

IN REVIEW

Saving Capitalism from Robert Reich

REVIEW BY DAVID R. HENDERSON

Robert Reich, a former U.S. secretary of labor under President Bill Clinton and now a professor of public policy at the University of California, Berkeley's Goldman School of Public Policy, has written a book whose title suggests that he wants to save capitalism. Well, not quite.

The good news is that *Saving Capitalism* is nothing like *Locked in the Cabinet*, his earlier memoir about being labor secretary, in which he literally made up stories that made himself look good, as reported by Jonathan Rauch in his *Slate* review, "Robert Reich, Quote Doctor," (May 30, 1997). In the new book, Reich starts by making an important—probably correct—point and, to his credit, documents virtually all of his empirical assertions with checkable citations. But some of his most important empirical claims are wrong, he has a peculiar sense of what is a large amount of wealth and what is a small amount, and one of his claims shows a basic misunderstanding of wealth accumulation.

Government and free markets / Reich starts by decrying the way so many arguments about government economic policy quickly degenerate into whether the free market "is better at doing something than government." In his view, that makes no sense because, he argues, "There can be no 'free market' without government." The free market, he writes, "does not exist in the wilds beyond the reach of civilization." That's true. But according to Reich, civilization is created by government because government "generates the rules." Yet there were many historical instances in which civilized rules were generated without government. Economist

Edward P. Stringham has written about some of these cases in his recent book, *Private Governance: Creating Order in Economic and Social Life*. And, of course, centuries ago there was the *Lex Mercatoria*, the Merchant Law, which businesses created and enforced in Europe, completely separate from any government.

But maybe we shouldn't throw out Reich's baby with the bath water. He argues correctly, for example, that copyright law, patent law, and bankruptcy law are government creations and that they could be set up differently. He points out that much wealth in the U.S. economy consists of intellectual property. Without patent and copyright law, that property would be worth much less. For instance, in 1998, Congress passed the Copyright Term Extension Act, giving corporations a copyright for 95 years after the date of creation. For obvious reasons, wags at the time called it the Mickey Mouse Extension Act. One cannot argue that this extension was needed to give people an incentive to produce what had already been produced.

Whatever the optimal length of a copyright is, I'm fairly confident that it is well below 95 years. But the bigger-picture point is that Reich is right that these rules, which many free-market economists like me favor, are government-made. For that

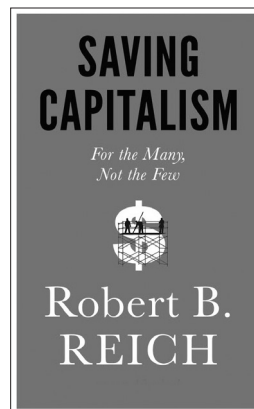
reason, in fact, some free-market economists go so far as to oppose patent and copyright as unjustified government-created monopolies, and they make a stronger case for that policy than you might think.

Some serious problems / Unfortunately, this is the high point of the book. The rest of it reads like one of the standard books that "progressives" write advocating heavy government regulation of human affairs. And Reich's case is about as unconvincing as the cases made by others for those same or similar interventions. It's impossible, in a short review, to cover all of his arguments for all of his regulations, so I will single out five of the most important.

One of his biggest objections is to the 2010 U.S. Supreme Court decision in *Citizens United v. Federal Election Commission*. Citizens United is an incorporated nonprofit political group that released a

movie criticizing Hillary Clinton when she was running for the Democratic presidential nomination in 2008. That violated the McCain-Feingold Act of 2002, which forbade such actions for the period just before an election. The Supreme Court found for Citizens United. One of the majority's arguments was that just as media corporations such as the *New York Times* are free to advocate the election or defeat of a federal candidate, other corporations should have this same freedom.

Reich does not deal with that argument. Instead, he writes, "As a practical matter, freedom of speech is the freedom to be heard, and most citizens' freedom to be heard is reduced when those who have the deepest pockets get the loudest voice." Actually, freedom of speech is *not* the freedom to be heard; it's—as the term implies—the freedom to speak. There is no guarantee, nor should there be, that you will be heard. Moreover, the *New York Times* is heard, or



Saving Capitalism: For the Many, Not the Few

By Robert B. Reich

279 pp.; Alfred A. Knopf, 2015

read, more than I am. Without the *New York Times* around, my work might be read a little more. Reich's reasoning, taken all the way, would argue for prohibition or at least regulation of the *New York Times*.

In his discussion of antitrust laws, Reich contradicts himself in the space of a page. He criticizes—correctly, in my view—Amazon's successful urging of President Obama's Justice Department “to sue five major publishers and Apple for illegally colluding to raise the price of e-books.” Just two paragraphs later, he complains that “the new monopolists have enough influence to keep antitrust at bay.” But his own example shows that Amazon did *not* keep antitrust at bay, but *used* antitrust to go after competitors. So, apparently for Reich, antitrust is good except when it's not.

At places in the book, he makes one wonder if he understands the importance of incentives. Consider his discussion of student loans. Former students are “laden with student debt,” he writes. He mentions that in 2014, student loans were a whopping “10 percent of all debt in the United States.” He then writes, “But the bankruptcy code does not allow student loan debts to be worked out under its protection.” The “but” makes no sense. It's precisely the fact that student loans cannot be discharged in bankruptcy that gives lenders an incentive to make such loans, causing the loans to be such a big percent of all debt.

Reich advocates letting students use bankruptcy to get out of loans that “were made to attend schools whose students have low rates of employment after graduating.” That would create a huge incentive problem: students would have even less incentive than they do now to get into schools and/or majors that give them a good shot at a job. On the other hand, maybe his proposal is not so bad. Lenders would respond by charging huge interest rates for students in such situations, and maybe students would get the market-induced hint.

Reich has long advocated a high minimum wage, and in this book he calls for

raising it to half the median wage. How does he handle many economists' concern that a high minimum wage would destroy job opportunities for people with the fewest skills? He cites work by economists who have found little negative effect of minimum wage increases to levels well below that which he advocates. Interestingly, California Gov. Jerry Brown recently signed a law that will raise the minimum wage to about 69 percent of the median by 2022, considerably *above* what Reich advocates. It will be interesting to see if Reich opposes such a move.

In response to a claim that many poor Americans do not work hard, he claims that, au contraire, they do. He writes, “The

Reich says that he wants to save capitalism for the many, and he may believe that. But to save capitalism we need to eschew most of what he proposes.

reality is that America's poor work diligently, often more than 40 hours a week, sometimes in two or more jobs.” But the U.S. Bureau of Labor Statistics study he cites to back that claim is not of the poor, but of the “working poor.” It's not surprising that the working poor work, but that says little about the work habits of poor people in general.

The data on how much poor people work are not hard to find. According to the U.S. Census Bureau, in 2013, 61.5 percent of households in the bottom fifth of the income distribution (and that would include all poor households because they are about 70 percent of the bottom fifth) had no one working at any time during the year, even at a part-time job. Only 13.4 percent of households in the bottom fifth had someone working a full-time job for more than 27 weeks.

Reich does give some news that most Americans would welcome, though he does not: in order to get certain kinds of government aid—in particular, the Earned Income Tax Credit—one must

work. He comments, “In effect, the new work requirements have merely reduced the number of poor people who are jobless, while increasing the number of poor people who have jobs.” It's unclear why he thinks it's bad for poor people to get jobs.

In a paragraph about Bank of America's \$16.65 billion 2014 settlement with the federal government over practices connected to the previous decade's housing bust, he shows a peculiar sense of what a big number is. That settlement, he writes, “paled in comparison to the bank's earnings.” And what were those earnings? In 2013, he writes, they were \$17 billion. So \$16.65 billion pales in comparison with \$17 billion? It's 98% of \$17 billion. If Reich

were making \$300,000 a year and the government forced him to pay a fine of \$294,000, would he think the fine “paled in comparison” to his pre-tax income?

One of Reich's important empirical claims

about wealth betrays a misunderstanding of how wealth is accumulated. See if you can spot it: Referring to a 2013 poll of Americans with more than \$3 million of investable assets, Reich writes:

Nearly three-quarters of those over age 69 and a majority of boomers just below them are the first in their generation to accumulate significant wealth. For the rich under the age of 35, however, inherited wealth is more common.

Of course, it's more common. *Accumulating* wealth takes time. So, naturally, the ones who have great wealth at age 35 are necessarily more likely to have inherited it. I'm a good example. When I was 35 and my wife was 36, our combined net worth, including all our IRAs, was about \$20,000. If I continue working full-time until age 69, our investable assets should be about \$1.5 million. That's what a 30-plus year stretch of saving and investing does.

Conclusion / Reich says that he wants to save capitalism for the many. He may genu-

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inely believe that. But he has two problems.

First, he rarely if ever notes the regulations that keep the fruits of capitalism from the many. Consider housing. He tells how his modest-income parents were able to buy a house in the 1950s. Left unsaid but implicit is that it's much harder now, especially—as he well knows—in coastal California. But why? Could it have something to do with restrictions on building houses? Harvard's Edward Glaeser and Wharton's Joseph Gyourko have shown

that a huge part of the premium for houses in high-priced areas is due to restrictions on building ("Zoning's Steep Price," Fall 2002). But Reich says not a word about such restrictions.

Second, the various regulations that he advocates would make economic growth even more tepid than it is now, making it even harder for the many to rise. We do need to save capitalism for the many, not just the few. And to do that, we need to eschew most of what Reich proposes. **R**

This is the difference between the revenue the IRS is permitted to collect by law and what it actually collects. The authors note the Tax Gap is roughly \$450 billion—that is, clever (or deceptive) accounting results in nearly a half-trillion-dollar underpayment. Why should the average taxpayer care about the IRS's Tax Gap? For one, it creates a social cost of inequitable tax burdens among some taxpayers; those with more creative accountants and lobbyists tend to help create the gap.

Finally, there are the economic costs of a broken tax system. Again, estimates here vary wildly, between \$148 billion and \$609 billion. As former Supreme Court Chief Justice John Marshall noted some 200 years ago, "The power to tax is the power to destroy." Taxes simply increase the cost of doing business, from buying materials to paying for labor. The wide range for these economic costs derives from the studies over the years trying to find an appropriate figure. On the low-end, Sören Blomquist and Laurent Simula estimated in a 2010 paper the deadweight loss of tax compliance at \$148 billion, after accounting for income, payroll, and state income taxes. At the other end, Martin Feldstein estimated \$609 billion in deadweight losses with the payroll tax and \$388 billion without.

