that Ireland’s GDP had increased by 26.3% in 2005 (compared to 8.5% the previous year) had people scratching their heads. The Sept. 3, 2016 issue of *The Economist* raised the perennial question of whether GDP figures released by the Chinese government are reliable. Then Japan began revamping its GDP calculations after some contradictions appeared in official statistics. This is not counting the routine articles that follow the quarterly release of estimates and the monthly revisions by the Bureau of Economic Analysis (BEA), the federal agency that calculates U.S. GDP and other numbers contained in the National Income and Product Accounts (NIPA).

PIERRE LEMIEUX is an economist affiliated with the Department of Management Sciences of the Université du Québec en Outaouais. His latest book is *Who Needs Jobs? Spreading Poverty or Increasing Welfare* (Palgrave Macmillan, 2014).

GDP is a complicated concept that raises many issues. Understanding them requires a good grasp of the concept of GDP, its methodology, and the economic theory behind it. As an illustration of these treacherous grounds, the Irish GDP increased so much in 2005 because the “domestic” in “gross domestic products” refers to the residents (including corporate entities) of the territory over which it is measured. In 2005, several multinational corporations relocated to Ireland to avoid higher taxes elsewhere, giving the Emerald Isle an enormous one-year GDP boost.

There is much to learn in order to understand the use and misuse of GDP. Princeton University Press's recent release of two books on GDP gives us an opportunity to do this. Let's start with some basics, and then take a look at the books.

Oranges, apples and happiness

What is GDP? It is defined as the market value of final goods and services produced in a given country (or other area) during a given period of time. GDP is intended to measure an economy's production. It incorporates only the production of final goods, which will not be further transformed during the period under consideration (usually one year). Intermediate goods—goods that are to be inputs for other goods—are excluded in order to avoid double-counting. For example, only the value of a finished loaf of bread is counted; adding the value of the flour that went into the bread would be double-counting since it is already accounted for in the price of the bread.

Soviet planners, who did not want to consider prices because they smacked of capitalism, aimed at measuring all production in physical volume. One drawback is that, with this method, they could not produce a single number that measured the production of their economy; they only had the amounts of apples, oranges, or tanks produced. They did not accept the concept of GDP. But then, without market prices, it is unclear how Soviet planners could have meaningfully calculated GDP.

Prices determined on free markets and used to calculate the value of GDP are not arbitrary. The free-market price of a

good equals the marginal utility of that good—all consumers will buy additional units up to the point where the utility of the last unit is equal to its price. (Think of “utility” as satisfaction or happiness, although the technical concept is more complicated. See “John Hicks and the Beauty of Logic,” Winter 2014–2015.) GDP thus sums up production as valued by the consumers themselves in their quest to maximize their utility. GDP is a measure of economic efficiency.

One must tread very carefully here. Saying that the free-market prices used to compute GDP represent the value that consumers attach to the last units consumed of all goods does not mean that GDP measures the total utility of consumers, called “social welfare.” A person gets more utility from what he consumes than what he pays for it; economists call this “consumer surplus.” So GDP is worth more than its money value.

Another reason why GDP does not measure social welfare is that utility can be distributed differently among individuals and inter-individual comparisons of utility are scientifically impossible. In a 1950 paper, “Evaluation of Real National Income,” the future Nobel economics prizewinner Paul Samuelson provided definitive proof that GDP computed from

prices and quantities cannot measure social welfare.

There are three equivalent ways to calculate GDP. On the *expenditure side*, it can be calculated as the sum of final expenditures by consumers, governments, businesses purchasing equipment, and foreign importers. Equivalently, it can be calcu-

lated as the sum of values added in all industries: this is the *value-added side* of the ledger. Finally, it can be calculated as the sum of incomes received—the *income side*. We thus have a triple-entry accounting system that makes it difficult to falsify GDP figures. Production must generate incomes that serve to purchase everything. (What is not purchased is held in inventories, which are defined as a sort of investment alongside machines, equipment, and buildings.)

