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BRIEFLY NOTED

Does the Jones Act Endanger American Seamen?

BY THOMAS GRENNES

The Merchant Marine Act of 1920, more commonly known as the Jones Act, requires (among other things) that all goods transported by water between U.S. ports be carried on U.S.-flagged ships, constructed in the United States, owned by U.S. citizens, and crewed by U.S. citizens and U.S. permanent residents. This provision was intended to strengthen the country's merchant marine and increase national security.

Now, nearly a century after the law's adoption, there is increasing evidence that it has the opposite effect. Because American-built ships have become increasingly expensive, shipping companies are slow to purchase new ones and, as a result, the U.S. merchant marine fleet has become older and less safe. This is an example of the unintended consequences of certain policies. It is doubtful that the original sponsors or the current defenders of the Jones Act intended to create conditions that would increase the dangers faced by American seamen, but that has been the result.

El Faro tragedy / A recent tragedy illustrates this point. In 2015, a Jones Act–compliant ship, the *El Faro*, sank on a voyage from Jacksonville, Fla. to Puerto Rico. All 33 crew members died after the ship sailed into a hurricane.

The *El Faro* was 40 years old, 31 years older than the average foreign-flagged ship of its type. There was strong criticism in the press about the poor preparation of the ship for the conditions, and a sharply worded article in the *National Review* asked if the Jones Act was to blame for the deaths.

If old age contributed to the disaster, exactly what factors were relevant? U.S. Sen. Bill Nelson (D–FL) and others complained about the inadequacy of the ship's open lifeboats. These lifeboats were once common, but newer ships rarely use them today. Others complained that a more modern ship design would have protected against the loss of propulsion that left the crew unable to control the *El Faro* in the powerful winds. Previous crew members claimed the ship was in poor general condition even after its owner spent $21 million on service and upgrades. In comments to CNN, they described the *El Faro* as a "rusty bucket" whose "decks were filled with holes."

The Coast Guard commissioned a Marine Board of Investigation that held hearings on the disaster to investigate its causes, possible misconduct and violation of laws, and to make recommendations to improve future safety. The board has not yet issued its report.

Older ships, greater risk / Systematic evidence indicates that American-flagged ships are older, and older ships are less safe. Age varies by type of ship, but over all types, the average age for U.S. ships in 2016 was 33 years old, whereas foreign-flagged ships averaged 13 years, according to the *World Maritime News*. In every ship category, U.S. vessels were older.

A recent study by a group at Southampton University analyzed shipping data for the last 15 years. It concluded that older ships were associated with more frequent accidents. Marine insurers have a powerful incentive to investigate the determinants of shipping risk, and their trade group, the International Union of Marine Insurance, has compiled data also indicating that older ships have had more frequent accidents. Signee nations of the Paris Memorandum of Understanding on Port State Control, an international agreement on ship inspections, collect data on inspections of ships in ports and frequency of detentions of unsafe ships. Their latest data for July 2017 indicate that U.S. ships ranked 36th out of 42 relatively safe countries. In safety, they ranked below all the Western European countries and Japan

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and China. They also ranked below two of the leading "flags of convenience" countries, the Marshall Islands and Liberia.

Comparative advantage / How does the Jones Act affect the safety of American-flagged ships? Answering that question requires an understanding of the economics of shipbuilding.

American shipbuilders once had a comparative advantage over other nations in producing ships because of the U.S. abundance of forest products. As a result, American shipbuilders had lower costs for wooden ships that were powered by sails and the wind. But American-built ships today cost approximately five times as much as comparable ships on the international market. Over 90% of commercial ocean-going ships are now produced in South Korea, Japan, and China. The United States is a small, high-cost producer with only three shipyards producing commercial, ocean-going ships.

Because new Jones Act–compliant ships are so expensive, domestic shipping companies delay replacing them. Consequently, the American-flagged fleet is older than the foreign-flagged fleet.

Because compliant ships are so expensive, domestic shipping companies delay replacing them, making the American fleet much older than the foreign fleet.

The lack of competitiveness of American shipyards is evident from the choices made by American companies that ship their products internationally. American exporters and importers are not constrained by the Jones Act, and they choose foreign-flagged ships nearly all of the time to make those shipments.

Subjecting American seamen to greater danger is an unintended consequence of U.S. shipping policy. There are other examples of government policies that have had the unintended effect of making transportation more dangerous. For instance, consider the "fracking" revolution in natural gas and oil extraction, which has resulted in oil being produced in locations not served by older pipelines. Strong opposition to building and extending pipelines has led to more oil being carried by railroads and, as a result, there have been widely reported deaths and substantial damage as a result of rail accidents. The opponents of pipelines probably have not intended to increase the volume of oil carried by railroads, but that is the result.

Jones Act's durability / Nearly all systematic studies have concluded that the Jones Act has imposed net costs on the American economy. Its contributions to national security have also been called into question. (See "America's Welfare Queen Fleet: The Need for Maritime Policy Reform," Summer 1991.) Couple that with the greater danger for American crews, and we're left to wonder how the law has survived for nearly 100 years.