The Intersection of Fiscal and Regulatory Policy

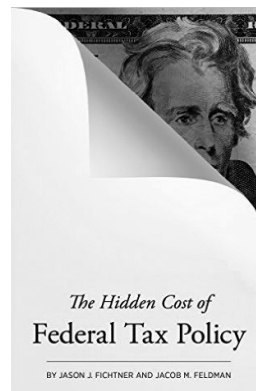
◆ REVIEW BY SAM BATKINS

Paying taxes is a sufficient annoyance for most people. The time, effort, countless forms, and accounting expenditures resulting from the federal tax code are just a few of the many factors why scholars have sought fundamental reform of the system. It isn't just the \$2.5 trillion or so in taxes taken from corporations and individuals every year, it's the \$215 billion to \$987 billion in various hidden costs that makes federal tax policy anti-growth, anti-marriage, and—perhaps most pervasively—pro-special interest.

In *The Hidden Cost of Federal Tax Policy*, Jason Fichtner and Jacob Feldman survey the chief culprits behind flawed tax policy and offer key principles for successful reform. Although not entirely focused on the world of regulation, the ancillary components of current policy help to generate the 200 forms and 2.6 billion work hours associated with the individual income tax and the 235 forms and 2.8 billion work hours for the business income tax. Fundamental tax reform could save the nation billions of hours of paperwork and tens of billions of dollars in monetary savings. Broken tax policy is more than just a conversation about what is taken from a paycheck; it concerns what is taken from an economy.

Estimating hidden costs / Unsurprisingly, there are varying estimates for the benefits from reforming different components of federal tax policy. The authors highlight how one component, accounting costs, is driven largely by the more than 4,000 changes to the code from 2001 and 2010, including 579 in 2010. This accounting slate is responsible for between \$67 billion and \$378 billion in annual burdens. For what it's worth, the Internal Revenue Service estimates the individual income tax costs \$33.6 billion for Americans to navigate annually. Astonishingly, there is no estimate for the monetary burdens imposed by the business income tax, even though it generates more paperwork and more forms.

The second hidden cost lies in the infamous "Tax Gap."



The Hidden Cost of Federal Tax Policy
By Jason Fichtner and Jacob Feldman
262 pp.; Mercatus Center at George Mason University, 2015

Breaking the code / The authors spend nearly as much time in the book surveying the reasons the tax code is mindlessly broken as they do offering solutions for rational reform. To no one's surprise, lobbying plays a heavy role in creating tax credits, exemptions, and deductions that Americans end up subsidizing. As the saying goes, "If there is food at the picnic, ants will follow." Given the size and scope of government, there is always plenty of food.

Fichtner and Feldman note that research reveals intense lobbying is often

effective. They write, “Businesses that increased lobbying expenditures by 1 percent reduced their effective tax rates by 0.5 to 1.6 percentage points the following year.” Diffuse costs, concentrated benefits—if only we could all be so well-connected.

This lobbying extravaganza is often led by the plethora of lawyers in Washington, D.C. The authors somewhat gleefully remind the reader that there is a strong negative international correlation between the number of law students and economic growth. Conversely, nations with a high concentration of engineering students tend to have robust economic growth. Regardless, we can all agree that focusing the nation’s attention on producing tax carve-outs, rather than actual production, will do no favors for economic growth.

Who doesn’t take tax breaks / Part of the problem with a government of our size is that it intrudes into virtually every area of life: subsidizing the purchase of a home (\$69 billion) and health care (\$185 billion), to name just two. Through the years, everyone has become dependent on, or taken advantage of, favorable tax treatment created by the code.

The mortgage interest deduction (MID) is singled-out for special treatment, and rightfully so. If you live near a coast or in a major city, it is likely one of your largest tax breaks; if you don’t, you’re subsidizing large home purchases elsewhere. As the authors note, less than one in 10 Americans earning less than \$50,000 can claim the MID. High-income earners net a tax benefit that is nine times larger than tax filers earning between \$50,000 and \$100,000. Middle-income Americans can thank the real estate industry for this inequity.

And yet, this deduction does little to advance its intended function of promoting home ownership, which is a dubious goal of government in its own right. Instead, the MID encourages more debt and borrowing. Despite the deduction, the United States is nowhere near the top for home ownership rates. That title belongs to Singapore at 87 percent, yet Singapore

has no MID. The United States clocks in at 65 percent, slightly lower than the United Kingdom, which also doesn’t have a MID.

Reform / There are a million different proposals for reforming the federal tax code, but Fichtner and Feldman spend just a few words on broad reform principles: simplicity, equity, efficiency, and permanency. In the utopian world where federal tax policy does undergo wholesale reform, expect ancillary regulatory benefits as well. Consider that a 50 percent reduction in the IRS’s paperwork burden would generate roughly 4.5 billion hours

in savings. Even assuming a conservative \$20 per hour rate for IRS compliance, that would equal \$90 billion in annual savings.

Don’t hold your breath for that, unfortunately. Yet, anyone interested in learning the history of the current tax code and surveying its failures would do well to review the work of Fichtner and Feldman. R

READINGS

- “Marginal Deadweight Loss when the Income Tax Is Nonlinear,” by Sören Blomquist and Laurent Simula. Uppsala University (Sweden), 2012.
- “Tax Avoidance and the Deadweight Loss of the Income Tax,” by Martin Feldstein. *Review of Economics and Statistics*, Vol. 81, No. 4 (1999).

Progressivism’s Tainted Label

◆ REVIEW BY PIERRE LEMIEUX

During a Democratic Party presidential debate this past February, Hillary Clinton and Bernie Sanders sparred over who was the most “progressive.” The label has a connotation of social reform. Liberals (in the American, as opposed to the classical, sense) and socialists are viewed as progressive. For many people, the term is nearly synonymous with “good.” Yet, if you know the history of the progressive movement, it will seem strange that some would try to reclaim such a tainted label.

What, really, was progressivism at the time of its zenith in America? Thomas Leonard’s book *Illiberal Reformers* casts a scholarly but uncompromising eye on what was called the Progressive Era, which he conceives as stretching from the mid-1870s to the United States’ entry into the Great War in 1917. In doing this, he combines the Gilded Age of the last quarter of the 19th century with what is more commonly considered the Progressive Era, starting about 1890.

The progressives wrote in the *New Republic* and in many scholarly journals of their times. Their academic centers were Columbia, Johns Hopkins, Wisconsin, and Pennsylvania, as well as the Institute for

Government Research, which became the Brookings Institution. Many progressives were activists in associations such as the American Association for Labor Legislation (AALL).

According to Leonard, an economist and research scholar at Princeton University’s Council of the Humanities, all progressives shared a “recognizable and historically specific set of intellectual understandings.” First, they opposed individualism and classical liberalism. Second, they wanted to replace the waste of capitalism with the efficiency of experts and social engineers—the “fourth branch of government” or “administrative state”—working for the common good. Third, they opposed what they saw as monopolies.

Eugenics / The most glaring example of the progressives’ illiberalism was eugenics. A signature idea of the Progressive Era, eugenics, Leonard reminds us, “describes the movement to improve heredity by the

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social control of human breeding”:

Racial health was too important to be left unregulated. The individual's liberty to make her reproductive, marital, labor, and locational choices free from state interference ended precisely where her choices were seen to endanger the health of the race.

The “health of the race” was subject to externalities (in today's economic parlance) that justified widespread government intervention.

Eugenics was (mistakenly) inspired by Darwin's evolutionary theory, but with a twist: evolution could be bettered by state intervention. The nation, often identified with the race, could be improved if the state encouraged the breeding of the fittest individuals and discouraged the breeding of individuals with bad heredity. The progressives wanted “social selection” to replace and improve natural selection.

Most progressives apparently shared biologist Jean-Baptiste Lamarck's belief that acquired traits such as virtues and vices were genetically transmitted. Eugenics called for lifting the poor out of poverty by improving their offspring. It also meant fighting “race poisons” like alcohol, tobacco, meat, and promiscuity. Progressive economist Irving Fisher viewed public health and eugenics as a joint campaign. Lester Frank Ward, an early progressive who became the first president of the American Sociological Association, provided a prudential argument: until science has conclusively ruled out the environmental determinants of heredity à la Lamarck, he argued, it is prudent to “hug the delusion.” In case of scientific doubt, the state must intervene for the good side.

If the poor and socially defective could not be uplifted, their breeding had to be controlled. Political journalist Herbert

Croly, co-founder of the New Republic, believed that the state had a responsibility to “interfere on behalf of the really fittest” and improve human nature by improving “the methods whereby men and women are bred.” Richard T. Ely, a famous progressive economist and main founder of the American Economic Association (AEA), opined that “there are certain human beings who are absolutely unfit, and should be prevented from a continuation of their kind.”

These were not pious wishes. Compulsory sterilization was practiced in 30 states, starting with Indiana in 1907. Before he became president in 1913, New Jersey governor Woodrow Wilson signed his state's forcible sterilization law in 1911, targeting “the hopelessly defective and criminal classes.” Some 30,000 persons were sterilized between 1920 and 1939. Compulsory sterilization was approved by the U.S. Supreme Court in an infamous 1927 decision, where the majority, including progressive justice Louis Brandeis, declared that “the

principle that sustains compulsory vaccination is broad enough to cover cutting the Fallopian.”

Like today's public health movement (see “The Dangers of ‘Public Health,’” Fall 2015), eugenics was both a scientific and social movement. Most well-known scientists and intellectuals in the Progressive Era were eugenicists. Everybody fashionable was in favor, including conservatives and socialists. Leonard notes that Frank A. Fetter, “sometimes regarded as part of the Austrian tradition in economics,” also adhered to eugenics.

Debauch of competition/ Progressive ideas were radically opposed to classical liberalism. Like today's liberals, the progressives were not extreme state socialists, but they looked with great suspicion on any market that was not tightly regulated. They

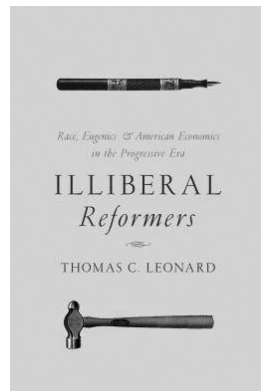
enlisted in a crusade “to dismantle laissez-faire and remake American economic life through the agency of an administrative state,” Leonard writes. They saw free markets as neither efficient nor moral. Economic freedom was not adapted to the requirements of the new, large-scale, diversified business firms that depended on scientific management and planning. Ely believed that unregulated markets were forcing “the level of economic life down to the moral standard of the worst men.”

Contrary to the populists, the progressives were not against business size per se; on the contrary, they “regarded small business as inefficient and outmoded.” The problem was competition and the unregulated market. Large, efficient firms were necessary but had to be coordinated by the state, progressives believed, and industry barons often agreed. As a Chicago asphalt industrialist lamented, progressivism must save humanity from the “debauch of competition.”