AN AFFECTIONATE VIEW

GDP: A Brief but Affectionate History is a short book by Diane Coyle, an economist, professor at the University of Manchester (United Kingdom), and former adviser to the UK Treasury. The book explains the basic concepts and statistics behind GDP while reviewing its intellectual history. Three economists who worked on GDP-related concepts ultimately earned Nobel economics prizes: Richard Stone (1913–1991), Simon Kuznets (1901–1995), and Wassily Leontief (1906–1999), but there were many other precursors. Coyle's book also broadly traces the history of economic growth, which is measured by GDP per capita. The book constitutes a defense of GDP, affectionate perhaps but very critical at times.

Coyle notes that “very few people ... truly understand how the regularly published GDP figures are constructed.” She adds, “This excludes many of the economists who comment on GDP,” but I suspect this is a typo: she must have meant to include many economic commentators in her blame. Both conceptually and statistically, GDP relies on a vast set of assumptions. Coyle explains many issues in GDP accounting and data collection, from “chained” GDP to purchasing power parities and hedonic prices.

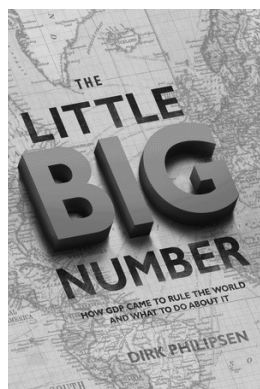
She also reviews many limitations of GDP. Because of data collection problems, GDP excludes the underground economy (drugs, prostitution, illegal labor, and such). This is beginning to change, however; European Union governments have recently started to incorporate estimates of their underground economy. Another



GDP: A Brief but Affectionate History

By Diane Coyle

186 pp.; Princeton University Press, 2014



The Little Big Number: How GDP Came to Rule the World and What to Do about It

By Dirk Philippsen

416 pp.; Princeton University Press, 2015

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limitation: GDP excludes non-market production such as household work (cooking, taking care of children, gardening, etc.).

Coyle notes that GDP does not measure welfare or happiness, but at times she seems to forget it. She does note that several other indexes that attempt to do this, such as the Human Development Index, are strongly correlated with GDP. Money does not bring happiness, but it seems to help.

Some of Coyle's criticisms of GDP are not as convincing as others. For example, she claims that new digital services with zero price—think Google search—drive a growing “wedge between what GDP measures and aggregate economic welfare.” I am not sure this claim is correct, and not only because GDP does not measure welfare. Goods that are zero-priced for consumers do carry a positive price for others—advertisers in the case of Google. They generate new incomes and new value added. The advertisers make a profit and help Google make one. In the accounting logic of GDP, nothing seems to be lost.

Coyle criticizes the special and convoluted treatment of the financial sector in GDP. I am not totally sure she is right in her criticism of how the contribution of finance is calculated. She certainly is wrong when she questions “whether finance should be included in GDP at all.” If a market good or service is demanded by some consumers, it should be included in GDP. Except for extreme cases (like, say, murder contracts), GDP is not a moral concept. Or, at least, we try to keep it from becoming so.

Environment / Environmentalists have argued, and Coyle seems to agree, that depletion of natural resources or natural capital should be deducted from GDP, just as depreciation of physical capital is deducted to give Net Domestic Product (NDP). This environmentalist idea is not as useful as it may first appear. As suggested by Kuznets in 1973, the volume of resources available depends on human knowledge and technology, which influence efficiency in the use of those

resources. Since the production of this sort of knowledge is not incorporated in GDP, why and how should natural capital and its depreciation be calculated?

We can go a bit further with a normative argument. The moral desirability of deducting depreciation of natural capital from GDP assumes that future generations—which, except for government follies, should be wealthier and healthier than we are—have a claim on today's resources. Will they not be at least as altruistic as we are and wish we had enjoyed the best possible life? Or else, what monsters are we breeding?