The act has the political advantage of having concentrated benefits but diffuse costs. The beneficiaries are a small number of shipbuilders, operators, and their labor unions. Those groups have formed an effective lobby in favor of continuing the act.

Conversely, many of the law's costs are spread rather evenly among millions of users of transported products. Most consumers are not aware of the Jones Act, and the cost per person is small relative to most items in their budgets. One estimate places the total consumer cost of the Jones Act at $1.8 billion per year. Spread that cost evenly among 325 million Americans, and the cost per person would be about $5.50 per year. That is little more than the cost of a couple of gallons of gas and less than one six-pack of good beer. Hence, individuals have little incentive to spend their time and money lobbying against the Jones Act.

The law also continues to receive strong support from presidents and members of Congress in both parties. It has developed one of the most effective lobbies in Washington. U.S. Sen. John McCain (R–Ariz.), one of the few prominent opponents of the act, stated in 2012 that repeal legislation would not get 20 votes in the Senate. Earlier attempts to reform the Jones Act, including the efforts of a former commissioner of the Federal Maritime Commission, were not successful.

THINKSTOCK

However, the safety issue could weaken the support of some members of Congress for the act. Surely no Jones Act supporters intend to increase the risk faced by American seamen when they do their jobs. The huge cost differences in ships are indisputable, and the high cost of American-built ships has resulted in an older and less safe American-flagged fleet. Less safety is an unintended consequence of the Jones Act.

Union leaders are strong supporters of the Jones Act. Do they represent their members well if the Jones Act results in less safe working conditions? Or are union leaders subject to the same agency problem faced by heads of corporations? Many shareholders have complained that CEOs have represented their own personal interests rather than the best interests of shareholders. Are union leaders ignoring the additional risks faced by officers and crews of older and less safe Jones Act ships?

Reform/ The Jones Act's perverse incentives that make American ships older and more dangerous could be eliminated by simply repealing it. Unfortunately, the political realities noted above make it unlikely full repeal will happen anytime soon. However, a more modest reform would reduce the incentive to use older ships on some of the most dangerous routes.

Ocean-going ships traveling to and from the non-contiguous regions (Hawaii, Alaska, and Puerto Rico) could be exempted from the Jones Act mandate to use the more expensive American-built ships. This exemption would allow carriers to buy the much cheaper and more modern foreign-built ships and replace them more frequently. This exemption has been formally proposed by the Hawaiian Shippers' Council. Other features of the Jones Act, such as requiring American crews, ownership, and registration, could remain in force.

Support for this modest reform could be increased by offering to compensate some shipbuilders for possible loss of jobs. Buyouts of special-interest groups that gained from historical protectionist policies are controversial, but they have been used successfully to end some old and inefficient programs, such as the U.S. tobacco and peanut support programs that dated back to the 1930s. Even with the cost of the buyout, those initiatives have benefited the general public by removing a gross inefficiency.

Conclusion/ Requiring Americans to use American-built ships on domestic routes increases shipping costs in the short-run and reduces innovation and slows growth in the long-run. In addition, the Jones Act makes the American-flagged fleet older and less safe than it would otherwise be. Instead of producing a stronger merchant marine, the Jones Act has contributed to a smaller and older domestic shipping industry with more dangerous conditions for American seamen. *R*

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Deregulation through No Regulation?

BY SAM BATKINS AND IKE BRANNON

In the first few months of Donald Trump's administration, Congress has passed and the president has signed a record 14 Congressional Review Act (CRA) resolutions of disapproval, withdrawing rules implemented by Barack Obama's administration in its final months in office. These CRA actions will save a total of $1.1 billion in annual compliance costs. In addition, Trump issued an executive order calling for the repeal or amendment of two existing rules for each new rule an agency implements.

Some advocates of limited government have complained that, so far, the administration's regulatory accomplishments have largely been limited to those CRA votes. They hope Congress will undertake expansive deregulation of financial services, health care, and energy in the coming months.

But one feature of Trump's regulatory policy is being overlooked: the decline in the issuance of new rules. There has been a massive slowdown in regulatory output, which Trump's supporters should take as proof that his administration is serious about regulatory reform.

We examined the data and found ample evidence to support the perspective that rulemaking has slowed dramatically since Inauguration Day. Through its first five months, the Trump administration has imposed just 1.9% of the average number of rulemakings for that same length of time since 1994.

Methodology/ To carry out our analysis, we compiled data from the Office of Information and Regulatory Affairs (OIRA) from 1994 to present. We used 1994 as our start year because it was the first full year after President Bill Clinton issued Executive Order 12,866, which mandated that all major regulations—that is, those that have a compliance cost of $100 million or more—undergo cost-benefit analysis. The order dramatically narrowed and focused the scope of OIRA's scrutiny. In 1992 OIRA

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reviewed 2,285 rulemakings, but by 1994 the number of reviews declined to 831.