For the progressives, efficiency could only be the product of government management and economic planning. New Dealers such as economist Rexford Guy Tugwell were soon to buy these ideas. (See “Total Regulation for the Greater Whole,” Fall 2014.)

Progressive economists opposed economic freedom. The founding core of the AEA was comprised of young economists who had studied in Germany. They had come home imbued with the theses of the German Historical School whose teachings were very different from classical economics and from the developing neoclassical and Austrian schools. According to German historicists, there was no place for a general economic theory; everything depended on historical and national circumstances, and economists were at the service of their national state.

German political thought exerted a major influence on the progressives. John Burgess, a pioneering American political scientist and professor at Columbia University, had also studied in Germany. He thought that Great Britain was America's motherland and that Germany was “the motherland of our motherland.”



**Illiberal Reformers:
Race, Eugenics, and
American Economics
in the Progressive Era**

By **Thomas C. Leonard**
264 pp.; Princeton
University Press, 2016

Charles McCarthy, a progressive Wisconsin bureaucrat, argued that his state, a beacon of progressivism, was a “German state” because many Wisconsinites were of Teutonic stock. Like many observers at the time, Frederic C. Howe, a former student of Ely, saw Germany as the most advanced scientific state in the world, just as Wisconsin was in America.

Religious and temperance leaders were at the forefront of social reform. Twenty-three of the 55 charter members of the AEA were clergymen. The reformists preached a “social gospel” where social salvation substituted for individual salvation. Sociologist Edward Alsworth Ross believed that sin was social in cause. Fisher thought that eugenics was “the foremost plan of human redemption” and that Americans “must make of Eugenics a religion.” Christian economic reform, said social gospeler Walter Rauschenbusch, was about “saving the social organism.”

Ultimately, Leonard observes, “the social gospel economists, like all progressives, turned to the state.” “God works through the state,” claimed Ely. “Redemption,” Leonard continues, “required more than providing the poor with what they wanted but lacked; it required teaching the poor what they *should* want.”

Anti-individualism / Progressivism was built on an anti-individualist philosophy. Society was the first reality in both a methodological and a political sense, a concept that was defended by the then-developing field of sociology. Society is “an enlarged individual,” Croly wrote. Ely believed it was “strictly and literally true” that society is an organism. Ward, whom Leonard label “the intellectual spearhead of the progressive assault on laissez-faire,” imagined a “collective mind of society.”

Individuals were cells of the social organism, and could have no rights against the whole. For social gospeler Washington Gladden, an AEA charter member, respect for individual liberty was “a radical defect in the thinking of the average American.” Woodrow Wilson thought that government itself was “a living thing” and that the idea

of divided government was outdated.

Eugenics was an application of these anti-individualist ideas. Scott Nearing, a radical economist, thought that “persons with transmissible defects have no right to parenthood, and a sane society in its efforts to maintain its race standards would absolutely forbid hereditary defectives to procreate their kind.”

The progressives harbored a naive belief in science and management. They called for disinterested experts—government bureaucrats or advisers—to replace corrupted politicians in running government and directing society. Sociologist Charles Horton Cooley wanted a “comprehensive and ‘scientific management’ of mankind.” Charles R. Van Hise, president of the University of Wisconsin, favored a “government of experts.”

The progressives trusted the state completely. They did not share the classical economists’ conscience of government failure—even those economists, such as John Stuart Mill, who accepted wider government functions. Leonard notes that “laissez-faire’s standing derived less from worshipful celebrations of capitalism’s self-regulating powers than it did from prolonged contact with government failure.” For the progressives, a powerful, centralized administrative state was needed in place of decentralized and divided government. The progressives nominally believed in democracy, but could never reconcile this belief with their desire to have experts control people’s activities for the public good.

One of the many telling quotes in *Illiberal Reformers* comes from Grosvenor Clarkson, a member of the World War I-era War Industries Board. According to Clarkson, the war planning effort had converted 100 million “comparatively individualistic people into a vast cooperative effort in which the good of the unit was sacrificed to the good of the whole.” For him, this development of collectivism had almost made war “appear a blessing instead of a curse.”

Racism and immigration / Racism—a special form of anti-individualism—was an essential component of eugenics and pro-

gressive thought. All colored races were judged inferior. “Disenfranchising Southern blacks,” Leonard observes, “was ... a typical progressive reform.” The author of *Illiberal Reformers* points out that only white Anglo-Saxon men (including people of German stock, of course) escaped the charge of hereditary inferiority. Even backward Appalachian whites could be educated and saved from degeneracy. French Canadians and the Irish did not quite make the cut. Progressive economist John R. Commons estimated that 14% of Americans were genetically inferior: the 12% who were black plus the 2% who had mental or physical defects. The “inferior” minorities could perhaps have taken solace in the conclusions of intelligence tests run on WWI draftees and published under the auspices of the National Academy of Sciences and the Surgeon General: 54% were classified as “morons.”

Immigrants were considered to be especially dangerous. The progressives fueled the high wave of anti-immigration sentiment that swept America beginning in the late 19th century. Immigrants from Asia and eastern and southern Europe brought degenerate heredity that threatened the American “germ plasm.” Frances Willard, leader of the Women’s Christian Temperance Union, agitated for race-based immigration and against Catholic immigrants.

Immigrants competed with native labor and, claimed the progressives, pushed down domestic wages. “Competition,” complained Commons, “has no respect for superior races.” This claim, as Leonard explains, was based on the “living-standard” theory of wages, according to which workers accustomed to a low standard of living would draw down the wages of normal workingmen. This theory of wages contradicted the neoclassical theory of marginal productivity developed by John Bates Clark in the late 1880s as part of the marginalist revolution in economics. According to marginal-productivity theory, labor, like any other factor of production, is paid the value of its marginal productivity—that is, what the last laborer (in a certain category of labor) adds in

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value to the economy. In this perspective, immigrants were paid less because they typically were less productive laborers, but that didn't push all wages down.

According to living-wage theory, immigrants only compounded the same downward effect that domestic defectives and unemployables had on wages. The so-called "unemployables" were typically workers whom the progressives though should not have jobs precisely because of their supposed effect on other workers' wages. As University of Chicago sociologist Charles Richmond Henderson explained, the unemployables were those who "bid low against competent and self-supporting men." All these inferiors, immigrants and domestic unemployables bid down wages in a race to the bottom.

Supposedly, the "competent and self-supporting" workers' reduced wages resulted in their fathering fewer children, increasing the degenerative effect of domestic and imported defectives. An uncontrolled labor market thus led to "race suicide." In Leonard's words, for the progressives, "hereditary inferiority threatened both the American workingman and American racial integrity."

Minimum wage for exclusion / Hence, the labor market had to be controlled with minimum wages and other standards in order to keep immigrants and domestic defectives—as well as women—out of the workforce. "A minimum wage," writes Leonard, "was the holy grail of American progressive reform." Progressives understood that a minimum wage would cause unemployment, but that's precisely why they wanted it: to keep the less productive out of the market. Royal Meeker, a Columbia-trained economist and founder of the International Labor Organization, also supported the minimum wage; in his opinion, the state should both push the inefficients out of work and prevent the multiplication of their breed.

In the 1910s, progressives had minimum wage laws adopted in 15 states, starting in Massachusetts in 1912, plus the District of Columbia and Puerto Rico.

But like maximum-hour legislation, minimum wages applied only to women (and to male public-works and railroad workers). The progressives viewed women as both helpless victims of capitalism and a threat on the labor market. By pushing them out of the market, a minimum wage killed two birds with one stone.

Women were viewed as both inferiors and "mothers of the race"—one of many contradictions in the progressive ideology. Commons, mover of Wisconsin's 1913 minimum wage for women, argued that it protected the "welfare of the race and the nation." In progressive thought, race, nation, hierarchy, and state power all fit together.

Following the herd / How could so many people be seduced by so many noxious ideas? One easy answer lies in the power of fads, which does not spare the intellectual world. (See "Following the Herd," Winter 2003–2004.) During the Progressive Era, a rejection of classical liberalism colored the whole Western world. The progressives' totalitarian ideas could spread unchallenged.

Eugenic thought was widespread and fashionable. In England, Sidney Webb, who together with his wife Beatrice were the figureheads of Fabian socialism, wrote that "no consistent eugenicist can be a 'Laissez Faire' individualist," for the rule of the game is "interfere, interfere, interfere!" A free-market economy, he believed, leads to "wrong production, both of commodities and of human beings."

Prestigious authors agreed. Virginia Woolf thought that imbeciles "should certainly be killed." T.S. Eliot favored sterilizing "defectives" to protect society. Leonard quotes a horrible reflection (and premonition) of D.H. Lawrence:

If I had my way, I would build a lethal chamber as big as the Crystal Palace, with a military band playing softly, and a Cinematograph working brightly, and then I'd go in back streets and main streets and bring them all in, all the sick, the halt, and the maimed; I would lead them gently, and they would smile at me.

Were American intellectuals especially prone to fall victims to the new ideals? It's not too hard to imagine young American students landing in Germany and falling under the spell of brilliant European culture and German elitist authoritarianism.

Lessons for today / *Illiberal Reformers* is a scholarly and prudent book, but we can also use it as a warning for today.

Politics often amplifies popular errors instead of dampening them. This may have been especially true with the development of federal power following the Civil War. The Constitution and the Bill of Rights were shaky protections against abusive government, although we later saw in Germany how much worse it could be without this sort of imperfect constraint on the state.

Invoking the common good or public welfare against individual liberty is more an excuse than a justification. As Leonard points out, the vision of an anthropomorphic social organism simplified "the problem of determining what 75 million people wanted." It is significant that the progressives could not agree on what was this common good, which they claimed to represent.

In reality, the common good or the public interest can only be defined in terms of "public goods" (goods or services that everybody wants but that can't be financed efficiently by the market), and even then it must be defined restrictively. The progressives did not understand that the common good is necessarily very abstract and unattainable through the administrative state.

The progressive conundrum over democracy and the administrative state was also unsolvable. As public choice analysis has since shown, the interventionist state is bound to be captured by interest groups or by its own bureaucrats. As Leonard notes, Thorstein Veblen, another progressive economist, "simply did not consider the prospect that a Soviet of engineers might fail to be selfless servants of the public good."

Still another lesson is that political majorities are always dangerous for minorities. In the Progressive Era, the rul-

ing majority (at least the majority of voters) was made of white, non-handicapped, Anglo-Saxon men. Our epoch also has its unpopular minorities, although they are better hidden and sometimes oppressed more humanely. Under the administrative state we have inherited from the progressives, who will be the persecuted minorities of the future?

