

IN REVIEW

Sowell's Greatest Hits, Remixed

◆ REVIEW BY ART CARDEN

I have never regretted reading a book by the economist Thomas Sowell, a longtime fellow at the Hoover Institution and a syndicated columnist. He is one of the best writers and most incisive thinkers alive today: he has an admirable ability to weigh claims against evidence, and he is unafraid to question the accepted stories when they are inconsistent with the evidence. He can also turn a phrase and combine clarity and profundity like no one else. He is a joy to read, and one of the great communicators of our time. An opportunity to read Sowell is an opportunity to think hard about complicated and sometimes uncomfortable issues.

In his latest book, *Wealth, Poverty, and Politics*, Sowell summarizes theory and evidence on the geographic, cultural, and political factors that explain differences between the well-being of groups of people. It would, he argues, be quite a coincidence if spectacularly diverse geography, cultures, social conditions, and political institutions produced the same outcomes for everyone.

As in his earlier work, Sowell questions the popular but wrong assumption that differences between groups and individuals are prima facie evidence of malfeasance past or present. Just because this group or that represents x percent of the overall population but y percent of some subpopulation of interest does not mean something sinister is going on. Again, as Sowell notes, it would be surprising if long histories of varied experience across time and space produced such a pattern.

Much of what he brings to bear on the issue will be familiar to those who are already acquainted with his work. I found a lot of similarities between this book and his 2013 *Intellectuals and Race*, which I recently re-read in light of the unrest and activism at the University of Missouri, Yale

University, Claremont-McKenna College, and other institutions. Sowell's latest book reads like he took some of his greatest hits and remixed them for a new project. It is, if nothing else, comfort food for those of us who have read and learned from his earlier work and a revelation for those who have not—particularly those who adhere to the vision he has criticized so eloquently and thoroughly in his other work. (See his 2007 *A Conflict of Visions* for the clearest example.)

One of his strengths is that he tests domestic hypotheses against international evidence, as he did in his 2004 book *Affirmative Action around the World*. He shows that group differences in the United States are not so readily explained by uniquely American factors: differences between American blacks and American whites track closely with differences between urban American whites and Appalachian American whites and differences between upper- and lower-class whites in England. All around, he questions the “legacy of slavery” argument for things like labor force participation and the disintegration of the black family by pointing out that black families were stronger in the early 20th century even in the face of far more insidious and overt discrimination and oppression. Furthermore, black labor force participation was

higher than white labor force participation within a short time after Emancipation. As he points out, if many of the pathologies we associate with black poverty (like broken families) are the “legacy of slavery,” then that legacy appears to have skipped a few generations.

Geography and resources / Sowell discusses the importance of geography in the determination of historical patterns, and in the process makes an important point about local knowledge. Data on “navigable waterways,” for example, can be misleading if they are measuring (say) miles of river rather than continuous miles of deep river. A river with a lot of shallow spots is not nearly as useful for trade and transportation as a river that is consistently deep: a river with an average depth of 16 feet is less useful if it is only 2 feet deep at its shallowest point, as compared to a river that is 12 feet deep consistently.

This is not geographic determinism. Rather, it is the sensible point that the patterns we observe are influenced by access to trade, fertile soil, and so on. At the same time, he points out that “resources” are context-dependent. Gold, petroleum, aluminum, and other things only become resources when we determine how to use them to solve problems. Petroleum in the Middle East, coal in England and the United States, and vast deposits

of iron, copper, and other minerals were not resources to those who didn't find ways to use them. He notes, for example, that the former Soviet Union provides perhaps the definitive refutation of the idea that natural resources automatically lead to wealth, pointing out that perhaps nowhere else on earth was so blessed with minerals, petroleum, and fertile farmland—all of which were largely wasted.

Blocking movement / Sowell's discussion of

WEALTH, POVERTY
AND POLITICS

An International Perspective

THOMAS SOWELL

**Wealth, Poverty, and
Politics: An International
Perspective****By Thomas Sowell
336 pp.; Basic Books,
2015**

geography is interesting on many levels. It explains why some civilizations developed the way they did, but it doesn't explain why we have persistent poverty around the world given the low cost of moving people around. As William Easterly and other economists have argued, by treating a country or tribe as the unit of analysis, we ignore the fact that one of the simplest ways people can make themselves richer is by moving. Enduring patterns of poverty, therefore, are in part the result of immigration policy that locks so many poor people out of wealthy countries with market-friendly institutions.

The reader is treated to a wide-ranging discussion of the histories of different ethnic groups in the United States and beyond. Sowell describes the experiences of Jews in the early 20th century garment industry, Cuban immigrants who arrived here with nothing, and Fujianese Chinese who worked long hours washing dishes, clearing tables, and cleaning hotel rooms. Those people nonetheless succeeded in spite of formidable obstacles. Indeed, this success is the story of immigrant Chinese virtually everywhere: they arrive, they are oppressed, and yet they thrive. This is particularly interesting given that China went from being a global economic leader to being a global laggard by cutting itself off from the rest of the world a few centuries ago.

Again, there is much in this part of the book that longtime readers of Sowell will find very familiar. He marshals evidence on African-American achievement—such as historic enrollment at New York's Stuyvesant High School or the success of the District of Columbia's Dunbar High School, along with data on marriage rates, single parenthood, crime, and so on—to show that many of the problems we see among African-Americans today are reversals of historical trends. Black quality of life was improving until the United States expanded the welfare state and replaced racial oppression with racial preferences. Then advancement started to slow and in some cases regressed. He argues that even the reductions in poverty since the rise of the Great Society programs of the 1960s

are really just a slowing of an earlier, more vigorous trend.

There is one explanatory variable that, I think, is missing from Sowell's analysis: the "war on drugs." It began in earnest in the early 1970s and it has had a disproportionate effect on black communities. He is correct to point out that minimum wages reduced employment among African-American youths, and welfare programs with very high marginal tax rates discouraged work. But when these policies (and the accompanying sense of hopelessness they inevitably produce) are combined with ever more potent drugs and the profitability of crime as an unintended consequence of current drug policies, the result is a perfect recipe for the disintegration

of the black community. Future work on these issues will, I hope, explore the role of the drug war in explaining the patterns Sowell identifies on both sides of the Atlantic, as well as the "coming apart" of white America described by Charles Murray.

Sowell is at his best when he reminds us of what we're really seeking to explain. As he writes: "Poverty occurs automatically. It is wealth that must be produced, and must be explained." We ask why some people are poor and some nations fail; the more important question is why some people become rich. As he argues here and throughout his work, it isn't because of plunder, but because of a combination of cultural and political institutions that encourage production rather than predation. R

The Valium of the People

◆ REVIEW BY PIERRE LEMIEUX

Read James Buchanan and you are likely to move away from anarchism. Read political philosopher Anthony de Jasay—especially his latest book, *Social Justice and the Indian Rope Trick*—and you'll likely drift back.

A collection of published and original articles, the book contains many repetitions, which often help comprehension but sometimes in a disorderly way. If we were to construct a linear argument from the book, it might go this way: Equality and social justice as ideals are at best meaningless. Conventions provide the best solution to the problems of social cooperation, and embody the presumption of liberty. This presumption is opposed to "rightsism," the modern notion that individual rights must be explicitly delineated. A consensual social contract does not explain anything and is not required for the production of public goods. In reality, the state naturally maximizes its power and individuals will surrender to it, often inadvertently.

Like de Jasay's other works, this book is

challenging for the conservative, the classical liberal, and the libertarian alike.

Equality and "social justice" / De Jasay notes that "equality" cannot be a criterion of distribution because its value is not self-evident: "'Equal' is not self-evidently superior to 'unequal' the way 'good' is superior to 'bad' or 'ample' is to 'scarce,'" he writes. Simple equality, according to which two individuals are equal along some dimension, implies that they are not equal along other dimensions: "To each according to his work," say, means that individuals are not equal according to the size of their families, their needs, their merit, etc.

"Fairness" is an empty concept too. An extraordinary observation of de Jasay is that a word for this concept "exists only in English and has not even remote foreign equivalents." In French, for example, there

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is just one word, *juste*, for both “just” and “fair.” In sum, “fair” does not mean much more than “nice.”

To justify egalitarianism, utilitarianism will not work either. It relies on gratuitous assumptions like interpersonal utility comparisons, which are nothing but the “personal value judgments of whoever is doing the comparison.” Similarly, “equality of opportunity” cannot give a real content to egalitarianism. “In the limit,” writes de Jasay, “opportunities would become worthless as they become equal.” To appreciate this, think of the opportunities that would be offered by a doctoral degree if everyone were to have one.

In short, imposing equality requires redistribution—that is, using force against the individuals who are on the wrong side of the redistribution principle.

“Social justice” comes to the rescue of equality. It allows equality to rise by itself like the Indian rope under the fakir’s magic:

The essence of the Indian rope trick in ethics, then, is surreptitiously to identify “equal” ... with “just,” which is self-evidently superior to “unjust.” ... The identification is rendered less brazen by appending “social” to “just.” ... With equality identified as the defining content of *Social Justice*, it rises to the rank of a moral imperative in the same self-evident way as justice itself.

Conventions / Consider the proverbial “social cake,” which according to fashionable gibberish must be distributed in some way:

By the time the cake is “baked,” it is also sliced and those who played a part in baking it have all got their slices. No distributive decision is missing, left over for “society” to take.

By “justice,” de Jasay seems to refer to the classical concept: giving everybody his due. The rules of justice define a “ring fence” that “excludes wrongs, with every act one can perform while staying inside the fence being a liberty.” The main rule of justice must be “finders keepers” instead

of equal sharing.

Social justice, on the contrary, has no rules. It is a series of conflicting claims. A claim of social justice “is simply a good try. Whether it is satisfied depends on the politics of the time and place.”

Where do the rules of justice come from? De Jasay answers like Hume and game theorists: from spontaneously evolved conventions. The most important conventions are the rules against torts, which are enforced by satellite conventions.

In terms of game theory, conventions are “spontaneous coordination equilibria producing advantages for all participants.” “All conventions,” de Jasay explains, “are (Nash) equilibria.” They become self-enforceable because “rational individuals will find it worthwhile to find enforcing solutions to make worthwhile conventions work.” Game theory has shown that complex conventions can, over repeated interactions, solve difficult problems such as the Prisoner’s Dilemma.

The set of spontaneous conventions, enforceable without a central authority, generate an “ordered anarchy.” Contrary to standard theorists like Buchanan, de Jasay thinks that ordered anarchy does not need to be guaranteed by the state. We observe this in the business world (where de Jasay spent much of his adult life after a short academic career and before becoming an independent scholar). Looking at history, “the overwhelming evidence is that essential conventions have in fact duly arisen and taken root in much the same form in all civilizations.”

Presumption of liberty / Conventions “contain within themselves protections and interdictions that political discourse likes to enumerate separately as achievements of the social contract or the constitution.” But they evolve from the necessity of avoiding wrongs instead of defining rights. Although the two processes, conventional and constitutional, may look similar, the difference between them has crucial implications in de Jasay’s theory.

De Jasay defines liberty or freedom (he uses the two terms interchangeably) as the

set of acts that do not cause wrongs—that is, as everything not forbidden. Everything that is not explicitly forbidden is free to do or not to do, so there is a presumption of liberty. The inverse presumption, the presumption of *unfreedom*, would mean that “everything is unfree unless it is liberated for us by a specific presumption or right.”

Note also that there is no presumption of equality but, on the contrary, a presumption of inequality, for “in the real world all men are created unequal to varying degrees.”

“Rightsism” / One of the originalities of de Jasay’s political theory is its attacks on the idea of rights and the system he calls “rightsism.” A system that runs in terms of permissions, such as bills of rights, favors the presumption of *unfreedom*: when rights have to be defined, they are naturally seen as exceptions. “Everything that is not explicitly authorized is (liable to be) prohibited.”

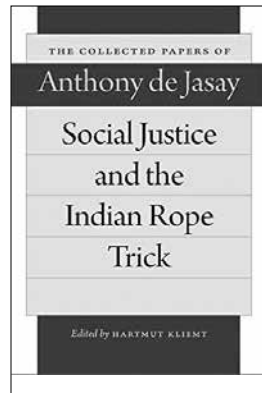
Rightsism ignores previous property titles, hence the absurd theorizing about how to divide a cake that somebody somewhere has baked. Property is not a right but a liberty. A property right or property title is very specific to a thing that has been created or acquired, and it generates obligations. In an exchange, the acquirer has to pay compensation to the former owner. In any event, nobody must interfere with the enjoyment of a property right. The “rights”—or “human rights”—of rightsism are spurious because, contrary to ordinary contractual rights, they create no visible obligation: “Rightsism gives without taking, or at least without taking visibly.”