We also obtained data on the total rulemakings as well as the number of economically significant rulemakings OIRA reviewed, and the number of rules that OIRA rejected in some ways or the issuing agency retracted because of objections from other agencies. This information allowed us to calculate the percentage of economically significant rules reviewed, the percentage of rules withdrawn, the number of approved rules, and the number of approved economically significant rules.

Finally, with data from the American Action Forum (publically available at www.regrodeo.com), we calculated the final regulatory costs for executive branch agencies (excluding independent agencies like the Securities and Exchange Commission or the Federal Communications Commission, which are exempt from EO 12,866) from 2005 to present, years in which data were available. With this information, we could observe a few broad trends in OIRA activity for the past 23 years as well as regulatory cost data for the past 12.

Historic slowdown / So far, the Trump administration's regulatory output is historically low, we find. The average number of OIRA-reviewed rulemakings over a five-month period during the 23 years we examined was 235, but there have been just 53 reviews in 2017, which is just 22% of the historical average.

When it comes to withdrawn rulemakings, previous administrations averaged about 19 over their first five months, but the Trump administration withdrew 27. The withdrawn measures were typically legacy rules of the previous administration, and withdrawing rules is common during presidential transitions regardless of party. For example, during the period studied, there were 130 withdrawn rulemakings in 2001, the first year of the George W. Bush administration, and 37 such withdrawals in 2009, the first year of the Obama administration.

The Trump administration has focused more of its attention on economically significant measures. Some 34% of OIRA's work under this administration has involved economically significant rulemakings, as compared to the Clinton and Bush administrations, where economically significant rules comprised less than half that proportion. However, at this early stage of the Trump administration, we are not yet ready to pronounce this a definite change of emphasis; given its two-in/one-out edict, the administration may simply be focusing on larger rules.

During the Obama administration, the proportion of rules that were economically significant rose to nearly 23%, and climbed to a record 30% in its last year. That administration published 118 major rules in 2016, 18% more than in any other year, but the total number of rulemakings was not that much higher than in Obama's previous years of governing.

On average, cabinet-level agencies finalized rules costing $30.1 billion for the first five months of the year. The Trump total was just $593 million.

During presidential transitions, the number of withdrawn rulemakings can cloud the OIRA review data because so many rules are withdrawn when a new president enters. But the datum that is most important to business—and, we argue, economic growth—is the number of new rules approved. The Trump administration has been positively stingy by this measure, approving just 26 measures during the period we examined, or 12% of the average for that length of time. By contrast, the historical average is 216 measures.

The Trump administration has approved 12 economically significant measures, 32% of the historical average. Even that small number overstates things; three of the 12 were formal delays of previous rules, and one reduced health care compliance costs. Removing those four leaves just eight significant new regulations approved, or 22% of the historical average.

Although counting up the sheer number of rules reviewed is instructive, it does not fully capture the extent of the burden of rulemaking because it fails to capture the magnitude of each rule. For instance, the Clean Power Plan imposed carbon emissions standards on power plants and was far more economically significant than the routine migratory bird hunting regulations that are approved annually.

Using data from the American Action Forum on regulatory cost estimates, we can determine the regulatory burden each year from 2005 to present. On average, the cabinet-level agencies together finalized rules totaling $30.1 billion in net present value costs in the first five months of each year from 2005 through 2017. The high was in 2010, when the Obama administration published rules with $97 billion in costs between January and June.

The Trump administration figure for that period is just $593 million, or 1.9% of the historical average, and $312 million of that figure represents routine airworthiness directives from the Federal Aviation Administration. In addition, a legacy rule from the Obama administration's Department of Labor that was finally published on January 23rd imposed $345 million in costs—a cost that goes under the Trump administration, but the rule is hardly a Trump product. Excluding those rules means the current administration has actually *cut* total regulatory costs by $64 million, and that figure doesn't include the cost savings from the CRA votes.

Can Trump keep it up? / While publishing few new regulations may be considered a good start for those who believe the regulatory state has grown beyond its usefulness, it is simultaneously not enough and also unsustainable. Just saying "no" to regulations for four or eight years—good and bad alike—will be politically difficult to maintain, even with a Republican Congress. Also, some believe that stopping new rules is only a first step to

repealing costly, ineffective rules already in place. The Trump administration has made only tentative steps in that direction thus far, no doubt in part because of a lack of personnel in place.

The Trump administration will need help from Congress if it wants to repeal portions of the Affordable Care Act, the Dodd–Frank financial legislation, and many of the Obama administration's energy rules. The public got its first glimpse of the broader Trump regulatory agenda when it published its Unified Agenda of Regulatory and Deregulatory Actions. Unlike previous agendas, this one focused more on deregulation.

It is easy to stop issuing new regulations, at least for a short period of time. But pulling back existing rules requires legislative and administrative proficiency that has yet to be demonstrated. Based on public information, not every agency has complied with EO 13,777, issued by Trump in February, which establishes regulatory reform officers and task forces within each agency. The administration cannot deregulate if it does not have political appointees in place to identify regulations for repeal.