We must be suspicious of hastily embraced popular ideologies. They must be constantly challenged. Many observations contradicted the progressive ideology. Acquired traits are not transmissible: cutting off mice's tails, as biologist August Weisman did in 1889 to test Lamarck's evolutionary theory, does not produce new generations of short-tailed mice. Defining and measuring race is a difficult task: the progressives tried unsuccessfully with head sizes and shapes. World War I revealed that the German state was not all that advanced after all. Fisher admitted that German economists had been prostitutes to their idealized state, but he then proceeded to propose a new grandiose agenda for the American administrative state.

In truth, the progressive ideology was rather laughable. Inferior groups were supposed to be simultaneously condemned to extinction for their deficiencies and yet dangerous to "superior" humans. An English sexologist, Havelock Ellis, thought that women's physical inferiority was caused by their having more water in their blood. Ely used the collective "we" in an incantatory, not scientific, fashion: "We can have just such a kind of economic life as we wish." Literally viewing society as a biological organism is nonsense. French classical liberal (and Academician) Émile Faguet mocked this organicist idea appropriately: "You think you were a man," he wrote; "in fact, you are a foot" (*Le Libéralisme*, Paris, 1902).

We (at least, we economists) like to think that economists are better prepared than other students of society to see through sociological blather, pseudo-scientific concoctions, and political snake oil because economic thinking is constrained by established, formalized theories that are based on methodological

individualism and a prejudice in favor of individual preferences and choices. A generation after the Progressive Era, this constraint proved beneficial: under Italian fascism, for example, the economists did not take the bait like the statisticians did. (See Jean-Guy Prévost's *A Total Science: Statistics in Liberal and Fascist Italy*, McGill-Queen's University Press, 2009.)

But this constraint was not helpful during the Progressive Era, partly because of the influence of the German Historical School.

Progressive economists were unable to see simple things, such as that competition between employers bid up wages as much as competition between workers bid them down. With a few exceptions—like William Graham Sumner, "the reform economists' bête noire," or John Bates Clark—economists during the Progressive Era fell headfirst for the new orthodoxy.

To reflect on the significance of the Progressive Era, *Illiberal Reformers* is a must-read. R

Applying Coase

◆ REVIEW BY TIMOTHY J. BRENNAN

Despite the author's Nobel Economics Prize and its standing as the most cited law review article in history, Ronald Coase's "The Problem of Social Cost" still seems unappreciated. Its core insight, that alleged externalities are at root the result of an inability to negotiate, fails to convince many readers who see environmental problems as the result of bad polluters harming innocent bystanders, requiring public policy to ensure that the bad guys are stopped. For this reason, the idea that one could best balance the benefits of reduced environmental harm with the costs of those reductions by creating property rights to facilitate subsequent negotiations still does not get the recognition it deserves.

Free Market Environmentalism for the Next Generation, the latest version of Terry Anderson and Donald Leal's compendium *Free Market Environmentalism*, follows the path opened by Coase. The book articulates the potential for resolving environmental conflicts through private solutions based upon negotiations between the beneficiaries of environmental protection and those who would bear its costs. The net of applications is cast far and wide, including potential markets for timber, grazing, water, and fishing rights. The contributing authors make a persuasive case that environmentalists should

avoid the "nirvana fallacy" and recognize that government action is slow, cumbersome, and—perhaps most important—too rigid to reverse error and adapt to changed circumstances, especially with multiple agencies having jurisdiction. Moreover, government is not without its transaction costs. Of course, one should watch out for the reverse "nirvana fallacy," the belief that no market failure is as bad as any policy to address it.

Winning the battle / Because the Coase-based perspective on market failure in general and environmental externalities in particular still may not get the attention it deserves, and because an unduly optimistic view of government often implicitly colors beliefs regarding the effectiveness of policy, *Free Market Environmentalism for the Next Generation* deserves a place on the reading list in virtually any environmental economics or policy course. But an instructor of such a course, or a policy adviser relying on the book, should keep a few things in mind.

One is that the admittedly appealing renegade tone of the book is not entirely

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warranted. Because supporters of market approaches to policy problems often feel like outsiders, it is important to note just how much of the battle for using markets to address environmental issues has been won. There has been little if any backtracking in economic policy circles regarding the use of markets since the implementation of sulfur dioxide permit trading beginning in the 1990s. Other examples include tradable fishing quotas or land development rights. To take the leading example of the day, policy disputes over climate change are very much between those who think we should do nothing and those who think we should adopt market instruments to address it. With few exceptions (notably Pope Francis), the central dispute is *not* about whether to implement a market-like mechanism—such as a cap-and-trade of emissions permits or a carbon tax—or to adopt command-and-control. Rather, the choice is whether and how to regulate at all, recognizing political constraints on the availability of market mechanisms. Even “Nth best” measures, such as renewable fuel requirements or automobile fuel economy standards, increasingly are implemented in a market-oriented way.

Assignment of property rights / The larger issue is whether government policy is necessary to resolve environmental conflicts, even when those policies are implemented using market instruments. From the book’s Coase-based perspective, the preferred first step would be to create property rights so that those who benefit from environmental protection and those who bear the costs of protecting it can negotiate a jointly beneficial solution. In some places, the authors lament that when property rights are up for grabs, litigation and rent-seeking will not be far behind.

Ironically, this lamentation undercuts the authors’ case. The belief that an environmental problem could be solved through the establishment of property rights presupposes that those rights have not been previously assigned. While Coase showed that in the absence of significant transaction costs the efficient solution to

environmental problems can be achieved regardless of how property rights are assigned, the assignment of rights—determining who has to pay whom for what—will typically have significant distributional effects.

Consequently, litigation, lobbying, and other forms of rent-seeking to influence the assignment of property rights will be inevitable. If those are to be avoided, then the assignment of property rights is to be avoided, leaving government—rather than market environmentalism—as the only solution. The only alternative is a viewpoint that, but for rent-seeking, there is some intrinsic or “natural” assignment of property rights that common law courts or legislators would institute as a matter of course. Whether that is so in this complicated world is doubtful, but in any event it invokes considerations of political philosophy outside the scope of this book.

Even if property rights can be assigned, the next step is to show that transaction costs are negligible. The standard view of Coase is that when those costs are negligible, externalities are eliminated as long as property rights are assigned, regardless of how they are assigned initially. However, Coase (unlike many of his readers) recognized that when transaction costs are substantial, the assignment of rights can matter. This concern forms the basis for the economic analysis of common law rules for tort liability, contract breach, and even modifications to property rights such as adverse possession and estray law.

The challenge for the contributors to this book is to show that transaction costs do not impede solving environmental problems through negotiations rather than government intervention when transaction costs seem large—most notably, when the number of polluters and number of those willing to pay to reduce pollution are large. One possibility could be to argue

that even with large numbers of affected parties, common law will arrive at efficient assignment of pollution liability without needing more intrusive environmental legislation and regulation. The chapters in the book by and large do not take that approach, which is understandable because when large numbers are affected, either

tort lawsuits are a public good or the incentives to sue are internalized through class action litigation. But these legal actions are troublesome, especially when litigation has been characterized as a form of rent-seeking.

The authors commendably do not ignore the “large numbers” problem. However, their solutions can take on a kind of “assume a can opener” character, referring to the joke about an economist on a desert island confronting a can of beans. Here, the can opener is some group like the Nature Conservancy that can, and often does, purchase property to preserve habitats and open

spaces. In defense of the authors, these are not hypothetical can openers as in the joke; sometimes they are real. But whether environmental groups are a reliable representation of aggregate willingness to pay for environmental benefits, or are an exception that proves the rule regarding the importance of transaction costs, is not resolved here.

As numerous examples in the book illustrate, non-governmental collective action is admittedly more plausible in relatively small settings such as fishing villages or ranching towns. Frequently citing the Nobel Prize-winning work of Elinor Ostrom, the authors provide a number of settings in which local social norms serve the function of government in terms of managing local public goods. As with Coase, Ostrom’s insights merit a wider audience, yet another reason this book would be useful in classroom settings. My guess is that social norms of



Free Market Environmentalism for the Next Generation

Edited by Terry L. Anderson and Donald R. Leal

200 pp.; Palgrave MacMillan, 2015

the type Ostrom identifies not only address public goods, but are what keeps the only barber in a small town from charging a monopoly price for haircuts. Whether libertarians should feel more comforted by the power of social norms relative to the power of collective government might be worth some thought. Complaints from conservative academics about the oppressive leftist culture in universities, going back to William F. Buckley 65 years ago, suggest that social norms strong enough to influence outcomes may not be an unmitigated blessing.

Conclusion / These observations will not deter readers who are already disposed to solutions to environmental problems based on relatively costless negotiations among stakeholders with clearly defined property rights. The question remains how to get this sermon to be heard beyond the choir.

One impediment the authors could have done something about is their book's title. Posing the issue as between "free market environmentalism" and "political environmentalism"—with the appendage "coerced" proving impossible to resist for the latter—will put off some readers as biased rhetoric reflecting an ideological commitment disconnected from outcomes. One could imagine the reaction from property rights proponents if the options were "exploitative capitalist environmentalism" and "democratic environmentalism."

A less rhetorical observation is that the "free" in "free" markets not only rhetorically implies a value judgment, it also rests on a value judgment that the underlying distribution of property rights is normatively acceptable. "Your money or your life" is a voluntary transaction if the holder of the gun has a prior property right over the life of the person staring into the barrel.

A harder challenge beyond the scope of the book is defending the view that the objective of environmental policy should be what the market produces or, at least, would have produced were property rights feasible to define and transaction costs negligible. Economic efficiency—that the environment deserves no more protection than that for

which environmentalists are willing to pay to compensate polluters—is irrelevant for those who find environmental protection morally compelling in and of itself.

Emphasizing Coase's perspective and economic efficiency also presents challenges to libertarians. The appeal of free market environmentalism is not the outcome as such, but the process: the view that (relative to the initial assignment of property rights) the outcome is voluntary and mutual. But if economic or political circumstances preclude ideal transactions, economic efficiency and libertarian norms can come into conflict.

Climate policy is a powerful example because of its prominence and because

there is no time machine that would allow current generations to negotiate with and compensate future generations to arrive at mutually agreeable sacrifices to limit climate change. Basing the libertarian argument against climate policy not on this involuntary redistribution but on alleged failures of science gives the almost certainly inaccurate impression that if the science were different, libertarians would then find climate policy acceptable.