From a positive (as opposed to normative) viewpoint, the pro-depreciation argument assumes that environmental and governmental apparatchiks are the best candidates to exercise the claims of future generations (who don't often demonstrate or riot in favor of social justice and against globalization). Why shouldn't decisions about the use of current natural resources be left to their private owners, who may have children or grandchildren to whom they would want to leave *their* resources?

Private property rights on natural resources partly solve the depletion and depreciation issue. The owner of an oil-rich piece of land decides whether the rent he would get is worth depleting his resource as opposed to leaving it to his children or, indirectly, to the children of a potential buyer bidding up the land price. This way, the optimal time path of depletion is, at least partly, reflected in GDP.

It is true that not all resources can be easily privatized and priced on markets—pure air or perhaps glaciers potentially affected by global warming are examples. But the first solution should be to try and better define and enforce private property rights. Shadow pricing of resources should only be resorted to when a Coasian solution does not work. (On Ronald Coase's theory, see “The Power of Exchange,” Winter 2013–2014.)

Coyle explains how GDP and NIPA as we know them were offspring of the Great Depression and WWII. In both cases, governments needed to measure the economy

in order to better control it. Keynesian macroeconomics soon provided a theoretical framework to justify government expenditures: “*By design*,” writes Coyle (the emphasis is hers), “GDP would increase when those policy levers were operated, at least in the short run.”

Government services / One major flaw of GDP relates to the treatment of government services. What is the value of these services, which are not priced on the market? In the early 1940s, it was decided to include in GDP all government expenditures on goods and services (including labor services, but excluding pure money transfers like, say, Social Security), as if government services were pure “profit” or value added. In other words, government services are valued at cost, contrary to ordinary services.

It is difficult to value something that is not sold on markets, but the main reason for overstating so blatantly government's contribution to GDP was to valorize war expenditures and hide how they reduced consumption expenditures. Many economists involved in the development of GDP, including Kuznets himself, disagreed with this government decision. Coyle makes it clear that GDP and the NIPA as we know them were developed mainly as a tool for government.

I have other quibbles with Coyle's book and I am not the only one (see the long and instructive review of the book by Moshe Syrquin in the *Journal of Economic Literature*). For example, I don't know how she can blame deregulation and “the creation of toxic financial instruments that multiplied and focused risk” for the Great Recession without mentioning that mortgage-backed securities were created by a federal housing agency, Ginnie Mae. Coyle often seems to show as much affection for government as for GDP. Yet, her book remains a useful introduction to the meaning and limitations of GDP.

TOTALITARIAN GDP

Dirk Philipsen's *The Little Big Number* is a very different animal. Despite lengthy

endnotes, this book looks more like the work of a political pamphleteer. The author, an economic historian at Duke University, argues that GDP is a dangerous number that forces an inappropriate focus on economic growth, wasteful material goods, and unsustainable capitalism.

Against what he sees as a sort of GDP totalitarianism, the author longs for a new economy based on “belonging” and “tight-knit communities that integrate all aspects of life” and would lead to “rising access to fertile land for purposes of physical and social nourishment,” whatever that last bit means. Many of his pronouncements are more clichés or incantations than economic arguments: “people and nature are increasingly reduced to commodities” and we need to contribute “to a larger social whole,” etc.

Economics? / The reader may sometimes question Philipsen’s understanding of economics, let alone GDP. The author of *The Little Big Number* does not seem to grasp the nature of value and the function of prices. He argues that there is no relation between price and value. “Few people,” Philipsen writes, “would have to think long when faced with a choice between either \$10 million in cash or, say, oxygen. Which would they value more?” He is puzzled by the low price of oxygen.

He seems unaware that Adam Smith raised this very problem in *The Wealth of Nations*, using water and diamonds instead of oxygen and cash. Economists have referred to this problem as the “water-diamond paradox,” and its solution was completed with the theory of marginal utility in the late 19th century. The solution is that, for a normal individual, the total utility of water is higher than the total utility of diamonds, but the marginal utility of diamonds, which are relatively scarce, is higher than the marginal utility of water, which is in large supply. An individual would prefer no diamond to no water but he would rather have another diamond than another glass of water.