What's more, the courts will likely stand in the way, or at least delay, many of the controversial deregulatory moves of the Trump administration. While many small-government supporters may agitate for the repeal of the Clean Power Plan or the Department of Labor's Fiduciary Rule, the reality is that the federal courts will likely determine their fate. Occasionally, courts have stood in the way of onerous new rules, but there is little doubt unions and environmental groups will spend most of the next three years in court litigating every aspect of deregulation. If President Trump's regulatory vision is to succeed, he will have to rely on deference from the judicial branch, otherwise the on-paper savings of regulation will dissipate with each new court opinion.

Another point that we have made previously in these pages is that rules that have already been implemented for some time, and that affected firms have already spent money and resources in order to ensure compliance, may not save anyone all that much money if they were to be repealed. Compliance costs typically increase fixed costs more than marginal, ongoing costs.

For instance, many coal-fired plants have already been shuttered in recent years, both in anticipation of more stringent emissions regulations and also because the sustained low price of natural gas has made much coal-fueled generation uneconomical. Repealing the rule will not reduce compliance costs for coal plants that have already spent money to adhere to the new regulations, and many of the shuttered plants have been dismantled. Those that are still in existence may remain cost-ineffective even with the rule repealed.

A successful deregulatory agenda will need to focus on the repeal of regulations that truly hold the promise of generating substantial cost savings compared to the loss of whatever regulatory gains are sacrificed.

Nothing is not enough / If libertarians were told in 2016 that the following year's regulatory output would be a tiny fraction of the historical average, they probably would have cheered. However, those who agitate for less regulation ultimately want to achieve more freedom, greater labor force participation, and fewer barriers to market entry, each of which should help boost economic growth. To truly boost economic freedom, it will take more than a regulatory slowdown and a few CRA resolutions of disapproval.

This has happened before. The deregulation of the late 1970s and early 1980s helped to transform the economy and was accomplished on a bipartisan basis. What's more, it was congressional legislation that spurred the deregulatory agenda, with the encouragement and assistance of Jimmy Carter's administration.

Whether the same sort of success can be accomplished through executive action alone is a question for the courts. But it is unclear whether Congress has the votes or the White House has the consensus-building talents for the kind of durable, bipartisan efforts that could replicate the successes achieved by Presidents Carter and Ronald Reagan. *R*

Which Agency Improves Rulemakings the Most?

BY SAM BATKINS

In a previous article ("Changing Rule Estimates" Spring 2014), Ike Brannon and I noted that the estimated aggregate burden of rules issued by some agencies tend to increase drastically from the rule's proposed version to its final form. However, for other agencies, namely in the environmental realm, the estimated burdens tend to shrink from proposed rule to final regulation.

I examined 73 major regulations (rules with a compliance cost of $100 million or more) issued during the last six years that monetized both costs and benefits in the proposed and final versions. These data revealed which agencies saw their benefit-cost ratios change over the course of the rulemaking, as well as the aggregate change in net benefits during the life of the rulemaking.

Of the 73 rulemakings examined, 34 (46%) improved their benefit-cost ratio from the proposed to final versions. The net estimated benefits increased by $22.5 billion, or $308 million per rule.

A handful of rulemakings drove those results. The Environmental Protection Agency's Mercury Air Toxics Standard (MATS)

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rule originally had estimated costs of $10.9 billion and benefits of just $118 *million*. But by the final rule, costs had declined to $9.6 billion and benefits increased to $57 *billion*, largely because they included the co-benefits of particulate matter reduction. This resulted in a gross change of $58 billion in favor of greater net benefits.

The Environmental Protection Agency's Greenhouse Gas Standards for Heavy-Duty Trucks underwent a drastic change as well. In its proposed version, annual costs were $1.3 billion, compared to $11.5 billion in benefits. By the final rule, costs had increased to $2.5 billion, but benefits had also increased to $19.8 billion, leading to $7 billion in net benefit gains. However, the rule's proposed benefit-cost ratio of 8.8:1 declined slightly to 7.6:1 for the final rule.

Other notable changes during the course of recent rulemakings:

- 2013 Ozone Standards: $20 billion reduction in net benefits
- 2017–2025 CAFE Standards: $4.4 billion decrease in net benefits
- 2015 Rule on Furnace Emissions: $4.4 billion increase in net benefits

In sum, while the ratio between benefits and costs might have declined for a majority of the major rules in the sample, the magnitude of some rules drove net benefits higher overall.

Table 1

CHANGES IN AGENCIES' ESTIMATED BENEFIT-COST RATIO BETWEEN PROPOSED AND FINAL RULE

Agency	Average Benefit-Cost Ratio	Increased Ratios	Decreased Ratios
Energy	40:1	13	7
EPA	11:1	8	9
FDA	2.9:1	2	4
Labor	10:1	1	4
Transportation	5.8:1	7	13

Agency results/ Given the examples above, the agencies that showed the greatest "improvement" from initial rule proposal to final rule aren't all that surprising. In the words of Washington rainmaker C. Boyden Gray, "Particulate matter and ozone seem to offer EPA an inexhaustible well of regulatory co-benefits." This statement is evident in the data. Table 1 tracks agencies with at least five rulemakings in our sample, and presents the average benefit-cost ratio by agency and the number of rules with increased and decreased ratios.