By clarifying the nature of environmental policy choices, *Free Market Environmentalism for the Next Generation* may help move this debate away from disputes about science and toward deliberation regarding political values. R

Hedgehogs, Foxes, and Economists

◆ REVIEW BY PHIL R. MURRAY

My professor had just finished covering the chalkboard with the First Fundamental Theorem of Welfare Economics, showing that free markets allocate resources efficiently. This was in the early 1990s, shortly after the Eastern Europeans abandoned central economic planning. I wondered whether the theorem endorsed capitalism. My professor pointed out that the economist's notion of Pareto efficiency was consistent with him being in possession of all the goods while the rest of us had none. He said, if I recall correctly, "That's not much of an endorsement for capitalism, is it?"

He was not taking sides in capitalism versus socialism; he was refining our understanding of efficiency in light of distribution. I still ponder the relationship between the First Fundamental Theorem and the real world. Does the theory exalt markets? If not, assuming markets outperform central planning, how good is the theory?

Harvard economist Dani Rodrik's book *Economics Rules* helps answer questions like

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these. "I wrote this book," he tells us, "to try to explain why economics sometimes gets it right and sometimes doesn't."

Modeling the world / There are two types of economics, according to Rodrik. On the one hand, "economics is a social science devoted to understanding how the economy works." On the other, "economics is a way of doing social science, using particular tools. In this interpretation," he elaborates, "the discipline is associated with an apparatus of formal modeling and statistical analysis rather than particular hypotheses or theories about the economy."

Rodrik prefers the latter approach. He defines models "as simplifications designed to show how specific mechanisms work by isolating them from other, confounding

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effects.” His first example is the model of supply and demand, which explains the efficient operation of a market. His second is the prisoners’ dilemma model, which explains how “two firms end up in a bad equilibrium in which both have to waste resources.” His third is a “coordination model”: If each of two firms in different industries buys capital, both will “end up profitable and happy.” If they fail to coordinate, which means neither buys capital, there will be an equilibrium, though neither firm will be profitable. His point is that a market works well, or fails to work, depending on the model.

He emphasizes that there is an abundance of models, and that this is a good thing. “The correct answer to almost any question in economics is, it depends,” he claims. An abundance of models is a good thing because “different models, each equally respectable, provide different answers.”

Take this question: “Does the minimum wage lower or raise employment?” The standard model of supply and demand predicts that employers faced with a higher minimum wage will lay off workers. An alternative model, in which employers have monopsony power, predicts that employers will hire additional workers. To paraphrase the author, the minimum wage eliminates the monopsonist employer’s ability to influence workers’ wages. Denied the option to pay a lower wage and hire less labor, and now able to hire more labor without having to pay a higher wage (up to a point), the employer hires additional workers to increase output and revenue. Whether the standard model or the monopsony model is relevant depends on “critical assumptions.” According to Rodrik, “an assumption is critical if its modification in an arguably more realistic direction would produce a substantive difference in the conclusion produced by the model.” With respect to the minimum wage, the standard model’s assumption that employers take the wage rate as given is critical because if it’s unrealistic, the conclusion that a minimum wage reduces employment will not hold. Likewise for the

alternative model: assuming that employers influence wages is critical because, if that’s unrealistic, then the conclusion that a minimum wage increases employment will not hold.

Verifying the models / How does one know which model is appropriate? This leads to Rodrik’s methodology of “model selection,” or what he calls the “craft” of economics. “The key skill,” he submits, “is being able to move back and forth between the candidate models and the real world.” One does this by using these “verification strategies”:

- Verify critical assumptions of a model to see how well they reflect the setting in question.
- Verify that the mechanisms posited in the model are, in fact, operating.
- Verify that the direct implications of the model are borne out.
- Verify whether the incidental implications—those that the model generates as a by-product—are broadly consistent with observed outcomes.

Let’s consider each. Following the author, suppose a rising price of oil causes the public to clamor for a legal maximum price. If we assume that producers take the price of oil as given, the “competitive model” of the market for oil predicts that the legal maximum price will cause a shortage. If we assume that producers are colluding to restrict output and raise the price, the “monopoly model” predicts that a legal maximum price—provided that it is “not set too low”—will induce producers to compete, increase output, and lower the price. In the competitive model, the critical assumption is that individual producers cannot influence the price of oil. In the monopoly model, the critical assumption is that producers can influence the price by forming a cartel.

Here’s how Rodrik would verify whether producers have market power: he’d examine the number of producers in the market, the market share of each, and the extent of barriers to entry. Many producers, less concentration, and few barriers support the competitive model. Few producers,

greater concentration, and significant barriers would support the monopoly model.

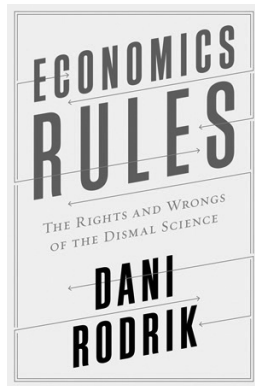
Sticking with alternative models of the market for oil, both the competitive model and the monopoly model “derive,” to use Rodrik’s jargon, the “mechanism” by which a decrease in the supply of oil causes the price to rise. He verifies that this process is at work in the market for oil because it “makes sense intuitively” and “there are plenty of real-world examples” of a decrease in the supply leading to a higher price of oil. Recall the 1970s.

Confirming that a model’s predictions are consistent with what’s happening in the real world involves more than econometrics. “Economists employ a wide range of strategies to verify whether the immediate implications of different models are confirmed in the real world,” Rodrik explains, “from the informal and anecdotal to the sophisticated and quantitative.” For example, being familiar with the Mexican economy would confirm that the monopoly model had long been appropriate for the Mexican oil industry. Now that the Mexican government is allowing the private sector to develop oil resources, the competitive model will be more appropriate so long as we observe increasing output and falling prices.

Rodrik discusses various types of economic “experiments.” “Thanks to [lab experiments],” for instance, “economists are learning more about what drives human behavior besides material self-interest, such as altruism, reciprocity, and trust.” The author recognizes that “many economists remain skeptical” of lab experiments. The “field experiment” and “natural experiment” appear to be clever and promising techniques to verify direct implications, though caution is still necessary because specific experimental outcomes “may not apply to other settings.” What motivates some teachers in India to show up and do their jobs, for example, is “placing cameras in the classroom.” However that tactic might not motivate teachers elsewhere.

Models have “incidental implications.” For example, the standard model about

the minimum wage law focuses on the direct implication of reduced employment of low-skilled workers. Perhaps an incidental implication is that firms will substitute workers with more skills for less-skilled workers and employment of the former will rise. Other incidental implications might be the effect on non-wage benefits or the prices of goods and services produced with lots of low-skilled labor. Verifying whether low-skilled workers, who manage to keep their jobs following an increase in the minimum wage, suffer the loss of non-wage benefits helps us to decide whether the standard model is correct; likewise for output prices.



Economics Rules: The Rights and Wrongs of the Dismal Science

By Dani Rodrik
253 pp.; W. W. Norton, 2015

Economists' errors / A former professor of mine joked that economists have license to wreck the economy. Some wreckage follows from "errors of commission, in which fixation on a particular view of the world makes economists complicit in policies whose failure might have been predicted ahead of time." In order to illustrate this mistake, Rodrik focuses on the ideology of the Washington Consensus, which he characterizes as "market fundamentalism," the blanket term for the view that markets are the solution to all public policy problems." Market fundamentalists, for instance, would recommend free trade as a growth strategy for developing economies. Lower tariffs encourage imports and discourage import-competing industries. Simultaneously, entrepreneurs redeploy idle resources in expanding export industries. "In Latin American and African countries that adopted this strategy," Rodrik tells us, "the first part of this prediction largely materialized, but not the second." How could this misfortune "have been predicted"? By recognizing "the deeper institutional underpinnings of a market economy," such as "the rule of law" and "contract enforcement." Real

market fundamentalists, of course, would resist the charge that they fail to recognize the importance of institutions.

Rodrik cites developing country successes in Asia. Curiously, this is not because governments permitted free trade in the context of proper institutions (property rights, rule of law, and contract enforcement). "Instead of liberalizing imports early on," Rodrik explains, "South Korea, Taiwan, and, later, China all began their export push by directly subsidizing homegrown manufacturing." Trade barriers "protected" import-competing industries so as to prevent unemployment. To boot, "all of them undertook industrial policies to nurture new manufacturing sectors." Just when this reviewer thought he was supposed to swallow the bitter pill that free markets don't work and central planning does, Rodrik warns: "This interpretation

is incorrect." The moral of the Asian success stories, according to the author, is that economists should know when to use "models that take on board some of the major second-best challenges these economies faced."

Another way "economists go wrong" is through "errors of omission, in which a blind spot shows up in the inability to see troubles looming ahead." In order to explain this problem, he focuses on the Great Recession. Most economists failed to forecast the financial crisis of 2008. Specifically, they "overlooked the extent of problems in housing and finance." Why were economists unable to anticipate the bursting of the bubble in house prices and the financial panic that ensued? They were relying on the wrong models. "Many of the favored models," according to Rodrik, "revolved around the 'efficient markets hypothesis' (EMH)." The gist of the hypothesis is that the price of an asset (such as a stock) equals the value of the

asset. Proponents of the EMH refrain from predicting future stock returns. Rodrik does not expect them to predict when recessions will occur. His critique is that "it is hard to square the model with reality: a sustained rise in asset prices followed by a sharp collapse."

The author nevertheless tells us how to align the EMH with the events of 2008. When expectations suddenly switched from economic growth to recession, according to this account, a large sell-off occurred. Although that story reconciles the EMH with the crash in the stock market, Rodrik finds fault in that it "reverses the generally accepted line of causation, which goes from the financial crash to the Great Recession."

The author argues that instead of relying so heavily on the EMH, economists should have been pondering bubbles, principal-agent problems, and behavioral finance. It's safe to say that he criticizes his fellow economists for putting too much "faith" in markets and too little in government. "In sum," he concludes, "economists (and those who listened to them) became overconfident in their preferred models of the moment: markets are efficient, financial innovation improves the risk-return trade-off, self-regulation works best, and government intervention is ineffective and harmful." Perhaps the zeitgeist leading up to the financial crisis of 2008 was enthusiasm for markets, globalization, and technology. But then, perhaps the author commits his own "error of omission" by neglecting to mention the role of dubious government interventions that played a role in the financial crisis, such as Fannie Mae and Freddie Mac, and political pressure that lowered lending standards.

Conclusion / Rodrik is critical of a pro-market bias. "It is certainly true," he claims, "that economists err on the side of markets." But he is not anti-market. Economists "think they understand how markets work," he admits, "and they fear that most of the public doesn't—and they are largely right on both suppositions."

In order to recommend the proper per-

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spective for an economist, the author turns to the difference between a “hedgehog” and a “fox.” According to Rodrik,

The hedgehog’s take on a problem can always be predicted: the solution lies in freer markets, regardless of the exact nature of and context for the economic problem. Foxes will answer, “It depends”; sometimes they recommend more markets, sometimes more government.