The author of *The Little Big Number* apparently does not understand the func-

tion of property rights. He sees externalities everywhere and constantly calls on government, which is both a knight in shining armor and a black box, to legislate and regulate. He cites Coase twice in footnotes, apparently and strangely invoking him against GDP.

Under Philipsen’s pen, finance is a dirty word and a fuzzy concept. It is used as a synonym sometimes of money, sometimes of physical capital. Another time, “financialized” is identified with “given a price.” He does not seem to understand that financial assets are claims on physical capital and that it is normal that capital exceed annual GDP, just as a machine is worth more than the profits it generates in one year.

Philipsen argues that society and the economy must be reinvented according to “intelligent political design.” He does not explain how such constructivism works. He does not cite Friedrich Hayek even once.

Understanding GDP / It is not obvious that Philipsen understands what GDP is. For example, he claims that “modern governments ... generate almost half of GDP.” This is not correct. Although public expenditures *including transfers* are often close to and sometimes above 50% of GDP, government production (strangely measured by its purchases, as we saw) is around 45% of public expenditures. In the United States, where total government expenditures represent about 40% of GDP, government thus “generates” slightly more than 20% of GDP.

Philipsen also falls prey to Frédéric Bastiat’s broken-window fallacy: he sees “robust GDP growth in the wake of disasters.” This makes sense only if there was Keynesian unemployment when the catastrophe hit; otherwise, resources for repairs and reconstruction are just diverted from what they would otherwise have produced. The accounting of GDP is consistent with this criticism of the broken window fallacy.

Some statistics reported in the book are questionable or unfindable. Some statements are at best metaphorical. For an

example of the latter, we read in *The Little Big Number* that “humans are the only species that tolerates in its midst things like poverty and unemployment, despite an overabundance of wealth.” I am not sure that all chimpanzees have access to the best food (and all males to the best females) and are employed full-time at twice the primates’ minimum wage.

Petersen constantly attacks the “one percent”—the top percentile of income earners—and suggests that income equality is unacceptable both in the United States and in the world. But if inequality is unacceptable in the world, most Americans are on the wrong side of “social justice.” According to humanprogress.org (a project of the Cato Institute, publisher of *Regulation*), any American with a net income of more than \$32,400 is among the top 1% of incomes in the world. Some back-of-envelope calculations with tax statistics suggest that four in 10 American taxpayers are among these. Similarly, a person receiving only the basic income entitlement that Philipsen proposes (\$15,000 per year) would rank among the top 10% of income earners on the planet.

Anti-GDP elitism / What Philipsen fundamentally does not like about GDP is that the measure represents, however imperfectly, what consumers want. The preferences of most consumers do not correspond to *his own* preferences. He does not seem to like tobacco, fast food, guns, bottled water, “a sedentary life on stuffy couches,” Walmart, Facebook, or cars. He likes what the intelligentsia like, such as education, walks in the woods, beautiful bathrooms, tasty food, poetry, and “tight-knit communities” (although, as a practical matter of revealed preferences, intelligentsia denizens often live in cosmopolitan environments).

Philipsen proposes to redefine the economy around his own preferences, with the possible help of “several international leaders of either the caliber or political understanding of ... Elizabeth Warren.” But “another scenario,” he tells us, could give the job to “enlightened bureaucrats

IN REVIEW

and academic elites.” I suspect he is not opposed to his “reconstituted political and legal enforcement agencies” having guns to enforce his preferences.

Philipsen would protest that it is not what he likes that must be produced, but what “we, as a society” want. He does not understand that individual preferences cannot easily (if at all) be aggregated into social preferences and expressed as collective choices. He believes in methodologi-

cal unicorns like the “satisfaction of the social body.”

He does not see that no “democratic dialogue” or “public conversation” can lead to unanimity, except perhaps at the level of an abstract constitutional contract à la James Buchanan. (Philipsen does not mention Buchanan’s work.) He does not understand Hayek’s point that each individual has his own goals and that a free society cannot impose a single goal on everyone.