The EPA and the Department of Energy stick out immediately. But like many issues with small sample sizes, outliers are a factor. For instance, in the Energy Department's Pre-Rinse Spray Valves Efficiency Rule, the original benefit-cost ratio was 341:1, owing largely to the insignificant costs. The final rule further reduced costs and the ratio increased to 646:1. Despite the agency's sterling ratio of 40:1, excluding the Pre-Rinse Spray Valve Rule reduces the average figure to a more pedestrian 8.7:1. The cumulative increase in net benefits for Energy is $5.9 billion, implying that the agency has acted to reduce costs and increase benefits during the rulemaking process.

The "inexhaustible well of regulatory co-benefits" has aided the EPA's efforts to implement regulations as well. The agency's benefit-cost ratio for individual rules ranged from costs exceeding benefits by 10:1, to benefits exceeding costs by 23:1. In the EPA's 2013 Particulate Matter Rule, costs were merely $69 million, compared to $3.7 billion in benefits, good for a 54:1 ratio. The final rule drastically increased both: costs from $69 million to $350 million, and benefits from $3.7 billion to $8.2 billion. Thus, even though the benefit-cost ratio declined from the proposed to the final version, the net benefits increased by $4.1 billion.

Two agencies, the Food and Drug Administration and the Labor Department, had positive benefit-cost ratios but negative net benefit changes. The FDA only had six rules in the sample, but cumulative net benefits declined by $181 million as rulemakings progressed from the proposed to the final rule stage. In its Poultry Slaughter Inspection Rule, costs increased by only $5 million, but benefits declined by more than $340 million. Thus, the benefit-cost ratio went from 18:1 to a mere 1.2:1.

The Labor Department largely suffered because of net benefit declines to its controversial Fiduciary Rule for investment advisers, thanks to a massive increase in

estimated costs. In the proposed version, costs were just $570 million; however, the final rule estimated burdens at $1.9 billion. Benefits did increase from $3 billion to $3.4 billion, but the benefit-cost ratio declined from 5.2:1 to 1.7:1. The agency gained largely from its Silica Rule, which managed to turn a proposal with $2.8 billion in net benefits into a final rule with $3.7 billion in net benefits. Despite those gains, the benefit-cost ratio declined from 5.2:1 to 4.5:1.

Improvements in net benefits do not necessarily equate to a more favorable cost-benefit ratio. The opposite is true as well.

Explanations / This discussion largely illustrates that improvements in net benefits don't equate to a more favorable cost-benefit ratio. The opposite is true as well. Although they are sometimes used synonymously, plenty of rulemakings can improve ratios while also narrowing the gap between benefits and costs. Likewise, agencies can drastically improve net benefits but the overall ratio can decline.

As noted, this is largely a function of rising benefits or declining costs. It appears from the data that costs are more prone to fall and benefits are more likely to rise, resulting in an increase in net benefits. Overall, regulators increased benefits in 39 rules from proposed to final stage, compared to 36 times for costs. With regard to net change, the cumulative benefits in the sample increased by more than $9 billion from proposed to final rule, but costs declined by $4.3 billion. The average rule in the sample gained $127 million in benefits, but lost $61 million in costs.

Does this mean that regulators often tap the "inexhaustible well of regulatory co-benefits" while finding ways to ease compliance burdens during the notice-and-comment period? It's unclear. The largest rule in the sample, the proposed Ozone Rule, lost $13.6 billion in costs from the proposed to final stage, but benefits also declined by $33 billion. The MATS rule also shed $1.3 billion in costs during the process.

One could assume that agencies begin a major rulemaking by proposing one of the strongest regulations possible, leaving room to remove compliance burdens to placate industry. However, if this were true, why do benefits increase more frequently and with a greater magnitude than costs? Perhaps agencies have broad discretion with benefits as well, able to appease environmentalists and special interests by touting higher health benefits with the final rule? It is notable that the FDA, one of the major agencies without access to particulate matter and ozone benefits, has one of the lowest benefit-cost ratios among the agencies studied.

Conclusion / The short answer to the title of this article is the Department of Energy, which improved the benefit-cost ratio in 65% of its rulemakings and increased net benefits by $5.9 billion. Yet that is hardly the entire story; explaining why benefits and costs vary so much within a rulemaking's life is far more important than noticing that they fluctuate wildly.

Still, the trends across this sample are interesting. For observers who complain that public comments don't move the needle on regulatory burdens, there is evidence that costs often decline, dropping by $4.3 billion in the sample. Benefits, on the other hand, seem to evolve and grow, gaining more than $9 billion.