Given this taxonomy, the author rea-

sons that “Economics needs fewer hedgehogs and more foxes engaged in public debates.” This raises questions. Does he consider economists with a penchant for government intervention to also be hedgehogs? Does he think we need fewer of them? What economists are quintessential examples of hedgehogs and foxes? If good economists are foxes, was another of my professors correct to claim that “Good economists are like good lawyers: they can argue both ways”? R

ous ruler having absolute or near absolute control over his subjects through most of the history of humanity, to the unique notion of a constitution embodying federalism and the rights of the individual resulting from the heroic efforts of the Founding Fathers, he lays out antecedents to the modern progressives’ ongoing assaults on the U.S. Constitution. As he notes, “The Ruling Class have rebranded themselves from the beneficiaries of a despot who inherited his position to a new kind of despot who inherited his position for the benefit of his society.”

In part two, Lindsey evaluates the governing performance of the Ruling Class in America over the latter part of the 20th century through the years of the Obama administration. Increasing economic inequality for America’s minorities; a burgeoning national debt and inadequate sustainable funding of Social Security and Medicare; declining performance of American children in reading, writing, and arithmetic (as compared to other developed nations); bureaucratic and economic mismanagement of the nation’s physical infrastructure; ongoing governmental threats to limit the rights of Americans to arm themselves for their self-defense; and expansion and abuse of the government’s powers (and consequent deterioration in due process and accountability) in the civil taking of citizens’ property are explained and described with publicly available data and explicit examples of ruling class behavior.

In part three, he offers his policy prescriptions for regaining the liberties that have been slipping away from Americans. This is the section of the book that fulfills his subtitle—*How to Break Their Grip Forever*—and he explains what activities and policies he believes Americans must embrace to throw off control by the Ruling Class.

Securing liberty/ Lindsey makes an empirical case that there is a pro-liberty majority in America, noting that in an April 2012 survey, potential voters said they wanted smaller government by a 22-point margin and believed that government regulation made society less fair by a 28-point margin. Moreover, in a March 2015 Rasmus-

Liberty and the Ruling Class

REVIEW BY THOMAS A. HEMPHILL

Larry Lindsey knows whereof he speaks. As a former governor of the Federal Reserve System from 1991 to 1997, and as director of the National Economic Council under George W. Bush, he has helped craft economic policy at the highest levels of government. However, while the Harvard-educated economist views himself—along

with many other people with whom he served in government—as “getting the job done and moving on,” he is concerned about a different group of top-level government employees who, he says, have a very different agenda. As he writes in his new book, *Conspiracies of the Ruling Class*:

The purpose of their government service was to accumulate personal power and to exercise that power over others. They didn’t have a noble cause, even though they always acted as though they did, but a hidden need to wield power and maintain control of their little domain.

Lindsey notes that he did not take “these people” too seriously until they began expanding their fiefdoms and turned their attention from the bureaucracy to the country itself and individuals like him. “These people” are politicians, appointees, and bureaucrats who are career government employees and academics who wait for their opportunities to assume positions

of political power. He dubs them “the Ruling Class” and describes them thus:

They view their jobs not as leaders, who encourage the rest of us to make the most of our talents, but as people who are superior—as though they are the shepherds and we the sheep. They ridicule the successful and do everything they can to make the population dependent on them.

Lindsey identifies “progressives,” or modern liberals, as the ideological group that is the latest incarnation of the Ruling Class. Secure in their control of the media, the entertainment industry, and academia, a member of the Ruling Class will adopt an ideal such as “social justice” when in government service and attempt to implement this vision of a “just” world by taxing and spending, thus redistributing wealth by taking money from one person and giving it to another.

Lindsey divides his book into three parts. In the first, he discusses the Ruling Class’s threat to individual liberty. Beginning with a historical view of the imperi-

sen poll of likely voters, 52% responded that increased government spending hurts the economy while just 28% disagreed.

Yet President Obama, an advocate of expansive government, won re-election in 2012 with a 4 percent majority of voters. Why? According to Lindsey, Obama's Republican opponent, Mitt Romney, failed to connect with voters on one key self-oriented value, "Cares about people like me," even though Romney was viewed by voters as preferable to Obama on the leadership qualities of strength, vision, and values. While Lindsey does not believe that a liberty-oriented candidate should enter into a "bidding war" with a progressive Ruling Class candidate for votes, those voters who believe they are being abused by the government bureaucracy need to believe that a candidate embraces liberty because he or she genuinely cares about voters like them. Thus, a presidential candidate who frames the election as a choice between liberty and the progressive Ruling Class will win over the pro-liberty majority.

Lindsey also believes that a philosophy for a winning political campaign should be focused on improving people's lives through increased independence and individual control. When it comes to tax increases, the previously mentioned March 2015 Rasmussen survey found that 50% of voters believe tax increases hurt the U.S. economy while just 23% disagree. Lindsey recommends that, to be "philosophically populist and operationally libertarian," one should propose tax code simplification, for example a flat tax that is simple as well as fair in terms of taxes paid by different groups. As for the Affordable Care Act (ACA), he recommends repealing the individual mandate, repealing the employer mandate, and ending federal mandates and restrictions on what policies must cover and who may offer coverage. Those

steps would address the desires of 49% of those surveyed in a December 2015 Rasmussen poll who wanted to go through the law piece-by-piece and improve it.

He next turns to what must be done once a pro-liberty majority has been reestablished in Congress. First, he argues that Congress must reassert control of its constitutional responsibilities over administrative rulemaking. Federal lawmakers have delegated this authority to so-called "experts" in the executive branch and independent agencies. The first reform is to move this decisionmaking away from the "experts" and return it to Congress, while the executive branch focuses on enforcement responsibilities. Second, he looks to end lifetime careers in federal policymaking, both by implementing term limits for Congress and—more importantly—removing employment protections from Ruling Class bureaucrats who have numerous rights of appeal and who are rarely penalized for poor performance, much less fired.

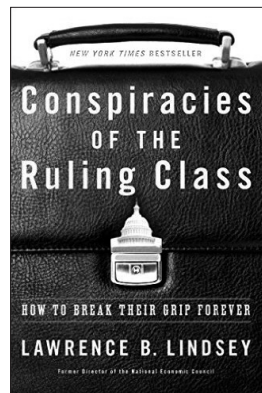
(Unfortunately, he offers no specific suggestions for civil service reforms.) He also recommends the federal court system end lifetime appointments to the bench, suggesting an 18-year term instead, which he believes is long enough to avoid the threat of political pressure.

As to the critical issue of budget reform, Lindsey first recommends that all government spending must go through the appropriations process (not just the present 30%, which excludes costly and expanding entitlements programs). Second, he would force Congress and the president, when enacting either a new entitlement or changing an existing one, to honestly estimate and designate a funding source for the long-term costs. Third, he would have long-term budget scoring in present-value terms be applied to both taxes and spending. Fourth, the currently weak PAYGO rules (which ostensibly require any increase

in federal spending or reduction in taxes be offset by other fiscal changes) would be reformed so they better adhere to long-term, honest budgeting principles. Fifth, he wants to establish a systematic method of addressing any political impasse that could result in a government shutdown. Sixth and most importantly, he wants a way to enforce these recommendations, suggesting that members of Congress must remain in Washington, D.C. (and away from family members) until the necessary compromises are reached.

Lastly, he confronts the public's distrust of the Federal Reserve. According to a November 2013 Rasmussen survey, only 34% of Americans viewed the Fed favorably, while 50% held an unfavorable view. He addresses some of the public's major criticisms of the Fed, and makes short shrift of them. For example, some Fed-bashers argue that it should follow some explicit "rule" when making monetary policy. However, he notes that if history provides little guidance on the relationship between Fed policy in the short-term and its effect on inflation, a rule that works well at one time might prove disastrously inappropriate at another. As for critic demands to "audit" the Fed, Lindsey points out that all expenses incurred by the Fed are already audited extensively by both internal and external auditors, and the Federal Reserve balance sheet is disclosed and audited. This demand, he argues, is really an effort to "second guess" Fed policy. Finally, he dismisses "End the Fed" sloganeering, pointing out that another institution, such as Congress, would step in to set interest rate and money supply targets, unless the nation returns to an inelastic currency, which raises the specter of sudden financial crashes like those of the late 19th and early 20th centuries.

Lindsey offers what he characterizes as a modest "reform" proposal (yet "philosophically populist and operationally libertarian"): pass a constitutional amendment that protects people's right to use something other than Federal Reserve notes to write a contract. That right does exist today, but it can be suspended at any time by presidential decree, as Franklin Roosevelt did in 1933.



Conspiracies of the Ruling Class: How to Break Their Grip Forever

By Lawrence B. Lindsey
263 pp.; Simon & Schuster, 2016

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Lindsey concludes his book by arguing that the progressive Ruling Class is eroding economic opportunities in America by “actively compressing, enervating, extinguishing, and stupefying us with complex rules, taxes, and obligations.” The Ruling Class, he says, views America as a country and not as a cause, and has “nothing to offer but empty promises built on the quicksand of ever-increasing demands on the resources, energy, and freedom of the rest of us.” In contrast, in his philosophy, liberty and the subsequent advancement of humankind is the moral high ground, and this political philosophy will be the foundation for permanently breaking the Ruling Class’ grip on the levers of power.

Populist and libertarian? / The phrase “philosophically populist and operationally libertarian” sums up Lindsey’s political and policy approach to throwing off the shackles of the progressive Ruling Class. As he notes, his academic training as an economist allows him the comfort of thinking in terms of “tradeoffs” in public policy and winning elections. After 100 years of embedding themselves in public institutions, it will be a daunting challenge to remove progressives from their Ruling Class positions.

His “populist” approach to regaining a pro-liberty majority will not make die-hard libertarian/constitutional conservatives joyful, but it may begin to turn the tide of modern progressivism in federal institutions. How? Through the successful election of more pro-liberty political candidates who will begin the arduous task of changing government from its increasingly active role as coercer/regulator of the American populace to a return to the Founding Fathers’ vision of government as the protector of individual rights.