Collective choices—“an economy that works for what we want”—imply that some will impose their views and lifestyles on others. To paraphrase H.L. Mencken, Philipsen’s proposed political system is one in which common people don’t know what they want and will get it good and hard.

If you do read this book, which will be released in paperback this spring, it may actually make you fall in love with GDP. It is an imperfect measure for sure, but one

A Glaring Misuse of GDP

Among the many forms of GDP misuse, one is obvious, frequent, and dazzling. It stems from an interpretation error that officials of national statistical bureaus readily recognize but apparently do not care to correct. (See “Are Imports a Drag on the Economy?” Fall 2015.)

One of the main accounting identities of NIPA states that GDP is equal to the sum of consumption, investment, government expenditures (excluding transfers), and exports. In other words, it is the sum of domestic production flows to domestic consumers, domestic purchasers of investment goods, domestic governments, and foreign importers. In still other words, the production side of GDP is equal to its expenditure side: everything that is produced is purchased.

This is an accounting identity, which means that it is true by definition and cannot be false. It is necessarily true because anything produced that is not purchased by domestic consumers, businesses, governments, and foreign importers will pile up in inventories, which is a form of (unintentional) business investment. Investment is *defined* as including (besides fixed capital) whatever remains after intentional purchases. This is how accounting identities are necessarily true in the real world: some residual adjusts as a matter of definition.

We could write our accounting identity as:

$$\text{GDP} = \text{consumer expenditures} + \text{business investment} + \text{government expenditures} + \text{exports}$$

provided that we took consumer expenditures, business investment, and government expenditures as including only goods and services *produced domestically*. As its name indicates, gross domestic product is made of domestic production only.

In the statistics that are actually collected, however, consumer expenditures (normally represented by C), business investment (I), and government expenditures (G) include some imported goods and services. The Chinese-made fishing rod you bought at Walmart was captured in C ; the printing press a newspaper company bought from Germany was

part of I ; and the salary of the foreign consultant hired by the government was included in G . Consequently, it would not be correct to write our accounting identity as $\text{GDP} = C + I + G + X$ (where X represent exports), because imports are captured in the right side of the equation and should not be included.

To solve this statistical problem, the accounting identity is written as:

$$\text{GDP} = C + I + G + X - M$$

The term $-M$ cancels the imports that are hidden in C , I , and G , as any good macroeconomics textbook explains.

If one did not have a good textbook in his introductory macroeconomics class or never took such a class, being misled is easy. The problem is compounded by the fact that $X - M$ is often grouped inside parentheses so that the accounting identity is remembered as:

$$\text{GDP} = C + I + G + (X - M)$$

For the non-expert, the last equation can easily suggest that $(X - M)$ is the balance of trade. This interpretation error is further encouraged by experts who call $(X - M)$ “net exports.” To repeat, it is only “net exports” if you forget that $-M$ is used only to cancel the imports that, in the process of data collection, were included in C , I , and G . In other words, the term $-M$ is a statistical trick.

Imports are *not* deducted from GDP. They cannot reduce the statistical measure of GDP because, by definition, they are not part it.

In its press releases, the BEA continues to write that imports “are a subtraction in the calculation of GDP” (see, for example, its release of August 26, 2016). This is not wrong when you know, as BEA economists do, that imports are subtracted after being added; but it is highly misleading. The typical journalist concludes that imports reduce GDP and transmits this impression to his readers, fueling protectionist sentiments.

that is not based on the personal preferences of ivory-tower elitists. “No growth,” notes Coyle in her book, “is for the rich.”

MIXED BAG

Technically, as Samuelson demonstrated, more GDP is neither a sufficient nor a necessary condition for increased welfare. Economist Robert Higgs counters that “if GDP is to make any sense at all, it *must* do so in relation to some concept of economic welfare” (emphasis in original). Otherwise, why would we be interested in such a figure? But, Higgs argues, it is an “exceedingly poor” measure of welfare. However, it seems to me, a poor measure is not always useless. GDP statistics can sometimes provide useful information. For example, observing a large increase in GDP per capita over a long period of time, or a much higher GDP per capita in one country than in another, helps document the likelihood that welfare is higher for most people.