With only 73 rules in my sample, additional data could inform this research. The specific answers to many of the questions posed are likely specific to individual rules and could inform federal rulemaking generally. *R*

Regulation and Big-Firm Capitalism

BY BRUCE YANDLE

With the U.S. economy growing at a zombie-like pace, we're now hearing whispers that American-style capitalism is passing away. A recent paper by Credit Suisse analysts Michael Mauboussin, Dan Callahan, and Darius Mjad indicates that more than half of all U.S. publicly traded companies have disappeared from stock market listings in the last 20 years. The authors note that the disappearances are not explained statistically by growth in gross domestic product or other relevant independent variables when they model the count of publicly traded firms. The same phenomenon is not seen in other parts of the industrialized world. Put another way, something else is going on in the United States.

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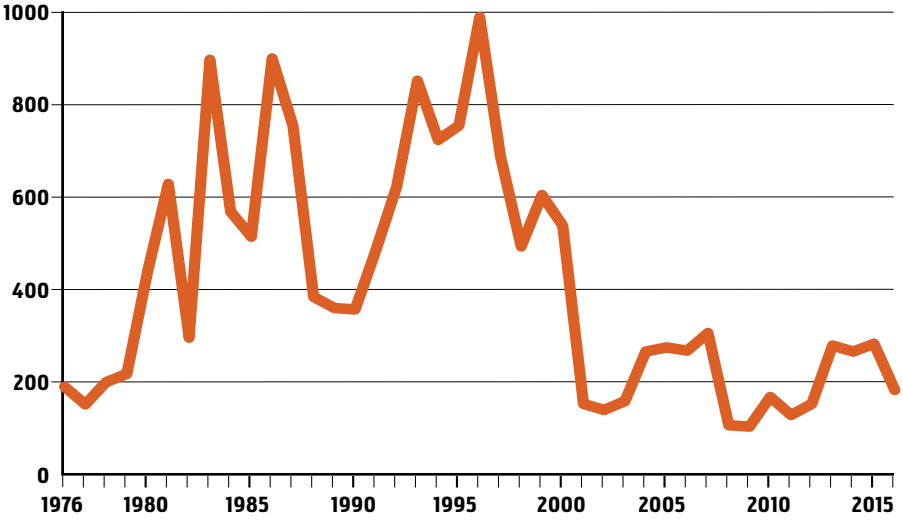
He expresses appreciation to the University of Texas, Austin's Center for Politics and Governance for their support of this research.

In 1997 there were 7,355 exchange-listed firms, according to Mauboussin et al.; today there are less than 3,600. According to their estimates, there's currently a 5,800-firm shortfall, if historical trends had continued. But though the number of market-listed firms has gotten smaller, the firms themselves have gotten much bigger and older; the average market-capitalized value of listed firms has increased 10-fold and the average age of listed firms has risen 80%.

What's going on here? Could the disappearance of exchange-listed firms be

FIGURE 1

COUNT OF NEWLY LISTED FIRMS, U.S. EXCHANGES. 1976–2016



SOURCE: "The Incredible Shrinking Universe of Stocks," by Michael J. Mauboussin,Dan Callahan and Darius Mjad. Credit Suisse, March 22, 2017: p. 22.

evidence of the rise of big-firm capitalism described by William Baumol, Robert Litan, and Carl Schramm in their 2007 *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity*, in which they argue that large firms have distinct advantages in global market operations? Or could it be that, among other advantages, large firms benefit from regulatory economies of scale, as Kevin Murphy, Andrei Schleifer, and Robert Vichny described in a 1993 paper and Richard Wagner in a 2016 book?

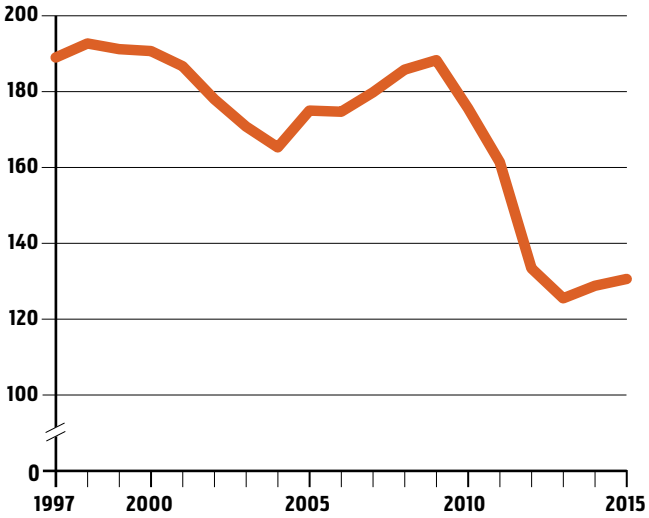
Big firms, big markets / Baumol, Litan, and Schramm offer a taxonomy as well as a theory of capitalism's evolution. They first describe bad systems in which national economies are formed by way of *state-guided capitalism* in which national governments pick winning firms, industries, and sectors. By way of subsidies, loans, or other special treatments, governments then seek to give a predetermined advantage to the selected firms or sectors. We see an example of state-guided capitalism in the current U.S. government's support for certain forms of renewable energy (ethanol and solar) and low-emission automobiles, the extensive government management of health care, the regulation of housing finance, and the government direction of agricultural markets.