While most of his public policy proposals have broad public support and have a strong “common sense” basis to them, I take issue with a few of them. Granted, attempting to deal with key provisions of the ACA could effectively implode the legislation. But repealing it and immediately legislatively substituting a real health care reform law that embraces market-based

options, supports individual choice in health care management, and offers the potential for real cost controls (and limited government oversight) would be a far more effective response than keeping much of that 2,700-page legal and regulatory monstrosity in effect. Allowing Congress to actively reembrace its rulemaking authority—if it were circumscribed to being mandatory (as it is presently optional and rarely operationalized) for *major rules*, i.e., costing \$100 million or more—would be a welcome first step for the legislative branch exercising its constitutional authority. I would also agree with Lindsey that his recommendation for a constitutional amendment to use something other than Federal Reserve notes to write a contract is a “modest” proposal. I doubt, however, that this would be any game-changing policy for a pro-liberty candidate to run on successfully, and may actually appear to many voters as an avoidance of what is emotionally their primary issue: the continued existence of the Federal Reserve.

I enjoyed reading Lindsey’s book. He provides a wonderfully accessible description of the foundations of Ruling Class philosophy throughout the ages, and a thorough, empirically based analysis of the failures of progressive Ruling Class public policies in recent decades. I also appreciated his honest approach to legislatively dealing with the national budget and the need to directly discuss major entitlement programs such as Social Security and Medicare on an annual versus continuing basis. While I like his overall approach to evaluating public policy issues, and I think it has merit as a practical approach to politically coalescing a pro-liberty majority of voters, I did find myself a little disappointed by his policy prescriptions in the final section of the book. Nevertheless, he writes exceptionally well, with a remarkable ability to blend data with a measured narrative flair—no mean feat for an economist. I certainly would recommend this book for anyone who values liberty and would like to be a better informed voter in this election cycle. **R**

Great Data, Disappointing Economics

◆◆ REVIEW BY DAVID R. HENDERSON

Northwestern University economist Robert J. Gordon’s latest book is on U.S. economic growth from 1870 to 2014. With his careful sifting of the data, he shows how far we’ve come over that time span, and especially between 1870 and 1970. Examining the economy sector by sector, he finds progress in every area: life expectancy, food, housing, transportation, workplace conditions, clothing, entertainment, and health care, to name some of the most important areas analyzed. In almost all cases, his data are impeccable. For those who fondly wish to return to the “good old days,” he has important news: the “good old days,” compared to now, were really bad.

The book’s strengths are its data and Gordon’s common-sense interpretation of that data. Unfortunately, he does not do nearly as good a job of using basic economics to explain the causes of economic growth and the ways to offset the lower future growth that he anticipates. At times, he shows an awareness of the harm done by many government regulations: policies on drug regulation, housing, entry into occupations, and airline security, to name four. However, he actually claims positive

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effects of a now-defunct regulatory agency, the Interstate Commerce Commission, that economists have definitively shown was almost wholly destructive. Also, he never explains why we've had the kind of innovation and capital investment that has driven our standard of living. When he discusses tax policy, he seems unaware that one of his proposals would likely reduce that investment and innovation.

Getting better / First the good news, and there's a lot of it. We are massively better off than people were in 1870. I know that's not earth-shattering news, but the detail that Gordon gives makes this case overwhelmingly.

Consider life expectancy. In 1870, life expectancy at birth for U.S. white males was 45.2 years. By 1940, it had risen to 64.2 years, and by 2010 to 77.9 years. The main reason for this increase was a huge improvement in health, and major contributors to good health were better food, better working conditions, sewers, running water, vaccinations, penicillin, and the replacement of horse-drawn public transit with motorized vehicles.

Between 1870 and 1940, the kinds of food people ate and the way they bought it changed dramatically. In the 1920s, there was a huge shift from local merchants to chain stores such as A&P. Even in chain stores, though, "customers lined up and waited while clerks fetched items from shelves behind them." Later, of course, there was a large saving in labor as people started picking their own items off consumer-accessible shelves. Disappointingly for a fact-filled book, Gordon does not discuss that transition. He does, however, lay out the tremendous increase in food variety resulting from food processing, canning, and refrigeration, all of which happened in that 70-year period.

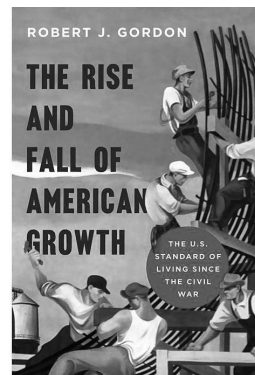
Housing also improved dramatically, mainly because most houses became "networked." That is, between 1870 and 1940, most houses obtained access to clean running water, sewage, electricity, and telephone lines. All of these were enormously beneficial: running water saved carrying

pails of water from an outside pump (which my mother did in our small town in Manitoba until 1958); sewage allowed for much safer disposal of human waste; electricity led to labor-saving devices in the home, plus lighting, which made evenings much more enjoyable; and telephones dramatically increased people's access to the bigger world.

A bumper sticker I used to see in the early 1970s in Los Angeles was "Cut Pollution: Ride a Horse." My impression, talking to fellow Angelenos, was that they saw no irony in this. People who think that horses were non-polluting would do well to read Gordon's book. He writes, "The horse was not only inefficient, eating up one-quarter of the nation's grain output, but also a source of urban pollution, disease, and occupational misery for the workers unlucky enough to have jobs in horse waste removal." And later: "Horses dropped thousands of tons of manure and gallons of urine on city streets; died in service, leaving 7,000 horse carcasses to be carried away in Chicago alone; and carried diseases transmissible to humans." On New York's Liberty Street, at one point, a manure heap measured seven feet high.

The advent of electric streetcars and then the internal combustion engine changed all that, making transportation easier, cheaper, and healthier, and extending people's range dramatically. One of the best parts of Gordon's book is his description of technological improvements in cars between 1906 and 1940, along with large reductions in price. I was pleased that he didn't bring the modern intellectual's disdain for cars to this book; Gordon well recognizes their huge value.

Entertainment also became incredibly more varied, easier to access, and cheaper. The three main improvements between 1870 and 1940 were the motion picture, the phonograph, and the radio. All became widespread during that time. By 1940, for



The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War

By Robert J. Gordon

762 pp.; Princeton University Press, 2016

instance, 80 percent of American households had a radio. Gordon also documents the huge improvement in entertainment between 1940 and 1970 (mainly TV) and between 1970 and now (smart phones that double as computers and music and video players).

If you aren't already convinced that health care in 1870 was primitive, you will be when you read Gordon's book. In a subsection titled "What Did Doctors Do?" he shows that they didn't do much good. For one thing, they still hadn't bought into germ theory, which was rela-

tively new. A few decades later, they had. Between 1870 and 1940, not only their knowledge, but also their tools, improved. These included the stethoscope, the ophthalmoscope, the laryngoscope, the X-ray machine, and the electrocardiogram.

Gordon understates medical progress since 1970, mainly, it seems, because the big increases in life expectancy had already happened. But there have been significant improvements since 1970 in quality-of-life medicine. If I need a knee replacement now, I can have one; in 1970 or even in 1980, I couldn't.

To his credit, he points out that regulation by the Food and Drug Administration has now slowed innovation to a crawl. Referencing work by Jan Vijn, a molecular geneticist at the Albert Einstein College of Medicine in New York, Gordon writes, "Had the regulatory norms of today existed in the 1940s, Vijn argues, innovations such as kidney dialysis and antibiotics might never have come to fruition." Who knows how many diseases we would have a better handle on now if not for the FDA's heavy regulatory hand?

The kinds of jobs we have and our pay have also improved dramatically. Although, surprisingly, Gordon presents no aggregate data showing the huge drop in workplace fatalities and injuries since 1870, he does

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give enough of a narrative to make you feel lucky not to be working under the conditions of the late 19th century. Hours were long, jobs were tedious and dangerous, and pay was low. The nature of work changed also. He writes, “The big shift over the century after 1870 was from truly disagreeable jobs mainly to repetitive occupations, leaving room for a small shift to nonroutine cognitive employment.” After 1970, there was another shift. “The ratio of disagreeable to non-routine cognitive jobs shifted from 7.9 in 1870 to 2.1 in 1940 to 0.1 in 2010, one of the great achievements of American economic growth over the past fourteen decades.” On pay, Gordon shows that between 1870 and 2010, real hourly compensation for production workers roughly twelve-tupled.

He shows that the first big improvement in clothing was the shift from home production to factory production, which helped women to pursue higher-value work outside the home. A much later shift was to imports. “The post-1980 years,” he writes, “observed a near total replacement of domestic-produced clothing by imports.” Because of increased imports, he notes, the rate of decline of clothing prices “more than quadrupled.” Their decline averaged 0.6 percent per year from 1940 to 1980, and then 2.6 percent per year from 1980 to 2013. Gordon cautions that the downside was the loss of 650,000 apparel jobs between 1997 and 2007, when Chinese imports increased rapidly. But given his earlier emphasis on the shift to “nonroutine cognitive jobs,” isn’t this decline largely a good thing? How, after all, are we Americans to get more interesting jobs if we don’t give up the less-cognitive jobs that can be done more cheaply in other countries?

Moreover, the main way we get progress, as Gordon shows, is with increased productivity, and increased productivity means doing more and more with fewer and fewer people. Consider U.S. agriculture, which is very productive. A table in his book shows that farmers were 46 percent of the work force in 1870 and only 1.1 percent in 2009.

But he seems at times to forget how progress comes about. He thinks that Amazon.

com has “weakened the economy” because he predicts that “there will be fewer jobs for construction workers building new shopping malls and fewer jobs for clerks, stocking staff, and managers at retail stores.” This is shocking coming from an economist who, elsewhere in the book, shows his understanding that producing greater output with fewer people is good, not bad.

Bad news? / Other reviews of Gordon’s book have given considerable attention to two of his claims: economic growth has slowed since 1970, and it will slow even more in the future.

His data do show lower growth since 1970. The good news is that economic growth since 1970 is higher than the data suggest. The reason is that the Gross Domestic Product Deflator and the Consumer Price Index (CPI), both of which are used to adjust for inflation, overstate inflation, and therefore understate economic growth. Gordon would almost certainly agree with this point. In 1996, he was a member of the Boskin Commission, appointed by the Senate Finance Committee and headed by Stanford University and Hoover Institution economist Michael Boskin. The commission estimated that the CPI overstated inflation by 1.3 percentage points annually before 1996. Although Gordon published some of his differences with the commission’s report, they were small. In a 2006 study published by the National Bureau of Economic Research, he estimates the bias to be at least 1.0 percentage point per year. If he’s right, official U.S. government data substantially understate current growth. Of course, that doesn’t undercut his point that growth since 1970 has been lower than before 1970 because the data before 1970 also overstated inflation and, therefore, understated growth.

But then the big question is “Why has growth fallen?” And here, Gordon disappoints. There seems to be a big elephant in the room, namely the increase in government scope and power, yet he doesn’t mention that. In 1966, Medicare and Medicaid, two huge government programs, began and grew exponentially. In 1970, President Richard

Nixon signed an executive order and congressional legislation creating two large agencies: the Environmental Protection Agency and the Occupational Safety and Health Administration. Since then, regulation has exploded even further, at the federal, state, and local levels. So there’s a good case to be made that the drop in growth is due, in part, to a large growth in government.