Contrary to a contracted right, human rights are positive rights that demand redistribution. If they are not illusory, they are privileges that require political authorities to “proclaim and confer them.” Again, they represent a presumption of *unfreedom*.

Instead of rights supposedly favorable to liberty, de Jasay wants us to think in terms of wrongs against liberties, the latter being presumed valid until proof of the contrary. This is precisely what conven-

tional rules do: they define wrongs because they are geared to maximizing mutual advantages and preventing anything that threatens these.

Liberalism in the classical sense has been corrupted by “liberal democracy,” which tends to be a very redistributionist regime. In *Social Justice and the Indian Rope Trick*, de Jasay presents himself as a classical liberal defending “the liberal principles we share.” It is a very libertarian version of classical liberalism, although many libertarians would object to different aspects of de Jasay’s theory.



Social Justice and the Indian Rope Trick
By Anthony de Jasay
200 pp.; Liberty Fund, 2014

The state / De Jasay strongly criticizes social contract theories, according to which citizens ostensibly consent to government rule. What they really consent to is far from clear: “The social contract

differs in its outward form according to who, in the long list of its authors from Aquinas to Rawls, is providing the text.” In order to justify unanimity as an essential feature of the social contract, modern theorists concoct an original position where individuals ignore some relevant features of their respective future. This trick, de Jasay argues, amounts to imagining the social contract as “an agreement of one standardized person with himself.”

A logical reason also vitiates the idea of a unanimous social contract: the signatories can do what they unanimously want to do without a social contract. They would do it because, by hypothesis, they are able to reach unanimity among themselves.

What the social contract does is legitimize collective choice and thus government coercion. It prevents resistance by making people believe that the state they have is what they would have rationally chosen. “Religion, it has been asserted, is the opium of the people,” writes de Jasay. “Should not someone announce now that social contract theory is its valium?”

The social contract is redundant, we

gather, because public goods (goods and services that provide indivisible and non-excludable benefits to all individuals) can be produced without it. Free riders are not really a threat. “A fairly plausible argument,” writes de Jasay, “shows *homo oeconomicus*

willingly acting the sucker under far from extravagant assumptions and without his having any care for solidarity, decency, or the semblance.”

De Jasay gives the example of a dam to protect a town from floods. Let somebody propose a conditional contract for voluntary contributions, stating that the dam will be built only if the full amount of money necessary for its completion is raised. Any potential free rider realizes that his refusal to do his part in the financing will prevent the dam from being built. He is thus incited to

contribute up to the amount the dam is worth for him. It is really in the interest of the potential free rider to act like a potential sucker.

Punters and pathbreakers will want to take their chances in initiating cooperation. In another interesting argument, de Jasay shows how this applies to the “Ultimatum Game.” In this experiment, a Proposer is given a certain amount of money and can offer a Responder whichever proportion of it he decides. If the Responder agrees, they both get the proposed share; if he refuses, nobody gets anything. Laboratory experiments have shown that the share proposed and accepted is generally not 50 percent, nor is it just a tiny amount that, we may think, the Responder would accept rather than take nothing.

To explain this result, writes de Jasay, “It is not necessary to have recourse to an assumption of love of fairness.” The Proposer simply guesses the odds of different proposals being rejected and the Responder bets on the chances that his refusal will send the right signal to any future Proposer. The lower the Proposer’s

offer, the lower the cost of the Responder to bet on the benefits of a refusal.

Given such mechanisms to overcome public-good problems, not much room, if any, is left for the state. What the state does in reality is to use intimidation and allegiance to maximize its discretionary power. This maximization is “the *point* of sovereign command, of *being the state* at all.”

In contrast, the ideal state would be an “antistate”:

The minimal state, if it existed, would be an antistate actor whose rational purpose would be the opposite of that of the state, preempting the place that a state can otherwise take and expand in.

How did we ever get stuck with the state? One reason is that free-riders want redistribution in their favor. Another reason is usurpation and conquest, as Hume thought.

People often surrender their freedom to the state inadvertently. The social contract and constitutional mysticism fool people into submission. A constitution is a self-imposed constraint that helps the state buy allegiance, minimize resistance, and optimize its power. The liberties that constitutions safeguard “are those that the state is fairly willing to remove from the competence of the collective choice.”

Unfortunately, the prospects for ordered anarchy are dim. “History,” de Jasay writes, “seems to demonstrate that a society of perfect freedom, immune from the habit of collective choice, perdures only for small and very poor societies of simple design in relatively geographical remoteness that isolates them from other societies.” But this is not “an incontrovertible corollary of the human condition,” he suggests; the emergence of the state “is a matter of ‘constant conjunction’ [quoting Hume] that has always occurred but may or may not occur again in the future.”

Logic and epistemology / *Social Justice and the Indian Rope Trick* is a book of political philosophy well informed by economics—like the rest of the author’s work. The theory is very persuasive and “makes a lesser

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demand on our credulity and wishful thinking.” De Jasay asks us to economize on ethics and reject moral gullibility.

Take the presumption of liberty. Where does it come from? De Jasay argues that we must rely on presumptions because moral arguments are not conclusive (as shown by the history of philosophy and politics). But why the presumption of liberty and not the presumption of unfreedom? The former, he explains “in no way depends on the love of freedom. It is a pure product of logic and epistemology.” There is an “asymmetry between two forms of validating a statement, namely validation and falsification.” Under the presumption of freedom, somebody who objects to a specific act can hope to prove, if it is the case, that the act creates a wrong to himself. Under the presumption of unfreedom, on the contrary, it is generally impossible to prove that a specific act will do no wrong, for it may have a very large number of complex or unknown consequences, each of which would have to be proven harmless.

Quibbles and questions / As instructive as it is, the book leaves some questions unanswered.

The first is, how would a society based exclusively on evolved conventions avoid stifling traditions? As we saw, de Jasay admits that anarchy historically “perdures only for small and very poor societies of simple design.” But he glosses over the problem. What seems to have happened is that violence was endemic among primitive men and that, in order to organize and control it, stifling traditions were needed and were enforced by bans or other dire punishments.

Anthropologist Adamson Hoebel notes how anarchic Eskimo societies were coordinated by customary rules, taboos, and fears. “We don’t believe; we only fear,” said the wise man of an Eskimo tribe. Another Eskimo explained the anti-rationalism of this culture: “Too much thought only leads to trouble.... We are content not to understand.” Infanticide, invalidicide, senilicide, and suicide were encouraged. For example,

a Labrador girl “was banished in the dead of winter because she persisted in eating caribou meat and seal together,” a taboo violation that was considered to endanger the whole community.

Primitive societies are not entrepreneurial or culturally rich, either.

De Jasay believes that bills of rights are “logically a by-product of an underlying presumption of unfreedom” and serve to elicit allegiance and boost state power. We must recognize this danger, but who would argue that many liberties guaranteed by the American Bill of Rights—think of the First and Second Amendments—would not be in even more dire shape if they had not been constitutionalized? Constitutions and bills of rights are certainly no sure bulwarks, but the more constraints put on Leviathan, the better.

The next question—actually, a set of questions—relates to contractarianism. Is a social contract really conceptually redundant? Can individuals engage in collective action without a founding near-unanimous agreement, if only tacit? The answer seems to be: only if there are no free riders when it comes to financing the (admittedly rare) public goods. But if these free riders exist, some more general agreement framework—like Buchanan’s constitutional first-stage agreement—may be needed.

The third question brings us back to the recurrent problem of public goods. There is no doubt that the concept of public good raises major problems. It is difficult if not impossible to find anything that literally everybody values and would be willing to pay for instead of going without it. Yet, it seems that some goods and services are wanted by the near-totality of non-suicidal individuals: think of the protection against antibiotic resistance or crashing asteroids. Public goods may be only near-unanimously beneficial, but so are many conventions.

Can all public goods be privately produced, as de Jasay believes? His own example may not be as conclusive as he thinks. He assumes an “ideal size of the dam,” which assumes indivisibility in production (and not only in consumption, as

by the definition of public goods). If the dam can be higher or lower depending on the desired level of risk protection, then it becomes in the interest of many free riders to withhold their participation in a conditional contract as a dam one fraction of an inch lower will not materially affect their risk while significantly diminishing their financial burden.

This leads us to a fourth question: can national defense, which is a sort of public good, be produced privately—say, with conventions obliging individuals to contribute their share of militia duties? The concern that this question embodies is actually shared by de Jasay himself, who suggests that anarchic societies may survive only “in relatively geographical remoteness that isolates them from other societies.” He also invokes Hume, who asserts that quarrels between different societies could give rise to government.

National (or to speak more properly, territorial) defense is the elephant in the room. If protection against foreign tyrants is impossible without the state, we should abandon anarchistic dreams and focus on the minimal state as a protector of whatever anarchy is possible. De Jasay does not go that far, but perhaps he should. In a recent article, Hartmut Kliemt, a “reluctant anarchist” and professor of philosophy and economics, walks in that direction.

At any rate, *Social Justice and the Indian Rope Trick* is a must-read for every political philosopher and every social scientist. This is how the moral question of the state and anarchy should be discussed. R

READINGS

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- *The Law of Primitive Man: A Study in Comparative Legal Dynamics*, by E. Adamson Hoebel. Cambridge University Press, 1990.
- *The Limits of Liberty: Between Anarchy and Leviathan*, by James M. Buchanan. University of Chicago Press, 1975.
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When Intervention Fails, Intervene

◆ REVIEW BY VERN MCKINLEY

On the heels of former Federal Reserve Chairman Ben Bernanke's book on the financial crisis, *The Courage to Act*, Adair Turner has also weighed in with a policy book. From Sept. 20, 2008 (a mere five days after the collapse of Lehman Brothers) until its abolition in 2013, Turner chaired the Financial Services Authority

(FSA), the United Kingdom's top financial regulator. The FSA subsequently has been accused of being "asleep at the wheel" in the run-up to and management of the crisis. Since his departure from the FSA, Turner has chaired the Institute for New Economic Thinking, a New York-based think tank founded by George Soros following the crisis.

In contrast to the sequenced, blow-by-blow approach of Bernanke's tome, Turner's is a curious brew of lengthy theoretical discussions and the thoughts of economic heavyweights of the past century. Discussion topics range from the efficient market hypothesis, to historical case studies of financial crises worldwide, to anecdotes and data from the recent crisis. His title is a reference to Mephistopheles, an agent of the devil from the German tale of Faust, who tempts the emperor to distribute paper money, increasing spending and writing off state debts.

Debt overhang and the free market / *Between Debt and the Devil* resembles Atif Mian and Amir Sufi's book *House of Debt* (which I reviewed in the Winter 2014–2015 issue),

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and it suffers many of the same flaws. Turner's approach appears to come from the same New Keynesian perspective as Mian and Sufi, with many of its adherents

advocating massive government intervention to address the perceived problems in the mortgage market in the wake of the financial crisis. Not surprisingly, Mian provides a blurb for the dust jacket for *Between Debt and the Devil*, calling Turner's book "superb" and a "must read."

Turner explains throughout the book what he calls the "debt overhang" problem, particularly as it relates to consumer mortgage debt. He argues the overhang is the result of a massive consumer spending binge prior to the crisis, and it also explains the weak recovery from the crisis and subsequent recession.

This phenomenon is illustrated by case studies from the U.S. financial crisis drawn from *House of Debt*:

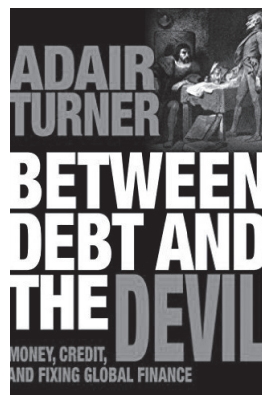
During the boom, households are tempted into borrowing, which appears to make sense because of rising home prices. But when house prices fall, borrowers suffer a fall in net worth, and the higher their leverage is, the greater the percentage loss they experience.... Faced with falling net worth, many households cut consumption.

Like Mian and Sufi, Turner makes value judgements about the decisions of market players in the economy and openly questions why markets should be allowed to work in an unfettered fashion. "In fact, financial markets, when left to free-market forces, can generate activity that is privately profitable but not socially useful," he decides. Elsewhere he laments:

The pre-crisis policy orthodoxy reflected overconfidence in the power of the free financial markets to deliver optimal results.... We need to reject the idea that the quantity and allocation of private credit can be left to free market forces.... Free market forces can produce severe economic harm in advanced economies.

In a chapter called "Too Much of the Wrong Sort of Debt," Turner cites various detailed breakdowns for bank lending in the UK and other advanced economies to reveal how financial institutions have migrated from non-mortgage lending to mortgage lending. For example, UK bank lending data reveal that nearly two-thirds is focused on residential mortgages. This prominence isn't just a U.S. and UK phenomenon; real estate lending rose from 30 percent of lending in 17 advanced economies in the 1940s and 1950s, to nearly 60 percent today. This evidence is meant to persuade the reader that the "free market" has allocated way too much in the way of credit for real estate, and in particular residential mortgages.