A related criticism is that GDP is mainly, in practice, a tool for state dirigisme. It is bound to be misused (see sidebar). This is a serious problem, and our evaluation of GDP (and other NIPA statistics) must be mixed. GDP is not useless, but it must be used with caution.

With a view to the long term, we may ask if it should be government that produces these statistics. Why not leave them to academic research groups such as the National Bureau of Economic Research (which was a pioneer in the field)? The advance of Big Data could lead to competing estimates from various private institutes. Already, ADP Research Institute and Moody’s Analytics, two private organizations, jointly produce monthly employment statistics based on payroll data collected by ADP, a payroll services company. The problem with the Japanese GDP figures, which I mentioned in the introduction, appears to stem partly from fewer people answering government surveys and censuses (*Financial*

Times, September 29, 2016), a problem that Big Data analysis could potentially solve.

In the shorter term, we should try to minimize the dangers of GDP in at least two ways. First, we should push for a methodological rethink of the contribution of government to GDP. Second, we should insist that official statistical agencies do not use GDP figures to mislead journalists and the general public. R

READINGS

- “A Review Essay on GDP: A Brief but Affectionate History” by Diane Coyle,” by Moshe Syrquin. *Journal of Economic Literature*, Vol. 54, No. 2 (2016).
- “Evaluation of Real National Income,” by Paul A. Samuelson. *Oxford Economic Papers*, January 1950.
- “Gross Domestic Product: An Index of Economic Welfare or a Meaningless Metric?” by Robert Higgs. *Independent Review*, Vol 20, No. 1 (Summer 2015).
- *Measuring the Economy: A Primer on GDP and the National Income and Product Accounts*, published by the Bureau of Economic Analysis. September 2007.
- “U.S. National Income and Product Accounting: Basic Definitions and Concepts,” by Liegh Tesfatsion. Iowa State University, undated.

Working Papers ➡ BY PETER VAN DOREN

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

Effects of Student Loans on Tuition and Enrollment

“The Incidence of Student Loan Subsidies,” by Mahyar Kargar and William Mann. July 2016. SSRN #2814842.

In the Summer 2016 issue, Robert Archibald and David Feldman examined the effect of federal student loan programs on the behavior of university “list” tuition and financial aid. They argued that at most nonprofit universities, the (presumably wealthy) marginal student’s willingness to pay list tuition is not affected by financial aid. But universities may “tax” federal financial aid by reducing their own financial aid offered to students.

Mahyar Kargar and William Mann examined a different federal loan program in a setting in which the marginal student’s ability to pay was affected and hence tuition effects are likely to be observed. Parent Loans for Undergraduate Students (PLUS) are unlimited up to the cost of attendance. Some 13% of parents of fulltime undergrads have PLUS loans, averaging \$13,000 per year.

Prior to 2010, PLUS loans were available under two federal loan programs: the Federal Family Education Loan program (FFEL)

and the Direct Loan (DL) program. In 2010 the two programs merged. As a result, credit history rules that had applied only to PLUS loans under FFEL were applied to *all* PLUS loans. The net effect of this rule change was to increase PLUS loan denials. Prior to the change, PLUS loan denials were 42% under FFEL but only 21% under DL.

The authors examine the effect of this unexpected reduction in credit availability on tuition at schools in which the marginal student’s decision to enroll is most likely to be affected by this reduction in credit availability: schools with more credit-constrained low-income students and more use of PLUS loans. They construct two variables: the percentage of students who use PLUS loans and the percentage of financial aid students whose family income is \$30,000 or less. They take the product of these two variables and divide schools into two groups based on above (treated) and below (untreated) median values of this variable.

Undergraduate charges for the two groups of schools grew at a similar rate prior to 2011. But after 2011, tuition charges grew more slowly for the “treated” group of schools. Enrollment also dropped in the treated schools. Treated schools experienced a 5% tuition decrease and 2.5% enrollment decrease. The authors conclude that a grant equal to 10% of tuition would expand enrollment by 10% and tuition by 7.5% at schools in the treated group.