Gordon’s more controversial claim is that future growth will fall even further. He forecasts 1.2% annual growth in output per hour from 2015 to 2040. That compares to annual growth of 2.71% between 1948 and 1970. He then makes three adjustments, all of which drive the number lower. The 1.2%, he argues, falls to a 0.8% increase per person because of the retirement of the baby boom generation. The 0.8% then falls to 0.4% growth in median output per person because, he argues somewhat plausibly, a disproportionate share of the gains from growth will go to higher-income people. Finally, he reduces the 0.4% to 0.3% annual growth in disposable median income per person because the government will find itself raising taxes to bail out Social Security and Medicare.

This does sound grim. The good news, as noted earlier, is that both the CPI and the GDP Deflator overstate inflation and understate growth. So, even in Gordon’s pessimistic scenario, growth of median disposable income per person could be, say, 1% annually.

But his most questionable number is the 1.2% annual growth in output per hour. How does he reach this? By taking the average growth from 1970 to 2015 and reducing it somewhat for a slowdown in the growth of educational attainment. In other words, he extrapolates from the last 45 years. That’s pretty iffy. He quotes Joel Mokyr, an economic historian and Gordon’s Northwestern University colleague, who observes, “History is always a bad guide to the future and economic historians should avoid making predictions.” Gordon doesn’t heed that advice.

He does realize that growth depends on economic policy. Unfortunately, with some important exceptions, the policies he proposes would reduce growth. Because he

worries so much about income inequality, he advocates raising the minimum wage and substantially increasing tax rates on dividends and capital income.

On the minimum wage, he writes: “Standard economic theory implies that an increase in the minimum wage would raise the unemployment rate of the low-wage workers. However, a substantial body of economic research indicates little or no effect.” Really? Is he unaware that another, much more substantial body of economic research indicates a bigger effect? So we have theory indicating an effect, some evidence of little or no effect, and more evidence indicating a bigger effect. Doesn’t it make sense, then, if one is worried about growth, to go with the theory?

And surely Gordon must be aware that

taxing capital more heavily, as increased tax rates on capital gains and dividends would do, would reduce the incentive to invest in capital. With a lower growth of capital, there would be lower growth of productivity and, therefore, output. Yet he mentions not a word about this large downside to his proposal. At that point in the book, I got the impression that one of his agenda items was to push for his preferred policies regardless of their effects on growth.

To his credit, he does call for large doses of deregulation. He would reduce the imprisonment rate of Americans, which, he points out, is a large multiple of the rate in Europe. That would save taxpayer money and increase the real incomes of people who would otherwise be in prison. He also calls for drug legalization, pointing out the savings to taxpayers

and the gains in tax revenues from taxing drugs, although not mentioning the gains to people who, as a result of legalization, don’t end up in prison. Possibly he thought that this gain was obvious. He also calls for rolling back regulations on land use, which he notes, citing Harvard economist Edward Glaeser, transfer wealth from the less affluent to the more affluent and also reduce productivity. Finally, he would get rid of many regulations that restrict occupational choice and thereby “restrict upward mobility for lower-income individuals.”

If you want to see how far we have come and how tough life was a century and a half ago, read Gordon’s book. If you want that progress to continue, eschew his tax and wage policy recommendations and go for large cuts in regulation. R

Working Papers ⇄ BY PETER VAN DOREN

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

Cigarette Taxes and Food Stamps

“Behavioral Responses to Taxation: Cigarette Taxes and Food Stamp Take-Up,” by Kyle Rozema and Nicholas Ziebarth. March 2015. SSRN #2586410.

In recent issues of *Regulation*, authors have presented evidence that the consumption of cigarettes by those who continue to smoke—both adults and teenagers—is now unaffected by cigarette tax increases (“Cigarette Taxes and Smoking,” Winter 2014–2015 and “Working Papers,” Winter 2015–2016). That is, current smokers have such strong preferences for smoking that additional cigarette tax increases do not reduce smoking further and cannot be justified by health benefits.

For low-income smokers, the price effects of the tax increases are large. From 2000 to 2010, cigarette prices doubled from \$3 to \$6 a pack. A full-time minimum-wage worker’s expenditure on a pack a day has increased from 4% to over 10% of a day’s income.

How have they managed? It appears that many have turned to food stamps. During the same time period, the share of the population receiving food stamps has more than doubled, from 6% to 15%. And low-income smoking households are 50% more likely to enroll in food stamps relative to low income non-smoking households.

Are these stylized facts causally related? The authors examine whether exogenous variation in the imposition of state cigarette tax increases changes food stamp enrollment. They conclude that

each dollar of tax increase raises the probability of an eligible (low-income) non-enrolled smoking household signing up for food stamps by between 2 and 3 percentage points from a baseline probability of 25%.

President Obama proposed increasing federal cigarette taxes by about \$1 in 2013. The estimated revenue increase was \$8 billion. The authors use their work to estimate that, because of the higher tax, food stamp enrollment would increase by about 400,000 people, costing the program \$500 million.

E-cigarettes and Adolescent Smoking

“How do Electronic Cigarettes Affect Adolescent Smoking,” by Abigail S. Friedman. April 2015. Available at http://scholar.harvard.edu/files/afriedman/files/how_do_electronic_cigarettes_affect_adolescent_smoking_circulate_0.pdf.

In May the U.S. Food and Drug Administration issued regulations on e-cigarettes under authority granted by the Tobacco Control Act of 2009. In response, many policy analysts, including my Cato colleague, Walter Olson, have argued that requiring e-cigarettes to navigate an FDA-approval process is a bad idea because e-cigarettes are less harmful than traditional cigarettes. (“The FDA’s Slow-Motion Ban of e-Cigarettes,” *Ricochet*, May 9, 2016.) To be sure, the FDA, in its final rule, acknowledged that many believe that “the aerosol is completely harmless or signifi-

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cantly less harmful than tobacco smoke from combusted tobacco products.” And the “FDA recognizes that the aerosol that is exhaled by users of some e-cigarettes and similar electronic apparatus may not pose as much harm as smoke emitted from combusted tobacco products.” But, sadly, “the Tobacco Control Act does not require that FDA make a finding that a product is harmful in order to deem it subject to chapter IX of the FD&C Act; FDA is authorized to deem any product that meets the definition of a “tobacco product” pursuant to section 901 of the FD&C Act.”

At least according to the FDA, Congress did not instruct it to reduce the risks associated with traditional tobacco use. Instead, Congress told the FDA to regulate tobacco or anything, such as nicotine, derived from tobacco, and that is what the FDA is going to do.

If the courts or Congress instructs the FDA to consider risk reduction in its treatment of e-cigarettes, then the findings of Abigail Friedman’s paper would seem relevant. She compares conventional smoking rates in states that have enacted e-cigarette sales bans for minors to smoking rates in states that have not banned sales to minors. She includes controls for state and year fixed effects. She concludes that cigarette use among 12–17 year-olds increases by 0.7 to 1 percentage points (relative to other states) after a ban on e-cigarette sales to minors is enacted.

Does easy access to e-cigarettes induce kids to “smoke” who would not smoke if only conventional cigarettes were available? Friedman estimates propensity-to-smoke regressions using demographics and other relevant variables. Those predicted to be unlikely to engage in conventional smoking show no change in recent use of e-cigarettes, while those predicted to be likely smokers exhibit falling conventional cigarette use over time and increased e-cigarette use.

Corporate Inversions

“Are Corporate Inversions Good for Shareholders?” by Anton Babkin, Brent Glover, and Oliver Levine. December 2015. SSRN #2700987.

Among industrialized countries, the United States has the highest corporate tax rate, at 35 percent. To take advantage of lower rates in other countries, some U.S. firms elect to sell themselves to smaller foreign firms, a process called “inversion.” These sales have drawn considerable ire from U.S. politicians and activists, and the Obama administration has vowed to “do something” about it.

In April, the U.S. Treasury Department issued regulations to throw sand in the gears of inversions. The commentary on these regulations—both pro and con—was the usual food fight about growth, taxes, and investment in the United States. Underlying all of that talk was the assumption that inversion reduces taxes for shareholders. But that assumption is incorrect in many instances.

The tax consequences of inversions are complicated because they are taxable events. That is, individual shareholders are taxed on the increased value of their shares. This can result in different tax outcomes from inversions for shareholders who have held

the stock for a long time prior to the inversion and short-term shareholders (including corporate officers exercising company stock options).

For an inversion to be advantageous, the present value of the corporate tax reduction must be larger than the capital gains tax payments. When the reduction in the effective corporate tax rate is modest, those shareholders who purchased the stock near the current market price and thus have little individual capital gain to be taxed are net winners while longer-term shareholders who purchased the stock at a price much lower than the current market price, and thus have large capital gains, are net losers.

The authors study 73 inversions that occurred from 1983 to 2014 for which equity price data are available. Using historical price and turnover data for the 73 inversions, the authors estimate returns for the average, median, 10th percentile and worst-off shareholder. For those investors who had owned stock for five years or more and whose firms had 35 percent foreign earnings, the average return (in the worst 10 percent of the distribution of inversions) was –2.21%.

So if many long-term shareholders lose from inversions, why do they occur? The authors focus on the difference in returns to CEOs and long-term shareholders. The return earned by CEOs of inverted companies is different than the return of average shareholders because the CEOs have options rather than stock and the difference between the option strike price and market price is not a capital-gain taxable event. In their data, the average CEO had capital gains of \$1.3 million and paid a capital gains tax of \$538,000, but they also had increased value of options of \$530,000.

In many circumstances, the CEO has incentives to invest that are not well-aligned with long-term shareholders. The authors show that the higher the option compensation of a CEO, the greater the likelihood of an inversion, controlling for industry and year fixed effects, normal firm characteristics, as well as the foreign share of taxes.

Public Housing and Crime

“Externalities of Public Housing: The Effect of Public Housing Demolitions on Local Crime,” by Danielle H. Sandler. March 2016. SSRN #2749322.

High-rise public housing has long been associated with crime in popular culture. This paper examines crime rates at the block level before and after the demolition of public housing buildings in Chicago from 1995 through 2010. The “treatment” radius is within 0.25 miles of demolition. The control sample radius is within 3 miles of demolition. Crime is reduced 0.047 crimes per month per block for every 100 units demolished or 2.4 percent for every building demolished. No increase in crime occurred within the control area around a demolition, so crime was not merely displaced. For the average demolition, total crime decreased by over 8% and murders and assaults decreased by over 30%. R

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