But like Mian and Sufi, Turner ignores the fact that the housing market is in no way an example of an unfettered free market. He completely ignores the key role played by government intervention through a litany of provisions in the tax code, zoning regulations, and government agencies and programs to distort decisionmaking in the mortgage market. These interventions played a primary role in bringing on the crisis through aggressive incentivizing to push people to take on mortgage debt, either getting marginal borrowers to purchase homes when they may have been better off renting, or getting qualified borrowers to buy bigger homes than they would have in a truly free mar-



Between Debt and the Devil: Money, Credit, and Fixing Global Finance

By Adair Turner

302 pp.; Princeton University Press, 2015

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ket. The interventions in response to the crisis have also distorted the process of realigning supply and demand post-crisis.

Right and wrong debt? / In Part IV of the book, Turner argues that the answer to the flaws in the mortgage market and financial system is “radical reform.” Authorities must “manage the quantity and influence the allocation of credit in the real economy.” He would reduce the role of what he calls “irrelevant bankers,” who make a living off of developing funding schemes for what he deems “socially useless activities” that can impose a “negative social effect.” Shockingly (at least to me as a former bank supervisor who examined the quality of banks), he argues that financial authorities’ resources that are now focused on assessing the governance and financial standing of banks should be redirected to developing massive schemes for credit allocation. “We therefore need strong public policies to constrain the total quantity of credit created and not solely to ensure solvent and better run banks,” he writes.

Turner argues that the interventions he advocates are necessary to reduce instability in the financial system and income inequality that has worsened in the past 40 years as a result of wild swings in the credit and real estate price cycle. In “Managing the Quantity and Mix of Debt,” in a section entitled “Enough of the Right Sort of Debt,” he restates his position on what the present focus of the financial system is and he suggests where the focus of the financial system should be redirected:

We have a financial system with a strong tendency to create excessive debt in residential and commercial real estate markets, but we still need to mobilize capital to support huge investments—for instance, in the area of clean energy—and debt finance will be essential to achieve that mobilization. Faced with a free-market bias toward real estate lending, interventions favoring other types of lending are justified.

Again, Turner’s inability to recognize the instability and inequality caused by

interventions in the run-up to the most recent crisis undermines his analysis. The idea that the right path is to double down on interventionism, redirecting it toward more “productive” purposes, is difficult to accept.

In the book’s waning pages, he chooses to delve into matters of monetary policy that were beyond the mandate of the FSA he once led, reserved instead for the Bank of England. This does not stop him from offering an analysis of what he calls the “ultra-loose monetary policy” of the United States, Japan, the UK, and the Eurozone in recent years. This section ends with the confused statement that “with fiscal policy blocked, ultra-loose monetary policy thus seems simultaneously both dangerous and essential.” His ultimate conclusion comes down on the side of easy money to fuel a fiscal jolt. He has confidence that the monetary authorities can do the right thing and not get too reckless with the printing press. I believe he should have

left the monetary discourse to those with better knowledge of the subject.

Turner spends most of his time on the economies and financial systems in the United States and the UK. However, a much more interesting case study would have been Canada. As Charles Calomiris and Stephen Haber documented in their recent book *Fragile by Design*, Canada has largely managed to avoid major financial crises since the mid-1800s. Turner does not consider whether Canada’s approach to mortgage lending makes our neighbors to the north less susceptible to crisis. To me this is a disappointing oversight for an author who spends so much time discussing a link between financial crises and mortgage lending. Turner cites a great many interesting economic and financial trends throughout *Between Debt and the Devil*, but overall his proposed policy responses are unsatisfying. A deep dive into case studies like Canada would have made the book a more relevant read. **R**

Not Feeling Much Bern

REVIEWED BY ART CARDEN

In his 2009 book *Why Not Socialism?* (Princeton University Press), the late philosopher G.A. Cohen argued that socialism remains a noble ideal even if we can’t reach it—after all, just because we can’t reach a particular bunch of grapes doesn’t mean they’re sour. After surveying the economic, political, and moral arguments for and against socialism in his book, *The End of Socialism*, Wake Forest University professor James Otteson considers Cohen’s quote and reaches a different conclusion:

The socialist grapes, therefore, seem impossible to harvest, have nevertheless induced numerous but destructive attempts, and yet seem sour in their moral core. Perhaps it is time to give up on the socialist grapes.

The collapse of the Soviet bloc, Beijing’s retreat from “socialism with Chinese charac-

teristics,” and the increasingly bizarre existence of North Korea all seem to support Otteson’s thesis. Yet some people continue treating socialism as an ideal whose time may yet come. To them, he offers a devastating critique: even if we ignore its many practical failures over the past half-century, its deeper problems are moral: “it isn’t clear the socialists have the moral high ground.” He evaluates socialism and “socialist-inclined policy” (policy that “tends to prefer centralized over decentralized economic decision-making”) by exposing several fallacies and problems in and emerging from arguments for socialism as an ideal.

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Great chess-board / Otteson argues that the case for socialism commits two serious fallacies: the Totalizing Fallacy, which treats the concatenation of innumerable small problems in an economy as if they are one large problem, and the Great Mind Fallacy, which imagines that there is someone out there—a man of system, perhaps—who “can arrange the members of a great society with as much ease as the hand arranges the different pieces upon a chess-board,” as Adam Smith wrote in *The Theory of Moral Sentiments*.

The Great Mind Fallacy is subject to what Otteson calls

The Herding Cats Problem of centralized policy making: because human beings have their own ideas about what to do, a central planner wishing for them to conform to his plan, however beautiful and attractive it might be to him, is bound to be frustrated.

Why? Because “in the great chess-board of human society, every single piece has a principle of motion of its

own, altogether different from that which the legislature might chuse to impress upon it,” again borrowing from Smith. To successfully organize society, socialist planners would need a staggering level of power and control.

The Social Problem, in short, is not one problem, but many complex, interacting, and perpetually changing problems that cannot be solved by a Great Mind with a large enough computer.

Arguments for socialism also must contend with the Day Two Problem, the Local Knowledge Argument, and the Economizer Argument. The Day Two Problem asks, “What do we do to address new inequalities that emerge after an original redistribution?” The problem emerges from a long tradition of treating *production* and *distribution* as separate problems, and while wealthy countries are able to accom-

plish these redistributions through various taxes and subsidies, there are legitimate questions about whether generous welfare states are sustainable in light of the political incentives that influence how the policies are implemented and the incentives created by the taxes collected in order to fund them.

Camping trip / Otteson attributes to Smith a Local Knowledge Argument that “does not assume that people are perfectly rational; it assumes only that they are *relatively better positioned than others* to make decisions about their own lives” because they have information and incentives outside observers lack. Related to this is the Economizer Argument: we have the strongest incentives to use our resources wisely because good choices increase our capacity to do what we want and bad choices decrease it. Planners with no skin in the game have weaker incentives to choose wisely on our behalf. Consider, for example, who has the strongest incentive to make a wise

decision on the football field: a quarterback who might get a bonus if his team wins the game, the fans screaming at him from the stands, or the armchair quarterback screaming from the comfort of his living room? I might be disappointed if my team doesn’t win the big game, but the loss’s effect on my ability to feed my family ranges somewhere between nonexistent and trivial. Even if I am an expert on football with encyclopedic knowledge of the sport and its history (and I most certainly am not), I’m not as well-positioned to decide whether to run or pass as is the quarterback or the coaching staff.

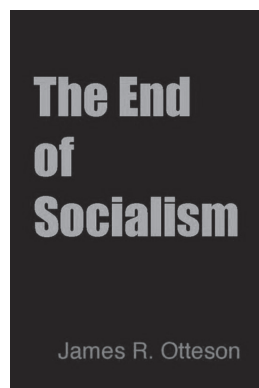
Otteson invokes Smith’s Invisible Hand Argument that we are compelled by our own interests to serve others. Cohen, in his book praising socialism, offers a “camping trip” thought experiment that the campers would all want everyone to have a good

time and would, therefore, recoil at the idea of every interaction on the trip being mediated by prices and markets. From this he argues that people should embrace a society based on communal reciprocity whereby I do for you because you need me. It’s an appealing thought experiment—after all, parents don’t charge their children for food, clothing, and shelter—but it falters once we start looking beyond very small groups.

We can know a lot about ourselves and a lot about those who are socially, morally, and genetically proximate (relatives and friends), but our capacity to know what strangers “need” is far weaker, likely to the point that “communal reciprocity” doesn’t scale well. And yet, as Smith points out, the invisible hand leads us to take care of strangers in order to take care of ourselves and those closest to us. Does Cohen’s case for socialism rule out market-mediated cooperation between strangers for the benefit of those with whom we are most intimately acquainted?

I wrote this review shortly before the annual festival of communal reciprocity that is Christmas. Am I allowed, in Cohen’s socialist society, to cooperate with strangers for the benefit of those I love the most—to buy roses or Nerf guns, for example, from people who don’t know me or care about my wife and kids the way I do, but who are simply looking to take care of themselves and the ones they love? One might object that roses and Nerf guns might be made in sweatshop conditions, but that would be changing the argument; Cohen’s claim, as I read it, is that self-interested exchange as such is objectionable. Smith’s Invisible Hand Argument, as Otteson points out, shows that when we are bound within a market economy to respect others’ moral autonomy—their right to say “no”—we necessarily have to make their lives better if want the same from them.

The Local Knowledge Argument also shows why “luck egalitarianism” fares poorly as an argument for socialism. How do we define what it means to be “lucky”? Which aspects of luck deserve recompense? Who is luckier, the man with a knack for



The End of Socialism
By James R. Otteson
240 pp.; Cambridge University Press, 2014

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making money born into a good family, or the man born with an extraordinarily serene disposition that helps him navigate the world of Epictetus far more ably than the rest of us? If Harry Bailey was right that his big brother George was “the richest guy in town,” is Mr. Potter entitled to relief because he was born with a sour disposition and a knack for finance? These aren’t idle questions. Capitalism’s critics argue that it encourages crass materialism and devotion to the trivial and the unimportant. Are not moral and dispositional inequalities at least as important?

Markets and morality / But why isn’t socialism a moral ideal? For Otteson, it is because it fails to respect others’ moral agency. Otteson defines the Man of System’s moral mistake as “assuming that his fellow citizens are not his moral equal.” Elsewhere, he writes, “If we decide we should ... prevent others from engaging in mutually voluntary cooperation, we presume for ourselves not an equal but a superior moral agency, and we hold the moral agency of those others to be inferior to ours.”

But there is so much pain in the world! Why not yield to the temptation to use the government to dry every tear? Otteson comes back to moral agency. We all agree that we should help the needy, but what counts as “help” and what counts as “needy” will depend on contexts that outside authorities likely do not have the local knowledge to navigate. In many cases, letting others bear the costs of unwise actions helps them develop sound judgment. In other cases, it isn’t at all clear that we make things better by getting involved. There are clear cases in which a parent will want to intervene—it’s probably not a good idea to let a baby play with knives, for example—but the case for intervention in other cases is far less clear. Think, for example, about foreign aid programs and charitable endeavors that were supposed to “stop the bleeding” in low-income countries but that have ultimately made things worse. With respect to things of which many disapprove—selling tickets to a papal appearance,

drug use, prostitution—Otteson writes: “Proposing to enact legal prohibitions from afar does not attempt to persuade people or change their minds.... It coerces them. Instead of *engaging* their moral agency, that *disregards* it.”

There is more to the end of socialism than economic and philosophical arguments. Twentieth century experiments with socialism show that it is far more

likely to produce the “camping trips” described by Alexandr Solzhenitsyn in *The Gulag Archipelago* than the ones in Cohen’s thought experiment. Cohen refers to the market as “a casino from which it is difficult to escape,” but the claim is better applied to socialism. As Otteson replies, “No one has ever built walls to keep citizens in capitalist countries.” And that’s a fact we shouldn’t forget. R

Frequently Insightful but Often Misleading

REVIEW BY DAVID R. HENDERSON

I can’t give a AAA rating to John Kay’s new book on finance; it’s closer to a BBB+. *Other People’s Money* is full of insights and, unfortunately, is sometimes misleading in important ways. His big-picture arguments are basically correct: that the financial sectors in the United States and the United Kingdom are overly complex and out of control; that this helped cause the 2007–2008 financial crisis; and that much of the dysfunction can be traced to regulation. Unfortunately, he misunderstands key events in U.S. economic history. And some of his proposed reforms are too vague to be useful; they sound more like wishes than reforms.

Regulation’s role / Kay, who writes a weekly column for the *Financial Times*, has himself been a player in the financial markets. In the 1990s he was on the board of directors of the Halifax Building Society, which lent money to developers to build housing. That position gave him a perch from which to observe financial industry changes that concerned him.