Oligarchic capitalism, the second bad category identified by Baumol, Litan, and Schramm, is generally observed in countries that lack an independent judiciary as well as predictable definition and enforcement of property rights. In these situations, strong families emerge as the owners and protectors of wealth, sometimes in collusion with government dictators and leaders or through extralegal means, such as with the mafia. In recent years, we have observed oligarchic capitalism emerge as previously socialist countries became transition economies. In those cases, oligarchic capitalism has been termed "crony capitalism." The absence of strongly evolved market-friendly institutions is part and parcel of these capitalistic schemes, where individual ownership of assets and trade in major products and services are dominated by a small number of individuals or families.

Big-firm capitalism is an important third category. It is not necessarily bad; in fact, it is fundamental to the formation of good capitalism. The big firms are large enough to exploit ultimate economies of scale and scope. They operate in fully national and global markets and in doing so take up the production of newly developed products and services, extending them to the four corners of the earth. Baumol, Litan, and Schramm see this category as a principal component of the currently evolving U.S. economy.

FIGURE 2

U.S. BUSINESS STARTS PER 100,000 POPULATION, 1997–2015



SOURCE: "The Kauffman Index of Startup Activity." Kauffman Foundation, Kansas City, KS.

In some cases, the big firms are the result of rapidly growing entrepreneurial firms, which represent the three scholars' final category. *Entrepreneurial capitalism* brings radical, transformative innovations and from which fundamentally different products and ways of doing business emerge. Current examples include transportation services Uber and Lyft, which demonstrate how small, innovative firms can emerge and—following a big-firm capitalism pattern established by Facebook, Google, and Amazon—quickly become large global players.

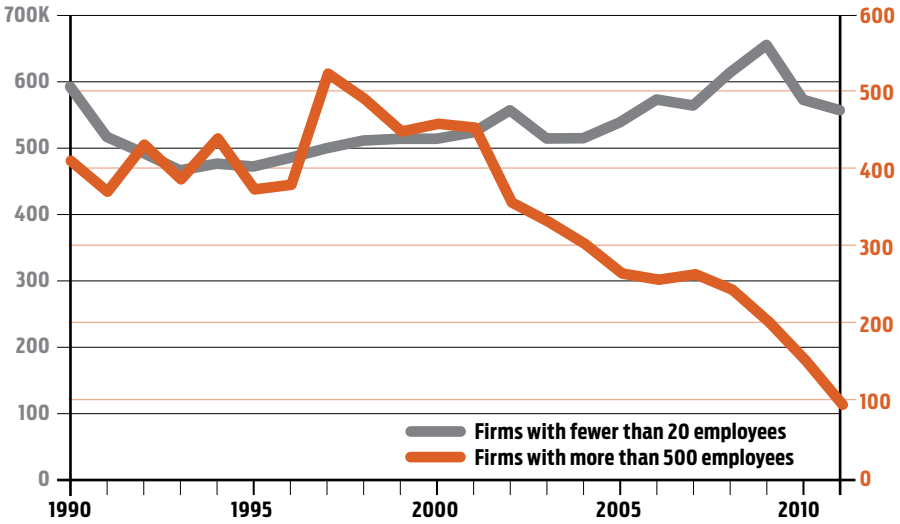
Baumol, Litan, and Schramm's

theory of American capitalism requires an economically healthy operating environment for high-growth small firms and for big-firm operators that convey newly emerging products and services to global markets. However, the authors do not deal with the political interaction and rent-seeking that occur as big firms gain dominant positions in their industries. Nor do they deal explicitly with big firms' demand for specific regulations that will increase or stabilize the firms' profitability and cement their dominant position.

Clearly, it is possible for big-firm capitalism to turn bad. Put another way, it is possible for a small number of big firms to have disproportionate power in influencing the direction taken by a political economy. These firms can also be protected from competitive entry by regulatory mandates that raise rivals' costs and reduce the flow of consumer-valued goods and services to the marketplace.