Corporate Accounting

"Estimating the Compliance Costs of Securities Regulation: A Bunching Analysis of Sarbanes-Oxley Section 404(b)," by Dhammika Dharmapala. July 2016. SSRN #2817151.

The Sarbanes-Oxley Act of 2002 (SOX) was enacted after the bankruptcies and subsequent findings of questionable accounting practices at Enron and WorldCom. Academic criticism of SOX was fairly intense in the years immediately after its enactment. Yale law professor Roberta Romano deemed the law "Quack Corporate Governance," to quote the title of her article that appeared in this journal (Winter 2005-2006). But in a paper evaluating the first 10 years of the SOX regime, Harvard law professor John Coates concluded that SOX's costs and benefits are roughly equal or net positive (Working Papers, Spring 2014).

Dhammika Dharmapala uses a different method to evaluate the net costs and benefits of SOX: examining the distribution of firms that are near an important legal threshold requiring SOX compliance. Most significant provisions of SOX apply to firms that have a "public float" (market value of shares held by others than firm insiders) of \$75 million or more. The author collects public float information for firms from 1993 to 2015, allowing for many years of data before and after SOX. Given the legal threshold of \$75 million, the author asks whether there is evidence of "bunching" of firms just above or below that threshold. Bunching above would be evidence of net benefits of SOX, while bunching below would be evidence of net costs.

In the pre-SOX period (1993-2002) there is no evidence of bunching. The frequency distribution of public float data shows no discontinuities around \$75 million. But in the years 2003-2015, following the enactment of SOX, there were 257 more firm-years below the \$75 million threshold than would be expected. And those firms reduced their public float by \$1.7 million on average. Using the average relationship between public float and market capitalization, the market value reduction implied by a \$1.7 million reduction in public float is about \$6 million dollars or 4-5% of the typical firm near the threshold. Thus, small firms facing the prospect of SOX compliance forgo \$6 million to avoid SOX regulation.

Patent Trolls

"Patent Trolls: Evidence from Targeted Firms," by Lauren Cohen, Umit G. Gurun, and Scott Duke Kominers. August 2016. SSRN #2464303.

Non-practicing entities (NPEs) are firms whose sole assets are intellectual property rights that they have purchased rather than developed themselves. Such firms' main activity is suing other companies for patent infringement. They have been criticized (see "The Private and Social Costs of Patent Trolls," Winter 2011-2012, and Working Papers columns in Fall

and Winter 2013) as well as defended (see "The \$83 Billion Patent Litigation Fallacy," Spring 2016) in *Regulation*.

The current paper is a comprehensive analysis of all NPE lawsuits (21,300) from 2005 through 2015. NPEs appear to behave opportunistically. NPEs disproportionately sue cash-rich firms. A one-standard deviation increase in cash holdings results in an increase in the probability of being sued from 8.6% for the average firm to 16% for the firm with more cash.

NPEs even sue cash-rich firms whose cash isn't from the business segments that allegedly engaged in infringing. In contrast, practicing entity firms, which develop intellectual property and then manufacture products based on that knowledge, do not disproportionately sue cash-rich firms. Nor, for that matter, do small inventors.

NPEs also forum-shop, looking for courtrooms where their suits are more likely to succeed. NPEs litigate 43% of their cases in the Eastern District of Texas, which is considered "friendly" to such cases. Only 7% of the cases brought by PEs are litigated in East Texas.

"While none of our results alone proves opportunistic legal behavior (patent trolling) on the part of NPEs, the mass of the evidence to this point appears most consistent with NPEs behaving as patent trolls," write the authors.

NPE suits have consequences for spending on research and development. After NPE settlement, defendant firms reduce R&D investment by more than 25%. Small inventors, the alleged beneficiaries of NPEs, do not appear to be getting much of the settlements nor increasing invention activity.

Minimum Wages

"Minimum Wage and Real Wage Inequality: Evidence from Pass-Through to Retail Prices," by Justin Leung. September 2016. SSRN #2786411.