One of his most important insights is that much of the complexity of financial instruments is due to government regulation. He lays out, for example, how the Basel Accords—which most of the world’s major

wealthy countries pledged to follow—led to some mischievous but totally predictable “regulatory arbitrage.” Kay writes, “The basic rule on capital requirements is that a bank must have equity capital—the money that can be lost before a business is forced into insolvency—equal to 8 percent of its assets.” Forget for a minute that, as Kay points out, 8 percent seems awfully low; the situation gets worse, and the reason has to do with the risk-weighting of assets. Mortgages carried a risk weighting of 50 percent, meaning that the capital requirement on such mortgages was 4 percent (8 percent × 50 percent) of the mortgage principle. But—this is my example, not Kay’s—mortgage-backed securities (MBS) carried a risk weighting as low as 20 percent.

Can you see where this is going? Kay does, but an example would have been helpful. Here is mine: Imagine that a bank has 10 high-quality mortgages on its books for \$100,000 each, for a total of \$1 million. On those mortgages, it must hold capital of \$40,000. The bank manager would like to relax that constraint, so what does he do? He packages the mortgages into an

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MBS, which requires that the bank hold only \$16,000 (8 percent \times 20 percent \times \$1 million) in capital on that security. The risk hasn't changed, but the capital requirement has fallen by 60 percent.

Kay notes another problem caused by the Basel rules: the crudeness of the risk weighting. Those weightings, he notes, "encouraged banks to accept riskier—and higher-yielding—loans within each risk category." One great example: "The risk weighting attached to a 60 per cent loan-to-value mortgage for a local physician was the same as that for the no-deposit loans to NINJAs ([borrowers with] no income, no job, no assets) that were marketed in US cities."

Kay points out that regulation led to regulatory arbitrage and new financial instruments to facilitate that arbitrage, and then the problems with those financial instruments led to more regulation. Although he doesn't quote Ludwig von Mises on this issue (he does quote Mises's and Friedrich Hayek's insights on central planning elsewhere), he could have. It was Mises who noted that government interventions often lead to problems that then cause government not to repeal the first interventions but to add more.

Comfort of bailouts / But why did bankers and other financial firms act so irresponsibly in the years leading up to the 2007–2008 financial crisis? The reason is moral hazard—the willingness of an actor to take greater risk if he knows someone else will bear part of the cost.

When the giant investment firm Long Term Capital Management (LTCM) faced a financial crisis in 1998, the federal government twisted a lot of bankers' arms to bail it out. I wish that Kay had pointed out that LTCM didn't need a government-organized bailout. What many observers forget is something that should be trumpeted from the rooftops: prior to the feds stepping in, Goldman Sachs, AIG, and Berkshire Hathaway had made LTCM a low-ball offer that it rejected. Had the company been confident that no government-organized bailout was forthcoming, it likely would have accepted the offer. The LTCM bailout was one of

the key precedents that led most managers of large financial firms to assume that if they ever faced a crisis, they too would be bailed out. And they were right. Of course the problem, as Kay points out, is that this near-certainty of bailout makes a future financial crisis more likely because investment firms have less incentive to refrain from overly risky behavior.

Kay adopts a tailgating metaphor used by Raghuram Rajan when he was chief economist at the International Monetary Fund. (I reviewed Rajan's 2010 book on the financial crisis, *Fault Lines*, in the Winter 2010–2011 issue of *Regulation*.) Rajan pointed out that drivers who tailgate on high-speed freeways find that the strategy works fine most of the time. But in the few instances when it doesn't work, the consequences can be catastrophic. Kay applies this metaphor to government. He writes:

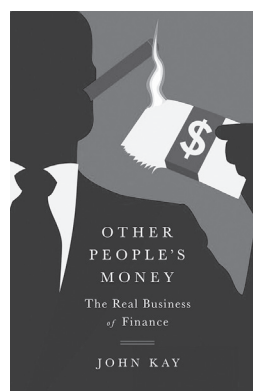
Governments too have become tailgaters, taking risks in support of the financial system that will probably pay off, but which may entail immense costs if they do not. Some governments will announce that the measures they took in 2008 had no cost, or even yielded a profit. Such claims have already been made for the US government's TARP programme. But guarantees are not free.

Kay properly points out a major problem with government regulation: economies of scale in managing regulation. Large firms can and do have whole departments of people whose jobs are to manage compliance with regulation. That is much harder for a smaller firm to do. The cost of compliance takes a much higher percentage of a small firm's revenue and, therefore, may wipe out small firms, including firms that might have started as small innovators and grown to revolutionize otherwise stagnant industries.

Some problems / As noted in my introduction, though, Kay often goes wrong, either by misleading or by being literally incorrect about important historical points. Consider his treatment of some so-called "robber barons."

With regard to five of them—Henry Clay Frick, Jay Gould, J. P. Morgan, John D. Rockefeller, and Cornelius Vanderbilt—Kay writes, "Their immense personal wealth was as much the product of financial manipulation as of productive activity." That charge may be true of Gould, who appears to have been a charlatan, but it's not true of the other four, who made their money mainly through productive activity. As I point out in "The Robber Barons: Neither Robbers nor Barons" (*Econlib*, March 4, 2013), Rockefeller's revolutionizing of the petroleum industry was a boon to consumers, and Vanderbilt's price-cutting brought down a shipping monopoly.

Kay also misleads readers about two relatively recent financial-industry heavyweights, Michael Milken and Frank Quattrone. He points out correctly that Milken helped invent "junk bonds." But Kay's tone is one of disdain and he ends his short section on junk bonds with the sentence, "Milken went to prison." Most readers will probably conclude that Milken *should have* gone to prison. However, though he did break several laws, those breaches appear to have profited him very little and cost others very little. In 1991, federal judge Kimba Wood, who had earlier sentenced Milken to a stiff prison sentence, told his parole board that the total loss from his crimes was \$318,000. In his 2011 book *Three Felonies a Day*, Harvey Silverglate, one of Milken's defense lawyers, wrote, "Milken's biggest problem was that some of his most ingenious but entirely lawful maneuvers were viewed, by those who initially did not understand them, as felonious precisely because they were novel—and often extremely profitable." Although Silverglate clearly was an



Other People's Money: The Real Business of Finance

By John Kay

336 pp.; Public Affairs, 2015

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interested party, that statement fits the facts that I have been able to ascertain over the years. Milken was unfortunate enough to have been targeted by a politically ambitious U.S. attorney named Rudy Giuliani, who wielded the Racketeer Influenced and Corrupt Organizations Act to intimidate Milken.

Similarly, Kay writes that Frank Quattrone of Credit Suisse “expected favors from friends and clients in return for allocations of hot stocks.” But Kay gives no citation for this claim. I think there’s a good reason for this: a lack of evidence. For what really happened in the Quattrone case, see my “Hurray for Frank Quattrone: Rotten Tomatoes for the Media” (*TCS Daily*, August 28, 2006), and the even more extensive article, “The Case for Frank Quattrone,” by Roger Donway (Atlas Society, July 1, 2004).

Although Kay does see government’s hand in the financial crisis, he is critical of the idea that excesses in mortgage securitization “were the result of US government measures to widen home-ownership.” It’s true that they weren’t *the* result, but surely laws like the Community Reinvestment Act of 1995 had *some* effect by legally encouraging lenders to sell mortgages to people who were bad credit risks. What is Kay’s argument against this view? He gives only one: the U.S. “transition from renting to owner-occupation had more or less been accomplished by the 1960s.” But that doesn’t handle the argument. Even if the regulations caused *no* net increase in homeownership, they surely increased the number of people with mortgages who were unlikely to pay.

Another problem: in arguing (correctly) that the risks that financial market participants care about are different from the ones “Main Street” cares about, he goes too far, writing: “The pedestrians on Main Street fear accident, illness and mortality, and worry about provision for old age.” Those risks, he writes are “mostly handled outside the financial system altogether” and are dealt with “by friends and family, and by government and its agencies.” With this latter, he presumably is referring (in the United States) to Social Security and Medicare. But financial markets certainly

do provide products for accident, illness, and mortality (insurance), as well as for old age (IRAs, 401(k)s, etc.)

And I can’t let pass his comment about “well-educated young white men baying for money and praying for liquidity.” Did he really need to mention the race, age, and gender of market participants? If they were old black women, would their actions be less deserving of criticism?

One big disappointment is Kay’s list of six principles for reform. They are not so much principles as wishes, with little elaboration on how to fulfill them. Here’s one such principle: “Require that anyone who handles other people’s money, or who advises how their money should be handled, should demonstrate behaviour that

meets standards of loyalty and prudence in client dealings and avoids conflict of interest.” How is this to be done? He doesn’t say.

Moreover, he seems to propose a world “where there are no futures contracts or stock market indexes.” Yet futures contracts existed long before the institutions that Kay justly criticizes, and have helped farmers and other businesses offload their risks onto those who want to bear them. Stock market indexes are a very cheap way that many of us use to estimate our wealth. It’s hard to see that they do damage.

Kay is at his best when he’s criticizing government regulation, especially regulatory arbitrage. But he’s at his worst when he makes outlandish claims with little or no attempt to back them up. Caveat emptor. **R**

What’s Really Disgusting?

REVIEW BY GEORGE LEEF

If you have a great talent for doing something “high” and “noble,” shouldn’t you share that talent with your fellow human beings even if you’re not paid for it? Evidently many people used to think so, according to this passage from Adam Smith’s *The Wealth of Nations*:

There are some very agreeable and beautiful talents of which the possession commands a certain sort of admiration; but of which the exercise for the sake of gain is considered, whether from reason or prejudice, a sort of publick prostitution.

Top opera singers, for example, were paid very well, Smith argued, in large part because such compensation was necessary to overcome the shame of falling into the avarice of the free market.

Today, of course, you would have a hard time finding anyone who believes that talented musicians (and dancers, artists, athletes, and so on) should share their labor out of purely altruistic motives and avoid the corruption of performing for money. However, the sentiment that there

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are some kinds of goods and services that should not be allowed for sale in the market remains strong. Many people harbor animosity toward a wide array of transactions, such as the sale of human organs or blood (see “Could PAYGO End the Prohibition on Paying Organ Donors?” p. 6), payments for pregnancy surrogacy, prostitution, human hair wigs, line-standing, and vote-buying. Their anti-commodification views are stoked or reinforced by intellectuals who write books and give lectures (usually for money!) that provide rationales for believing that it’s wrong for some things to be exchanged for money.

Entering the fray on the other side of this contretemps are Jason Brennan and Peter Jaworski, both professors at Georgetown University’s McDonough School of Business. Their book, *Markets without Limits*, provides an overwhelming case against the anti-commodifiers. Stated simply, the

authors' thesis is that if you may do something for free, then you should be allowed to do it for money. "There are legitimate moral worries about *how* we buy, trade, and sell," they write, "but no legitimate worries about *what* we buy, trade, and sell." In other words, while some things are wrong in and of themselves and shouldn't be exchanged for that reason, adding money to a transaction never turns an otherwise moral exchange into an immoral one.

Markets without Limits is a very carefully argued book. The authors present the work of their opponents fairly and confront those ideas not with rejoinders based on libertarian precepts, but with arguments that the anti-commodifiers themselves ought to accept. "We want to play and win in their ball park," Brennan and Jaworski write. What results is a tour de force of philosophical argument that leaves the opponents' camp routed and the ground strewn with gauntlets thrown down in challenge.

Markets and corruption / Here is a sampling of the anti-commodification claims that Brennan and Jaworski attack:

Anti-commodifiers often maintain that markets should not be allowed in certain goods because transactions might involve the exploitation of one party. We often hear, for example, that a market in human kidneys would be bad because many of the sellers would be poor people who are so desperate for money that the wealthy buyers will exploit them. In response, the authors show that human organ markets could be regulated in ways that would solve most if not all of the concerns about exploitation (although Brennan and Jaworski do not advocate such regulation). But instead of seeking such a solution to the alleged problem, the anti-commodifiers continue to insist that no market in kidneys should be allowed. That suggests to Brennan and Jaworski that some deeper, gut-level opposition to a market in kidneys is at work.

One of the book's recurring themes, in fact, is that when the anti-commodifiers argue against permitting a market, the reasons they give are often a mask

for an underlying aversion to voluntary trade. The anti-commodifiers employ high-sounding rhetoric as an excuse for imposing their preferences on the rest of us. When they succeed, the consequences are always harmful and the authors reserve their strongest language for condemning that—a point I'll return to.

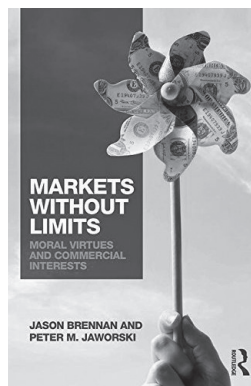
Another justification given by the anti-commodifiers is that markets in many (if not all) goods and services tend to corrupt people. That is to say, when people have to think about monetary gains or losses when dealing with others, they become selfish and grasping rather than exemplifying ethically better, other-regarding behavior. Markets thus encourage defective character traits, they claim.

Brennan and Jaworski consider five different kinds of "corruption" arguments: that markets encourage selfishness, crowd out better motives, lead to poor quality, reduce levels of civic engagement, and sometimes give people a stake in "bad" outcomes. By the time the authors finish confronting those arguments, the reader will wonder how anyone could have ever considered them convincing.

The different cases for corruption are based on little more than anecdotes and utterly ignore a great deal of evidence that market incentives actually improve humans and their products. Among many other points, Brennan and Jaworski observe that most of our great artists and composers were driven by the need for commercial success (Mozart, for instance, wrote his superb piano concerti to fill concert halls in Vienna and thereby fill his own pockets) and that the great humanitarian movements of the 19th century arose because commercial success had enabled large numbers of people to start caring about the plight of slaves, prisoners, the mentally ill, and animals.

The authors delight in showing the

empirical evidence that, far from leading to corruption, market-based societies tend to be the least corrupt. They cite the work of Claremont neuroeconomist Paul Zak, who concludes that market societies cause people to deal more fairly with others, and of economist and behavioral scientist Herbert Gintis, who surveyed numerous studies on markets and concluded, "Movements for religious and lifestyle tolerance, gender equality, and democracy have flourished and triumphed in societies governed by market exchange, and nowhere else."



Markets without Limits: Moral Virtues and Commercial Interests

By Jason Brennan and Peter M. Jaworski

239 pp.; Routledge, 2015

Commodification and disgust

Another category of objections to markets Brennan and Jaworski identify are "semiotic," which is to say that market transactions communicate "disrespect" or violate the "correct

meaning" of some relationship. Most frequently, we hear the semiotic claim that when people trade goods for money, it causes them to view the items in question as "mere commodities." That is the basis for a common argument against prostitution—it makes men think of women as mere commodities—and we also hear it from some animal rights enthusiasts who argue against permitting the sale of pets out of concern that markets make people view puppies and kittens as mere commodities instead of living things that deserve respect.

The authors have a host of rejoinders to these semiotic objections. One is that the advocates make a deceptive and logically flawed move when they claim that when people buy and sell commodities, that necessarily means that we view them as *mere commodities*. Actually, they note, it is quite possible for people to buy and sell goods and nevertheless maintain a respectful attitude. Evidence on the treatment of pets, for example, shows that purchased animals are treated better than ones taken for free.


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After a lengthy analysis of all the varieties of arguments against markets, Brennan and Jaworski end with a sharp analysis of the anti-commodifier mindset in a chapter entitled, “The Pseudo-Morality of Disgust.” For all the professed lofty concerns about society, the anti-commodifiers are essentially saying, “I’m disgusted by this and therefore it shouldn’t be allowed.” Is disgust a reliable guide to ethics? The authors note that some scholars say it is, such as ethicist Leon Kass who argues that deep-seated feelings of revulsion or repugnance are a clue to facts about ethics. The authors strongly disagree, writing:

Instead of counting on a rough-and-ready heuristic grounded in our primordial past to tell us what’s right and what’s wrong, we should instead rely on our considered judgments. If there is anything to be disgusted by, it is the fact that many life-saving and life-improving markets get legally blocked for want of a little reason and a little reflection.

When the anti-commodifiers get their way and laws incorporating their disgust at certain transactions are imposed on society, the results are harmful and sometimes fatal. For instance, lawmakers and the public are disgusted by sharp price increases for suddenly scarce goods following a natural disaster, labeling the increases “price gouging.” But anti-price gouging laws result in empty stores and a de facto infinite price.

The same goes for the law that prevents a market in kidneys. While anti-commodifier theorists congratulate themselves on preventing anyone from suffering exploitation, thousands of people die from kidney failure. The book’s parting shot is devastating: “But third parties, the loud and obnoxious people standing on the sidelines, are screaming at the dying that saving their lives would come at too high a price of an uncomfortable turn in their stomachs.”

I think it will be a long time before we see another book that so wonderfully blends philosophy with public policy as *Markets without Limits*. 

Government Knows Best?

◆◆ REVIEW BY PHIL R. MURRAY

In *Phishing for Phools*, George Akerlof and Robert Shiller profess a qualified faith in free markets. Qualified, that is, by government regulation and “heroes” who restrain markets. They intend to convince the public of the omnipresence of “phishing” and to incorporate the idea of a “phishing equilibrium” into economic theory.

The term “phishing” is commonly used to describe Internet-based scams, such as the Nigerian millionaire who wants to share his wealth with you (in exchange for some of your banking information). Akerlof and Shiller use the term to describe “getting people to do things in the interest of the phisher, but not in the interest of the target.” Phishermen catch “psychological phools” whose “cognitive” limitations lead them to “misinterpret reality.” Gamblers who don’t understand that the odds are against them are cognitive phools. Gamblers who do know the odds are against them, and other addicts who are “self-aware” but can’t quit, are “emotional” phools. The “informational phool” is a third variety, duped by dishonesty. According to the authors’ “dual view of our market economy,” Adam Smith isn’t quite right; self-interest leads the butcher, the brewer, and the baker to produce food and drink that’s consistent with our well-being, but self-interest also leads producers to induce consumers to buy more of what’s bad for them.

Overbuying / One reason people are “phishable” is that they respond to storytelling. Akerlof and Shiller object to advertising in the form of a story that diverts us from buying “what we ‘really want,’ or, alternatively stated, ... what is good for us.”

They have plenty of criticism for advertising executives, who conjure these stories for a living. Pioneer advertiser Albert Lasker created ads that “told the story” of the Wilson Ear Drum Company, which manufactured tiny tubes that supposedly “restored perfect hearing” when placed

in the ear canal. The hard-of-hearing bought the story and the company’s ineffective product. Lasker collaborated with Claude Hopkins to invent the trademark “Sunkist” for an orange-growers association, popularizing orange juice. To the authors, this proves that “consumers will be influenced by the story that they are ‘Sun Kissed.’” David Ogilvy created “the saga of the eye-patch man,” a print ad campaign featuring an aristocratic man in an eye patch, which boosted sales of C. F. Hathaway dress shirts.

In Akerlof and Shiller’s view, such advertising strategies wrongly prompt consumers to buy too many goods. They say that “advertisers, by statistical tests, can also see what works and what does not.” “If there is a way to make a profit from our monkey on the shoulder tastes [for goods we want that are bad for us] the phishermen will keep trying until they find it.”

If all we had to fear was buying too many oranges and dress shirts, that might be of little concern. However, the stakes are higher on big-ticket items and when we use credit cards. Akerlof and Shiller reason that when we buy cars, salesmen coax one in three to pay “an extra \$2,000 (inflation adjusted)” over the lowest price a salesman would accept. Homebuyers may overpay by thousands of dollars. Akerlof and Shiller focus on “a remarkable example of a rip-off” related to “initiating the mortgage.” Lenders formerly extended money to borrowers at the closing if the borrowers would “agree to pay an interest rate higher than ‘par’ for the duration of their mortgage.” Lenders first paid this money to the mortgage broker, who kept the majority of it, according to research

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reported by Akerlof and Shiller, before borrowers received their due. The Dodd-Frank Act now forbids the practice.

Another example of what they consider wrongful dealing is credit cards, which they say induce consumers to pay higher prices than if they were to pay cash. Akerlof and Shiller cite psychological experiments as evidence for this. They reason that the “cost of credit cards” amounts to “a significant fraction of the bills for our major necessities.” Other researchers estimate the “interchange fees” that burden cardholders and assert that credit cards are a “major cause of personal bankruptcy.”

Phishing has macroeconomic effects. Akerlof and Shiller argue that “reputation mining” explains the last financial crisis: Investment banks and rating agencies historically earned good reputations from their origins. But changes in the housing finance industry changed incentives for how the banks operated. Investment banks sold shares to the public, so “no longer did most [bank] partners have to tremble at the thought of a lawsuit that would make

them liable for most of their personal fortunes.” They created mortgage-backed securities (MBSs), contaminated with bad loans to home buyers with no incomes or down payments. Dividing the interest and principal payments from the MBSs into “tranches” that supposedly protected some investors from nonpayment concealed the bad loans. The incentives of rating agencies, tasked with judging the quality of investments, changed too. Whereas they previously earned income from “book sales and other small fees,” investment banks began paying them for ratings. Akerlof and Shiller explain that rating agencies handed out wrongfully high ratings in order to profit. If they “give a low rating, there will be no more deals,” the authors write. Buy-

ers of MBSs accepted the high ratings; they bought the “myth of the new economy,” as Akerlof and Shiller see it, “that the complex mortgage-backed securities were tailored in such a way that risk had disappeared.” Although the authors tell a story in which investment banks and rating agencies are the characters that caused the Great Recession, they neglect to mention Fannie Mae, Freddie Mac, and bad government policies.

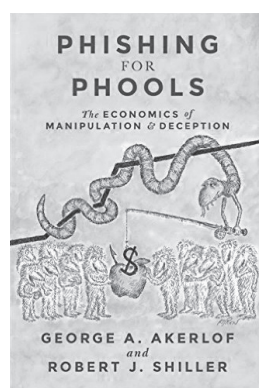
The chapter “Phishing in Politics” explains government failure. Akerlof and Shiller outline a “winning electoral strategy” whereby a politician tells the masses what they want to hear, tells “campaign donors” what they want to hear in return for their money, and then spends the money on advertising to build support. Lobbyists arrange deals between politicians and donors, who are the largest source of campaign funding. Take the American Jobs Creation Act, which enabled corporations to avoid paying taxes on a substantial share of repatriated profits: A “coalition” of corporations that lobbied for the act, researchers estimate, incurred “\$180 million” of “lobbying costs.” In return, they banked “tax savings of \$46 billion.” Numbers like these imply that the effect of lobbying is large and harmful to democracy and markets.

Battling schemers / After providing many examples of phishing, Akerlof and Shiller discuss antidotes. Their prescriptions will likely frustrate readers predisposed to markets. “Standard economics (the ‘purely economic model’) presumes no civil society,” they claim, “but in fact we live in a community of people who care about one another.” This gives the false impression that Adam Smith and his followers ignore ethics. “It is not the unadulterated actions of markets that bring us the cornucopia we enjoy,” Akerlof and Shiller allege, “for that same free-market system brings ever

more sophisticated manipulations and deceptions.” First, proponents of markets recognize the importance of institutions, including democracy, rule of law, and voluntary associations. Second, scamming is not only a market phenomenon: Akerlof and Shiller portray what happened in the Garden of Eden as a scam, but that predates markets by eons. And today’s Nigerian millionaire scam (which the authors don’t mention) did not come from a bastion of economic freedom. Nevertheless the authors rightfully exalt the “heroes” who battle schemers and set standards of acceptable practice.

Among their heroes are Harvey Washington Wiley, who initially headed the U.S. Food and Drug Administration, as well as Stuart Chase and Frederick Schlink, whose accomplishments include what is now the Consumers Union, publisher of *Consumer Reports*. “Business Heroes” participate in Better Business Bureaus and Chambers of Commerce all over America.

Under the heading “Government Heroes,” Akerlof and Shiller tell us of the 1817 “Supreme Court case, *Laidlaw v. Organ*, [which] established the joint principle of *caveat emptor/caveat venditor* (buyer beware/seller beware) as a foundation of U.S. commercial law.” Knowing that the U.S. Senate had recently ratified the Treaty of Ghent that officially ended the War of 1812, Organ speculated that the price of tobacco would rise and bought an enormous quantity from Laidlaw. Laidlaw queried Organ about the large order, but Organ “parried”; when tobacco prices soared, Laidlaw felt cheated. Legal wrangling over the deal reached the U.S. Supreme Court, where a unanimous majority decided in favor of Organ. Akerlof and Shiller criticize the decision, charging, “Since that time a line of legal heroes have been whittling away at it, making the law more flexible (and more reasonable).” Letting the buyer beware, they charge, “gives license to phish.” Perhaps, but that ignores the likelihood that buyers and sellers responsible for their own negotiating become better negotiators. Put differently, why didn’t Laidlaw delay selling and find



**Phishing for Phools:
The Economics of
Manipulation and
Deception**

**By George A. Akerlof
and Robert J. Shiller**

**272 pp.; Princeton
University Press, 2015**

IN REVIEW

out why Organ wanted to buy so much?