Economic analyses of the minimum wage often focus on the negative employment effects for low-skilled, young workers. Using scanner data from 35,000 retail stores in the United States, this paper asks whether minimum wage increases result in increased prices for some products.

The author concludes that a 10% increase in the minimum wage raises retail prices at grocery stores in poor counties (defined as those with ratios of minimum wage to average wage [the Kaitz index] above the median for the country) by 0.7%. When counties are divided into quartiles according to the Kaitz index, the poorer the county the larger the pass-through effect on prices.

This result is not simply because of an increase in labor costs at grocery stores in poor counties. The percentage of minimum wage workers in grocery stores in poor counties is not higher relative to rich counties. And the quantities purchased in grocery stores increase rather than decrease when the minimum wage is increased consistent with the minimum wage augmenting demand.

A 10% increase in the minimum wage results in a wage increase for workers in the 10th percentile of the wage distribution of about

1.6% relative to the median wage. But price increases in food stores reduce this increase by about 0.3–0.6% in poor counties.

Congressional Regulatory Mandates

“Preventing a Regulatory Train Wreck: Mandated Regulation and the Cautionary Tale of Positive Train Control,” by Jerry Ellig and Michael Horney. August 2016. SSRN #2821113.

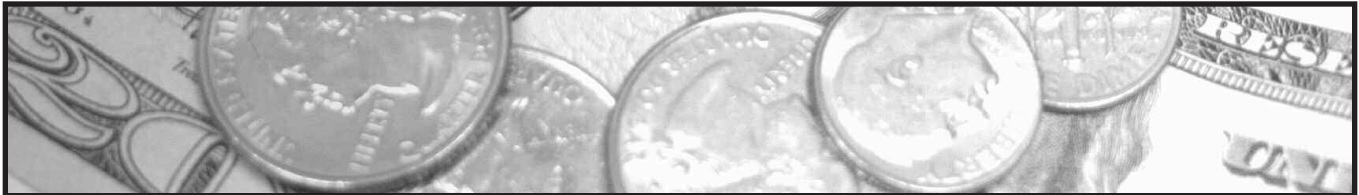
Regulatory agencies are often blamed for imposing costs on the economy that result in few if any benefits. But much of the blame should be directed at Congress. According to Jerry Ellig of the Mercatus Center, 49% of the economically significant regulations (costs exceeding \$100 million) proposed from 2008 through 2013 were required by law. That is, Congress specifically instructed agencies or departments to issue the rule. The executive order that requires review of economically significant regulations to determine whether they create benefits that exceed costs has little effect in such situations because the executive branch does not have discretion over whether to implement congressionally mandated regulations.

In 2008 Congress enacted legislation requiring the National Highway Traffic Safety Administration to issue a rule by 2011 to

enhance rear view visibility for drivers. NHTSA did not issue the rule until 2014. Normally, such a delay would be an example of bureaucratic ineptitude and waste. But in this case, NHTSA was responding to its own analysis that determined that driver error is the major determinant of the effectiveness of backup assist technologies such as cameras. In addition, NHTSA concluded that the cost per life saved for the cameras ranged from about 1.5 to three times the \$6.1 million value of a statistical life used by the Department of Transportation to evaluate the cost effectiveness of its regulations. Given those poor cost-benefit results, NHTSA delayed until the possibility of intervention by the courts forced it to issue the rule.

This paper examines another such rule, the requirement that railroads install automated positive train control to prevent train collisions and derailments. Health and safety regulations are often enacted after scandals or disasters, and this example follows that pattern. Congress required positive train control in October 2008 after a September 2008 commuter train crash in California killed 25 people.

The Federal Railroad Administration had conducted cost-benefit analyses of positive train control in 1994 and 2004. The estimated 20-year costs were \$10–\$13 billion while the safety benefits from lives saved and damages prevented were only \$440–\$670 million. The railroads balked at the cost and Congress punted, extending the compliance deadline from the end of 2015 to the end of 2018. R



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