The section “Regulator Heroes and the Question of Regulatory Capture” is revealing. Akerlof and Shiller review theories of regulatory capture and endorse a version dubbed “weak capture: there is influence by the Interests, but regulation does impose constraints and, on balance, serves the public good.” They admit that regulators can be “phished.” According to them, “The FDA leaves itself vulnerable to being phished by the companies it regulates by giving them five degrees of freedom in designing clinical trials and reporting the results.” The authors object to calls for deregulation “just because regulation has problems,” but they do not explain how to stop regulators from being phished.

During most of the previous century, according to Akerlof and Shiller, Americans assumed “that government, used effectively, can be genuinely beneficial.” That is no longer the case, in their view. Now people buy the “New Story” that markets are utopia and “government is the problem.” This tale that grips so many, the authors argue, “is itself a phish for phools.” They provide case studies to contrast markets and government.

“Our national system of Social Security,” Akerlof and Shiller state, “greatly reduces the poverty of the aged.” If the intended effect is to transfer income, it accomplishes that. But the job of an economist is to reveal unintended consequences. Akerlof and Shiller neglect to mention that demographic changes jeopardize the program. Instead they add, “Social Security thus goes a considerable distance in offsetting phishing for phools overspending.” That means that people who can’t “make a budget and stick to it” need not learn how; the government will tax others to take care of them. Dedicated economists would warn the public that Social Security induces workers to save less. Akerlof and Shiller instead offer this frivolous justification, “Older Americans can afford an occasional present to the grandchildren.”

Given their “more expansive view of the role of government,” they state, “Securities regulation is one of the most essential

government functions.” If so, one wonders why the Securities and Exchange Commission failed to expose Bernie Madoff. The authors’ answer is “budgetary deficiency.” They tell how Harry Markopolos, an independent financial investigator who first detected Madoff’s chicanery, tried for years to inform SEC officials that Madoff’s performance “defied the laws of finance,” but they couldn’t appreciate Markopolos’s sophisticated “quant” analysis. “This misunderstanding,” they write, “could have been cleared up if [the SEC meetings] had included someone with a background in finance.” But if SEC officials cannot find such a person on their staff, perhaps their “deficiency” is not a “budgetary” one.

That brings us to the authors’ third example of why so many are stupefied by the “New Story” that markets are good and government is bad. The U.S. Supreme Court decision *Citizens United* “explicitly denied the distinction between free speech by individuals and free speech by corporations.” Although Akerlof and Shiller assure us that free speech is “critical,” the reader should not be surprised that they waver: “But just as phishing for phools

yields a downside to free markets, similarly, it yields a downside to free speech.” They echo Justice John Paul Stevens, who argued that allowing corporations to speak freely enables them to influence whom we will vote for. In their view of the political process, Politician *A* votes to benefit Corporation *X*, which returns the favor with politically helpful speech. Their view is correct, so far as it goes, but they omit the role of competition, whereby Corporation *Y* or Nonprofit *Z* raises money to speak out against Politician *A*. And it misses the point that the way to stop Corporation *X* from wanting to give money to Politician *A* is to deny *A* so much authority to tax, spend, and regulate.

Akerlof and Shiller are likely to convince many readers that phishing is omnipresent. Their stories will help readers become savvier consumers and investors. If this reviewer’s understanding is correct, they will achieve their goal of incorporating a “phishing equilibrium” into economic theory when their “new variable,” which is “the story that people are telling themselves,” becomes the view that markets don’t work so well. Let’s hope markets prevail. R

Don’t Stop Me Before I Injure Myself

◆ REVIEW BY IKE BRANNON

When I began college at a school that had a pool with a newly constructed 10-meter diving platform, it seemed too good to be true. But when a couple of awkward leaps by some half-drunk freshmen resulted in concussions and trips to the emergency room, the school quickly made the high platform off-limits to everyone but the dive team.

The regular attendees of the Friday night open swim managed to find adequate thrills on the 5-meter platform by introducing a game that involved running off the lower platform and leaping to catch a football tossed from the deck. The new

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game also sent the occasional wounded student to the college health center, but we had learned not to tell them the cause of the injuries. In essence, we increased the degree of difficulty—and risk—to compensate for the lower height.

That, in a nutshell, is why we had the financial crisis.

And that, in turn, brings us to the new

book, *Foolproof*, by Greg Ip, reporter and columnist *par excellence* for the *Wall Street Journal*. Ip has written a magisterial and fascinating book on the role that moral hazard—assuming more risk when previous risk has been mitigated—plays in our lives and in particular how it affects financial markets.

Greenspan put / Moral hazard stinks. It seems like every time the government tries to make people's lives safer, we undo their munificence somehow. For some of us, this predilection manifests itself in stupid activities in a pool; for others it is risky investments.

It's not that we can't make the world safer. It's just that as we make it safer, we become inclined to take more risks, knowing that steps have been taken to protect us from ourselves. We see this sort of behavior everywhere. When I lived in Wisconsin, I

asked some softball teammates from the county sheriff's office to record the proportion of cars towed out of ditches in the next snowstorm that had four-wheel drive. They gleefully did this for an entire season and we discovered that fully 90 percent of the ditched cars had four-wheel drive, even though such vehicles made up well less than half of all vehicles on the road in the region.

While moral hazard—manifested here by people driving more aggressively with a safer car—can nudge us to take more risks in our lives, it can have an even more profound effect on financial markets. Perhaps the most famous example of this is the so-called “Greenspan put,” whereby stock market traders counted on Alan Greenspan and the Federal Reserve Board intervening with some sort of monetary stimulus whenever the stock market took a serious tumble.

Greenspan's successor as Fed chair, Ben Bernanke, saw the problems inher-

ent with the Federal Reserve having such a reputation. But by the time he assumed the reins there wasn't enough slack to fix the problem. Moral hazard was being compounded by the market, most famously by the giant global insurer AIG. The company's financial products division at the

time offered what was essentially insurance for a variety of financial products, most notably on the value of collateralized debt obligations (CDOs). Most of these were mortgage-backed securities.

Banks would sell the cash flow from the mortgages they issued, which would be packaged with various other mortgage payments from across the country and then resold to investors. By dint of these mortgages coming from all over the country, in places where real estate prices typically don't move together that much, the belief was that these things should not be all that risky. If home

prices fall in Michigan there's no reason to think they would simultaneously fall in Orlando. The very notion that we might see an economy-wide decline in real estate prices seemed absurd to most people at the time—such a thing had never happened before, after all.

And while geographic diversification might not remove all the risk inherent in such a product, insurance would theoretically do precisely that. AIG had developed a product to insure the value of CDOs, allowing investors to buy these mortgage-backed securities and be sure that they would hold their value—provided the insurance company makes good on its guarantees, at least.

And that's the rub: AIG woefully underestimated the risks inherent in these assets and criminally (perhaps literally, although the courts never concluded as much) underpriced the cost of the insurance. Investment banks went heavily into CDOs and leveraged up their bets to goose their returns, not caring whether the loans

underlying their securities were likely to be repaid. No one had any incentive to check that, it turned out.

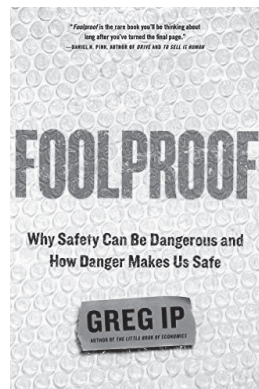
As a result, when real estate prices fell (not all that far in most of the country, truth be told) it caused the value of these investments to plummet. AIG couldn't make good on its insurance, as it hadn't set aside nearly enough to cover the guarantees. After that, as Ip points out, what befell the financial markets was simply a good old-fashioned bank run, as people rushed to get out and invest in something—anything—that was safe.

Too big to fail / Ultimately, the government stepped in and bailed out most—but not all—of the actors. Some entities—most notably Goldman Sachs, whose former chief executive was treasury secretary at the time—were made whole, while others—most notably the shareholders of AIG and Lehman Brothers—lost most or all of their investment.

Ip points out that the government didn't have much choice but to bail out the economy; letting the banks fail en masse and potentially destroying the global financial system simply wasn't a viable political choice. But bailing them out has sown the seeds for some future market crisis precisely because of the moral hazard engendered by the bailout.

Some of the most contentious parts of the 2010 Dodd-Frank Financial Reform Act try to address this specific problem. Notably, the legislation designates some large banks and insurance companies as being systematically important and makes them subject to stricter capital standards and enhanced regulations. In turn, the government seems poised to bail out these entities if they get in trouble once again. Few people seem happy about this, and the dissatisfaction doesn't break down neatly by party affiliation.

Some believe that the designated banks can use this implicit government backstop to improve the terms under which they borrow money. That, in turn, gives them an advantage over smaller banks. Because the large banks, which operate branches



Foolproof: Why Safety Can Be Dangerous and How Danger Makes Us Safe

By Greg Ip

336 pp.; Little, Brown, 2015

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all across America, tend to be somewhat reluctant to lend to places where they don't possess some inherent advantage, they're inclined to take deposits but not make loans in smaller communities.

On the insurance front, economists have pointed out that the very notion of a run on these companies is somewhat absurd given the nature of insurance. People with term life insurance don't have money in some account that they can simply yank out on a moment's notice; if they don't pay their premium next year, then they won't be insured and that's about the end of it. But what's left of AIG has to be, for political reasons, subject to enhanced standards, and it's a bit awkward if they're the only ones, so a couple other insurance companies join them.

Ip shows us how government's attempt to get us to behave in a way that comports with what might be deemed as in the best interest of society is often defeated by our rational self interest. If government makes things safer for us, we are inclined to take more risks. Foreclosing all avenues by which we can exploit this paternalistic behavior is neither possible nor necessarily desirable.

What Ip's tour through the wicked world of moral hazard teaches us is that our policymakers can do a much better job in anticipating how we will respond to their various edicts and not regulate under the assumption of some sort of behavioral stasis. This is easier said than done of course, and assumes a level of knowledge and capacity for acting in the public interest that may go beyond the ken of most government entities.

And coming up with the optimal regulations is not always in the self interest of the particular principal. I say this after witnessing more than one former government regulator grow prosperous by exploiting problems with the very regulatory structure he helped to create.

This isn't a unique story or even an unexpected one. It begs the regulator—and his ostensible boss, the politician—to act reluctantly, and only when absolutely necessary in the workaday world. R

Leviathan with a Human Face?

◆ REVIEW BY PIERRE LEMIEUX

It's tempting to view American history as linear: the Founding was a great victory for individual liberty, which endured for a while but then entered a long decline up to our days. But what to make of the treatment of blacks and American Indians during the "liberty" period? And so there is an alternative linear history that sees the Founding as only a first step, with liberty growing in subsequent eras, through our still-imperfect but more glorious times. As we see in Gary Gerstle's new book *Liberty and Coercion*, matters are more complicated.

Gerstle, a professor of history at the University of Cambridge, traces the evolution of liberty and coercion in America. He illuminates a troubling paradox of American government: the Revolution and the Constitution produced both a limited central government along classical-liberal lines, and "miniature Leviathans" at the state level. Liberty was supposed to be protected by federalism and the Bill of Rights at the national level, and by democracy at the state level. "Liberty and coercion," he writes, "were bound together from the earliest days of the republic." He then tries to explain how, over time, the small central government crushed states' rights and evolved into a big Leviathan.

The book contains much of interest to constitutional scholars, but also to students of economics and political philosophy.

Leviathan in D.C. / The Bill of Rights constrained the federal government in how it could treat individuals. But, over James Madison's objection, its constraints were not extended to the states, an interpretation confirmed by the U.S. Supreme Court in 1833. Instead, the states held the "police power" they inherited from British law:

Under England's public police doctrine, the king had not only the right

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but also the obligation to bring order and welfare into his kingdom. ... Like the authority that inhered in the eighteenth-century English king, the powers held by nineteenth-century American states were broad, capacious, and vaguely defined.

This police power "authorized state governments to act against anybody or any institution thought to offend public order or comity, as determined by democratic majorities," and "allowed state governments to engage in extensive regulation of the economy, society, and morality." Thomas Jefferson thought that a civic democracy of yeomen farmers would guarantee liberty at the state level; it did not work out that way.

With all their power, the states were able not only to enforce slavery in the South but also, everywhere, to control education, social welfare, family life and morality, to minutely regulate businesses, to limit free speech, to favor certain religions, and to negate due process. In 1853, for example, the overseer of the poor in Maine indefinitely committed to a work house a mother and her daughter deemed to be paupers and "living a dissolute, vagrant life"; the accused had no trial and no opportunity to defend themselves.

Widespread patronage and corruption developed, and would soon engulf the federal government too.

Much of the states' powers survived the Civil War. In the South, the states enforced apartheid. The prohibition of interracial marriages subsisted until the 1960s. Restrictions on free speech illustrated the con-

tinuing power of the miniature Leviathans. At the beginning of the 20th century, for example, a Denver editor was charged in state court with criticizing the Colorado judiciary, and his condemnation was maintained by the Supreme Court. Not until 1931 did the Supreme Court strike down a state law infringing freedom of speech.

Fortunately, state governments were not very efficient. And the exit option always existed. Some states were better than others, although Gerstle suggests only marginally.

Federal Leviathan / Contrary to the states, the central government was largely a “liberal institution in the classical sense of that term,” but it had become “democratically convulsive” by the time of Jacksonian democracy. It then took more than a century for the central government to impose liberalism on the states, but the meaning of liberalism changed in the process: from defending negative liberty (the freedom to be left alone) it came to mean the promotion of positive liberty (the right to force others to serve oneself). A large federal Leviathan appropriated the states’ police power and replaced the miniature Leviathans.

One step in this substitution was the ratification in 1868 of the 14th Amendment: “No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States ... [or] deprive any person of life, liberty, or property, without due process of law.” The amendment came to be interpreted as incorporating the federal Bill of Rights in the states’ internal affairs.

The federal government gradually broke its constitutionally imposed limits in a long and convoluted process that culminated in the New Deal and, later, the “Great Society.” The process largely consisted in extending the original mean-

ing of the federal powers enumerated in the Constitution, such as regulating interstate commerce or supervising the mail. Talk about slippery slopes! The history of this usurpation, of “the creativity of a constrained central state in circumventing the formal limits on its power” is a fascinating aspect of *Liberty and Coercion*.

Brilliant improvisation / Usurpation? Gerstle probably does not think that way, or at least this is not how his publisher encourages readers to think about the book. According to the Princeton University Press, “In *Liberty and Coercion*, Gerstle shows how national political leaders improvised brilliantly to stretch the power of the federal government beyond where it was meant to go.” Perhaps the “brilliantly” is just marketing talk, or perhaps it reveals something that is not so obvious in the book.

Gerstle certainly shows sympathy for the “social” Leviathan, but he is more critical of another process by which the federal government became Leviathan: through permanent wars and their national security requirements. This thread runs through the Indian wars, the Civil War, the two world wars, the Cold War, and today’s boundless War on Terror. It seems that the Constitution is suspended in times of war.

World War I brought the Seditious Act (among other lib-
erticidal legislation) under which Eugene Debs, leader of the Socialist Party, was condemned to 10 years in jail for merely criticizing the government’s decision to go to war. With the approval of the authorities, the American Protective Association organized raids to search for draft dodgers.

The 1940 Alien Registration Act (also known as the Smith Act) was soon used to prosecute and convict American citizens charged with the crime of being Marxist-Leninists. The economic controls established during World War II greatly embold-

ened the *dirigiste* central state.

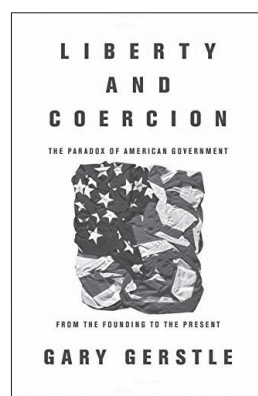
One striking point of *Liberty and Coercion* is how the Cold War fueled the American Leviathan. It justified the growth of the FBI and the federal surveillance apparatus. Dissidents or even non-dissidents deemed communists were harassed. The Cold War motivated the McCarthyist witch-hunt. It also justified the federal government’s maintaining the large income tax base that had been imposed during World War II, including the system of tax deduction at source by employers, thus enabling the growing warfare and welfare state.

The current War on Terror is another attack upon our liberties. The U.S. response to the September 11, 2001 terrorist attacks, Gerstle writes, “entailed keeping the nation on a war footing indefinitely.”

Leviathan’s dangers / There are a few problems with the book, which revolve around Gerstle’s presumption in favor of positive liberty and his opinion that the federal Leviathan was necessary after all.

He recognizes that the distinction between negative and positive liberty marks the difference between classical liberalism and today’s American “liberalism.” But he does not recognize that the federal government did not need to grow into a Leviathan to impose the Bill of Rights on the states. The protection of negative liberty would not have required the monstrous federal machine that emerged after the 19th century. Fighting the Soviet “evil empire” did not require—indeed, was inconsistent with—metamorphosing American society into an evil empire with a human face. Preventing public discrimination (in southern public schools, for example)—a very laudable goal—would not have required all the power that was necessary to ban all sorts of private discrimination (in commerce, employment, etc.).

Gerstle does not see clearly what separates the public and the private. Another example: he does not seem to understand that when the state co-opts private associations or corporations to do its bidding, any resulting blame for their actions should go to the state, not to “privatization.” By



**Liberty and Coercion:
The Paradox of
American Government**

By Gary Gerstle
472 pp.; Princeton
University Press, 2015

IN REVIEW

itself, the American way of producing public goods through voluntary associations is not to be blamed but to be lauded.

When the federal state used private cronies to build the intercontinental railroad, the problem was with government action and corruptibility, not the private interests that took the bait. The same distinction can be applied to the federal government using temperance leagues as spies and the American Protective League as an unofficial police force. Another example of the corruption of the private by the public occurred when the U.S. Department of Agriculture sponsored the American Farm Bureau Federation, which in turn, starting in the 1920s, lobbied government on behalf of farmers.

Everything is ultimately private—that is, done by individuals pursuing their own interests, outside or inside political institutions. The problem is not in the private interests, but in the frequent incapacity of social and political institutions to channel those interests toward the general welfare. When there is much to receive from government, private interests are diverted to government corruption, illegal or legal. Gerstle ignores this approach, brought to light by public choice theory during the second half of the 20th century.

He repeatedly argues that the lack of public financing for election campaigns has led to special—read “corporate”—interests buying elections and to the rise of the parties’ political machines. (His history of these machines is fascinating.) But he does not mention that public financing would not solve the problem if not accompanied by limits on private financing—that is, by restrictions on free speech. And again, he does not seem to understand that so much is invested in elections because the rewards are so high and Leviathan is so rich and powerful.

Economics is not Gerstle’s strong point. He speaks of “chaotic and often-ruinous capitalism.” He sees employees as impotent and employers as omnipotent, as if the latter did not need the former as much as the reverse. It seems obvious to him that free markets lead to worker “exploitation” and “power differentials between capital and labor,” that government is necessary

to cure recessions, that “the affluence that would have come to characterize broad sections of the working class by the 1950s ... would not have taken place without central state intervention,” that “the startling increases in federal government’s regulatory reach brought order and prosperity to ... agriculture and labor,” and that the “freeing” (he puts the term in quotation marks, perhaps not for the right reason) of finance led to the 2008–2009 recession, without even once mentioning Leviathan’s housing policy. He seems to believe that the “public interest” is an easily defined and obvious goal in “managing the capitalist economy.” At the very least, he could have mentioned that all these statements are economically very debatable. And he makes other economic blunders.

He does interpret some economic facts correctly. He observes that the New Deal’s agricultural policies hurt landless agricultural workers and tenants, coming close to public choice analysis when he writes, “The case of farmers underscores how much the pursuit of government privileges by advantaged or relatively advantaged economic groups fueled the growth of government power in America, even during the headiest day of the New Deal.” But he does not grasp all the implications of those observations.

Gerstle does not understand that a loving Leviathan is as dangerous as a warring one. It is true, for example, that the militarization of the police has benefited from military surpluses, but the immediate cause has been the very domestic war on drugs, which has been a war waged on U.S. consumers by a paternalistic Leviathan.

Other problems / It is difficult to disentangle Gerstle’s values from his muddled economics. He is a careful scholar, but he sometimes betrays his politics. Although “reproduction rights” are mentioned, nowhere does *Liberty and Coercion* mention the Second Amendment, even when summarizing the rights guaranteed by the Bill of Rights. He is blind to the elaborated and detailed surveillance that has hit financial transactions since the 1970s.

He does not like laissez-faire, except in

speech, sexual, and privacy matters. Perhaps he doesn’t understand how liberty in personal matters and laissez-faire in “economic” matters are intimately related. Yet he himself gives a good example of this interrelation when he notes that, after the Civil War, state laws obliged railroad companies to provide segregated cars, implying that the companies might have otherwise responded to considerations of demand and cost. Protecting “social” liberties requires guaranteeing economic freedom.

Perhaps because he honestly struggles with the consequences of a good Leviathan, Gerstle is not always consistent. “Today,” he writes, “the split between Democrats and Republicans about the proper scope of government constitutes a nearly unbridgeable divide.” At other places he suggests more correctly that the two parties have come to embrace Leviathan. He seems to admit that the “conservative revolt” of the late 1970s and 1980s did not change much.

He rightly criticizes conservatives, who feed Leviathan with their own pet preferences for law-and-order, war-mongering, and surveillance. Strangely, however, he also states that “they are the truest of eighteenth-century liberals.”

Libertarians, Gerstle admits, are more consistent: they are “no more favorably disposed to the power of the states than to that of the central government.” This is true. They also view with high suspicion, if not outward contempt, the notion of “sovereignty” at whatever level. Federalism is a means—an important means but still only a means—of protecting liberty. Liberty—individual liberty in the classical liberal sense—is the ultimate value to defend in all areas of social life.

The author of *Liberty and Coercion* perceptively detects a paradox in today’s American politics—a paradox also observable in other democratic countries. Americans want the government to get off their backs and, at the same time, to provide them with more services and privileges. In Gerstle’s perspective, the solution to the paradox would be for citizens to come to terms with the necessary burden of Leviathan and enjoy life with the positive

liberty that government gives them. But this is an illusion. Even without waging foreign wars, even when smiling, Leviathan is dangerous.

In his book *The State* (Liberty Fund, 1985, 1998), Anthony de Jasay developed a model of government that is more realistic than Gerstle's good Leviathan. The more the state intervenes, de Jasay argues, the more individuals will feel its burden, and the more they will ask for compensating privileges. If government subsidizes corporations, why shouldn't the laborers ask the same benevolent institution to protect their jobs and salaries? If race and religion are protected against private discrimination, why shouldn't injunctions be imposed for the benefit of other groups? Political parties (even if they were, in an ideal Gerstlian world, financed by all taxpayers) will compete to answer these many and conflicting demands. As Leviathan grows, everyone wants more compensat-

ing privileges and everyone is less and less happy with government's performance.

The result, de Jasay suggests, will be the Plantation State, where the state owns everything and everyone, becomes the source of all happiness, and totally controls its unhappy and ungrateful subjects. A good Leviathan does not exist.

On this sort of larger issue, *Liberty and Coercion* is silent. In a sense, this is understandable because it is a history book—and a very good history book at that. But Gerstle does more than history. He proposes or suggests justifications for liberty and coercion in America. And he tends to assume *à la* Hobbes that Leviathan is necessary to protect liberty. His Leviathan with a human face is, however, neither feasible nor desirable.

At this juncture, he may point to a sentence in his last chapter: "America still has its Leviathan, but in domestic matters, it is an institution besieged." How is that? As Gerstle himself writes in the book's conclu-

sion, "The federal government grew from a small institution with limited powers into a Leviathan with influence across numerous areas of American life." And "numerous areas" must be an understatement.

Any lover of individual liberty must be happy that some negative liberties—free speech, interracial marriage, sexual preferences, and some procedural rights—have gradually become better protected over the past century or so. I would add that, in the last decade or so, the right to keep and bear arms has also been better recognized and protected, although some state governments still resist.

Leviathan that gives can also take away. If Gerstle were more conscious of the danger of Leviathan, he would agree that the only way to preserve both federalism and states' rights on the one hand, and the promises of liberty in the Bill of Rights on the other, is to return to a classical-liberal or libertarian conception of liberty. R

Working Papers

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

Prescription Drugs

"Is the FDA Too Conservative or Too Aggressive? A Bayesian Decision Analysis of Clinical Trial Design," by Vahid Montazerhodjat and Andrew W. Lo. August 2015. SSRN #2641547.

Conservative and libertarian critics of the U.S. Food and Drug Administration often argue for "compassionate access" to experimental drugs. Under such access, severely ill patients can receive experimental drugs that have shown no deleterious effects in their initial Phase I "safety" trials, but that haven't completed further trials of safety and efficacy. (See "Breaking the FDA Monopoly," Summer 2004, and "Regulation Overdose" [book review], Summer 2010.)

Critics of this access, such as prominent bioethicist and oncologist Ezekiel Emanuel, point out that many safety issues are not discovered in Phase I trials. (See "Cancer in the Courts," *New Republic*, July 3, 2006.) Many forget that the drug Thalidomide, which caused the birth defects that led to the 1962 Food and Drug Act amendments requiring not only safety but efficacy testing before FDA approval, had already undergone Phase I safety trials.

According to Emanuel, another problem with compassionate access is that it would impede broader trials of a drug's safety and

efficacy. For instance, in the late 1980s many oncologists believed that bone marrow transplants could treat metastatic breast cancer. Because of political pressure, an allowance for compassionate access was created and 20,000 women received marrow transplants outside of the clinical trials. Because of that access, it took many years to gather 1,000 women who agreed to participate in a proper clinical trial of the treatment. The trial results demonstrated that the transplants were not effective relative to standard chemotherapy, which meant that as a result of the compassionate access, thousands of women suffered through a painful, grueling, unnecessary treatment that cost millions of dollars.

Both proponents and critics of compassionate access frame the issue in a binary way: compassionate access either should or shouldn't be allowed. Economists often eschew such "yes/no" policies in favor of policies that vary with costs and benefits. In the case of experimental drugs, the costs and benefits would involve false positive (Type-I) and false negative (Type-II) inference errors about the true effects of a drug on disease and health. This paper outlines a practical policy toward experimental drug access that addresses the Type-I/Type-II error issue.

The paper's premise is that the costs and benefits of Type-I and Type-II error avoidance vary with the disease context. For example, the five-year survival rate for pancreatic cancer is 1 percent, so

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patients with the disease are worried much less about Type-I efficacy errors with the experimental drug than they are about the effects of the illness. Thus, the current FDA tendency to avoid Type-I errors (approving drugs that don't work or have too many side effects) creates too many Type-II errors (rejecting effective drugs).

In general, for deadly diseases, Type-II error costs are larger than Type-I error costs—the value of lives saved offsets the costs of some false positives. For mild diseases the opposite is true: Type-I error costs are larger than Type-II error costs. In both cases, the costs are proportional to the size of the relevant populations.

The authors use mortality rates and years lived with disability to adjust the usual sample size and confidence level requirements for trials to create their Bayesian-adjusted equivalents. The more severe the mortality and disability consequences of the disease, the less confident we need to be of a drug's efficacy and safety in order to allow approval.

Trials currently require a difference in results between experimental and control patients that exceeds 1.96 standard deviations of the mean (that is, keep false positive errors to below 5 percent). In their framework, taking into account the deadliness of the disease, a difference of only 0.587 standard deviations (which keeps Type-I errors to below 56 percent) should be required for approval of a pancreatic cancer drug.

The framework of this paper operationalizes the intuition behind both sides of the debate. It reduces the hurdles for drug approval for diseases that have severe mortality or disability consequences that affect large numbers of people and increases the hurdles for those diseases with the opposite characteristics.

—Peter Van Doren, *Cato Institute*

Curfews and Crime

“Keep the Kids Inside? Juvenile Curfews and Urban Gun Violence,” by Jillian B. Carr and Jennifer L. Doleac. December 2015. SSRN #2486903.

Washington, D.C. uses outdoor audio sensor technology to detect gunfire incidents in four of the city's high-crime police precincts. Washington also has a curfew for people under age 17, which begins at 11 p.m. on weeknights from September to June, and at midnight on all other nights of the year. In this paper, the researchers use the sensor data and the exogenous one-hour difference in curfew times on weeknights to determine if the curfew is having a beneficial effect.

Curfews are premised on the idea that preventing nighttime interactions between youths will prevent violence. But there is a concern that curfews may have a perverse effect: by taking law-abiding youths off the streets, lawmakers may also take away “eyes” and “ears” that would discourage violence, as Jane Jacobs noted in her 1961 book, *The Death and Life of Great American Cities* (Random House).

The study's authors conclude that gunfire *increases* in the weeknight 11 p.m. to midnight hour from September through June

relative to the same hour during the summer. Thus the curfew costs lives rather than saves them.

How many lives are lost? Approximately seven additional gunfire incidents per week occur in that hour across the four monitored police districts. The literature suggests that one additional gunfire incident results in 0.0048 additional homicides. If one statistical life is valued at \$9 million, each gunfire incident results in around \$43,000 in costs. Thus, seven additional incidents per week for 45 weeks a year result in around \$13.5 million dollars in social costs accounting only for homicides.

—Peter Van Doren, *Cato Institute*

Auto Safety

“The Transformation of Automobile Safety Regulation: Bureaucratic Adaptation to Legal Culture,” by Jerry L. Mashaw and David L. Harfst. December 2015. SSRN #2703370.

Concise narrative histories of regulatory agencies are rare and invaluable. In 1990, Jerry Mashaw and David Harfst wrote *The Struggle for Auto Safety* (Harvard University Press) about the first 15 years of federal auto safety regulation following the 1966 unanimous approval by Congress of the National Traffic and Motor Vehicle Safety Act. This paper extends that history to the present.

The law's passage followed the publication of Ralph Nader's book *Unsafe at Any Speed* (Grossman Publishers) the previous fall. The premise of both the book and the law was that the market for vehicle safety failed and government regulation was necessary to force manufacturers to provide technical modifications to cars that reduce the injury and fatality rate from accidents.

In the first years of its existence, the federal auto safety agency (now called the National Highway Traffic Safety Administration [NHTSA]) attempted to live up to that premise. But the statute required that the agency's regulations be “reasonable,” “practicable,” and “objective.” Citing those requirements, car manufacturers sued to block the regulations, and between 1968 and 1978 they won six of the 10 cases litigated over the rules.

One of those cases (won by the manufacturers in 1972) was the passive restraint rule requiring manufacturers to install airbags. One provision of that rule prevented engine start unless the driver and front-passenger seatbelts were fastened. The courts left that provision intact, and NHTSA implemented it in 1974. Immediately, the agency and lawmakers were beset with public backlash. Acting with unusual haste, Congress repealed the interlock requirement that November, and even forbid NHTSA from requiring a warning light or sound lasting longer than 8 seconds indicating seatbelt non-use.

The agency responded to those setbacks and the subsequent regulation-skeptical Reagan administration by, first, passing no new rules at all, and then by issuing rules that mandated safety devices that the industry was adopting anyway. In a 2015 report on lives saved by NHTSA rules issued after the early 2000s, the

agency concluded that four of those eight major rules had effective dates that were *after* the median new car already was equipped with the mandated device.

The lack of regulatory activity didn't mean NHTSA was doing nothing about vehicle safety. Instead, it began issuing recalls for vehicles it deemed to have safety defects. NHTSA had realized that, though the evidence required for the issuance of defensible safety rules is high, the evidence required for recalls is light. Car makers are loath to publicly fight recalls because such fights hurt brand image and market share.

But recalls do little to improve aggregate auto safety because most accidents are the result of driver error rather than vehicle defects. A 2008 U.S. Department of Transportation report to Congress found that vehicle defects or failure accounted for only 2.4 percent of accidents, while driver error accounted for over 95 percent. According to the authors,

The efficacy of the recall program is mysterious and dubious. Yet, if anything, Congress and the public seem to want more aggressive recall activity, not less. NHTSA is happy to oblige.

Mashaw and Harfst conclude that the premise of the 1966 legislation (and industry opposition to it) was that safety does not sell and that Congress must compel auto manufacturers to provide it. But, they decide, "there does now appear to be something resembling a private market for safety, and industry is supplying it." And NHTSA codifies what they are supplying.

—Peter Van Doren, *Cato Institute*

Fiscal Rules

"Can Fiscal Rules Constrain the Size of Government? An Analysis of the 'Crown Jewel' of Tax and Expenditure Limitations," by Paul Eliason and Byron Lutz. Federal Reserve working paper, February 2016.

In the battle to rein in government spending, the Colorado Taxpayer Bill of Rights (TABOR) seemed to be a rare panacea. The rule, passed in the early 1990s, limited the state government's spending growth to the combined rate of inflation and population growth. If revenue increased beyond that rate—which could occur, for instance, if economic growth were to concomitantly boost incomes and tax revenue—then the surplus funds would be returned to taxpayers. The state's apparently salutary budget health in the early 2000s was attributed to TABOR, and then-governor Bill Owens briefly became the poster child for the libertarian small-government crowd.

However, a closer look at Colorado's budget since TABOR's passage reveals that it has not caused the state to behave any differently than similar states, according to a new working paper by Paul Eliason of Duke University and Byron Lutz of the Federal Reserve Board. Instead, the salutary view of TABOR stumbles on two serious problems.

The first is that Colorado can suspend TABOR temporarily.

The state has done this several times, especially in the last decade. It remains a truism that it's impossible for legislation to tie the hands of future lawmakers.

The second problem is that it is unclear what is the counterfactual—that is, what would Colorado have done if there were no TABOR? Simply comparing it to nearby states is deceiving: by dint of its major metropolitan area in Denver and the state's relatively well-educated and wealthy populace, it does not make sense to compare its budgets to neighboring states. Economically speaking, Colorado has little in common with Wyoming, New Mexico, or Utah. Neither does it make sense to compare it to any of the coastal states, which have economies substantially different than Colorado's.

To carry out their analysis, Eliason and Lutz cleverly create a synthetic state—a complex combination of states that have the most in common with Colorado—and compare Colorado to the synthetic state's tax and spending evolution over the years immediately before and after TABOR.

What they find is that there is no discernible difference between Colorado's actual spending patterns and its synthetic, unconstrained cousin. In short, they argue, Colorado did show a modicum of budget restraint at some point, but it didn't last all that long and it merely reflected the preference of the populace, manifested in the government it elected.

The reality is that budget gimmicks are not the answer to controlling government. There is simply no substitute for an informed populace that uses the ballot box to show its preference for limited government.

—Ike Brannon, *Cato Institute*

Tax Breaks for the Elderly

"Do Tax Breaks for the Elderly Promote Economic Growth?" by Ben Brewer, Karen Smith Conway, and Jonathan Rork. University of New Hampshire working paper, April 2016.

States compete on taxes in myriad ways. Several states do not have an income tax. Others have reduced taxes on businesses large and small. (Kansas has gone so far as to have abolished small businesses taxes two years ago.) And, of course, states offer a wide variety of tax breaks with the intent of luring specific industries or businesses to locate or remain in their realm.

But many states also compete for senior citizens by offering a lower tax rate for pension income. How states do this varies greatly. Some exempt military pension income from the state income tax altogether. Others offer tax breaks for public employee pensions and Social Security benefits as well. Still others give tax breaks for all pension income, whether public or private.

The rationale for this is that senior citizens don't place much of a demand on state services—their children are usually done with public schools, for instance—so having seniors around costs the state relatively little. The authors of this working paper acknowledge that fiscal tradeoff, but they suspect there's little reason to

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believe that retirees are influenced all that much by the tax breaks. Many retirees are unwilling to trade that home state—where their friends, relatives, and grandkids are abundant—for a neighboring state just to save a few grand a year. And the retirees who do move often “snowbird” in Florida for just six months (and one day, of course, to qualify as residents) and then return to their home states.

Or so the authors thought. The reality, they found, is that lower tax rates on retiree income do boost a state’s economic growth. Why this is so remains a mystery to the authors: they do find that taxes on lower-income workers seem to matter the most to seniors, so it’s tempting to construct some sort of Keynesian aggregate-demand story to explain the higher economic growth. However, if fiscal stimulus spending can’t explain sustained higher growth rates in an economy, then it seems unlikely that lower tax rates on seniors would do so.

I have an alternative hypothesis that’s broadly consistent with their data. Hundreds of communities across the country are chasing prospective “angel investors”: wealthy folks (but not exorbitantly so; think of a developer in a small city who sold the business for \$15 million when he hit 60). These folks are not quite ready to retire, but they’ve wisely cashed out on their career. Yet they still have a desire to chase one or two more “big ideas.” They won’t risk their entire nest egg, but if they find something promising, they’ll be tempted to throw some savings at it, along with their personal

attention and skills. And the place they’d want to do this isn’t Florida, but their hometowns, where they’ve lived for decades.

Suppose these potential angels already snowbird, returning home in the summer to see the grandkids. They’re less inclined to try a business idea if they’re only going to be in-state for less than half of the year. But if their home states adopt senior-friendly tax cuts, the Florida retirement village may no longer seem so inviting. Sure, they’ll still go south to skip the worst of the winter, but they’ll spend more time back home, where they’ll be more inclined to try that startup and give it a decade to see if it flies. And if it does (or even if it doesn’t), they might then be inclined to try another idea.

Ohio Gov. John Kasich (R) offered this idea to support tax breaks implemented in Ohio in 2011, and there’s some evidence that it’s working. It is, of course, a controversial idea that, for what it’s worth, the AARP rejected vehemently when the breaks were first proposed, precisely because they mainly benefited upper-income seniors. (Perhaps those folks are less likely to join the organization?)

It is worth noting that the working paper authors didn’t expect to find that retiree tax rates significantly affected economic growth. But to their credit they behaved like real scientists, did yeoman’s work in discerning the robustness of their result (very), and then set forth trying to explain it—and not explain it away.

This is fertile ground for much more research.

—*Ike Brannon, Cato Institute*



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