FIGURE 3

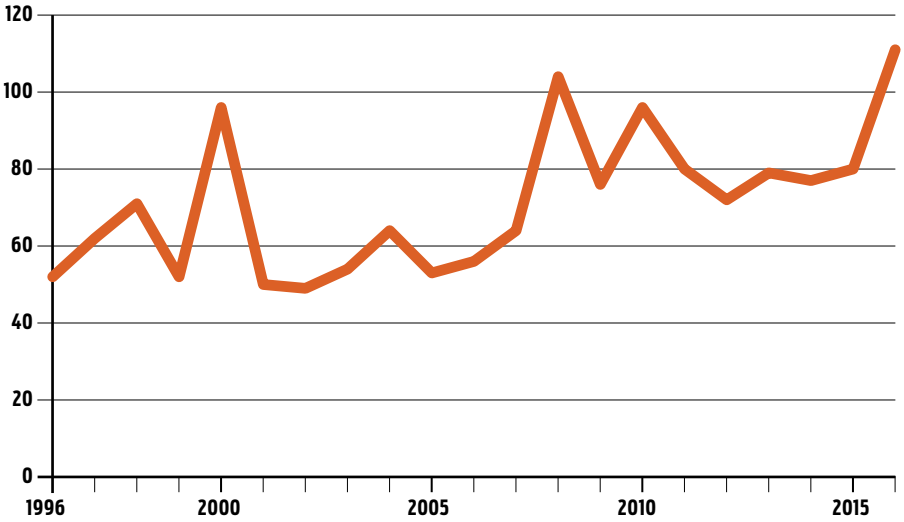
ENTERPRISE EXITS, FEWER THAN 20 & MORE THAN 500 EMPLOYEES, 1989–2011



SOURCE: Small Business Administration, Longitudinal Business Database

FIGURE 4

MAJOR RULES PUBLISHED BY PRESIDENTIAL YEAR, 1996–2016



SOURCE: George Washington University, Regulatory Studies Center

What data may tell us / Mauboussin, Callahan, and Mjad tell us that the number of U.S.-listed firms has fallen by 50% since 1979. The count of newly listed firms is an obviously important metric of the vitality of a capitalist economy. After all, financial markets provide access to capital and thereby nurture the growth of capitalist systems.

The authors also report that the average market-capitalized value of listed firms has risen from $620 million in 1979 to $6.8 billion in 2016 (both in 2016 dollars). Simply put, today's marketplace is dominated by big firms. Baumol, Litan, and Schramm should be pleased by the accuracy of this part of their 2007 analysis.

In addition, the average age of listed firms has risen from 10.9 years to 18.4 years. The big firms seem to be more durable and perhaps are better protected from competition. These data support the notion that entry barriers may be higher; the data also support indirectly the notion that regulation matters.

But there may be something else going on, something Baumol, Litan, and Schramm did not consider. As shown in Figure 1, new firm listings generally rose from 1976 to 1996 and then plummeted around the time of the 2002 Sarbanes-Oxley corporate governance and accounting legislation.

Obviously, something else could be affecting the listing decline, but it is hard to dismiss Sarbanes-Oxley out of hand. It significantly raised disclosure requirements and personal liability for corporate officers and directors, which in turn made the decision to become a listed firm far more costly. In commenting on the possible Sarbanes-Oxley effect, Mauboussin, Callahan, and Mjad indicate that the legislation could have been an influence, but that the decline in the total number of listed firms was underway prior to 2002. However, when just new listings are examined instead of total firms, it seems clear

that 2002 is a strategic date.

In their 2009 financial markets analysis of the costs and benefits of Sarbanes-Oxley, Yael Hochberg, Paola Sapienza, and Annette Vissing-Jorgensen examined lobbying activities by individual investors, large investors, and corporate insiders. They found evidence of higher abnormal returns for firm portfolios where small and large investors lobbied for final Sarbanes-Oxley rules, as well as for firms where insiders lobbied against the same rules. Probing deeper, the three authors found that insider opposition was higher for firms where there was evidence of higher agency cost and relaxed executive behavior.

Data from the Kauffman Foundation on new business starts adds another dimension to our discussion of entry in America's newly forming industrial organization. Figure 2 shows the trend in newly formed firms. Once again, fewer people are knocking at the door. In 2000 there were approximately 190.7 new starts per 100,000 population. By 2015 the count had fallen to 130.6, more than a 30% decline. With the start-up rate falling, all else equal, there will be fewer new listings on stock exchanges.

If entry is affected, what about exits? A Small Business Administration data set (ended after 2011) on the dynamics of the U.S. economy supports the notion that big-firm capitalism is somehow better insulated from competitive entry and other marketplace hazards. Figure 3 reports exit data—deaths of firms—with more than 500 workers and with 20 or fewer workers. Note that exit activities for the two categories follow a similar pattern from 1989 until about 2000. At that point, big-firm exits plummet.

With fewer exits across time, the average age of incumbent firms will rise, just as reported by Mauboussin, Callahan, and Mjad. Taken together, the three data sets—newly listed exchange firms, new starts, and exits by larger and smaller firms—describe the rise of big-firm capitalism where the larger firms seem to be insulated from competitive entry and other marketplace hazards that would cause them to fail. The data tell us that since the year 2000, fewer firms are being started and fewer yet seek to be publicly owned. The data suggest that regulation matters.

Regulatory advantage / We know there are economies of scale in managing regulations that have a high fixed cost component. We also know that there are economies of scope for firms that build lobbying networks across a large array of regulatory and other government agencies, nationally and internationally. How might this figure into the story? I contend that big firms benefit relatively from the adoption of major regulations—those that have a compliance cost of at least $100 million annually imposed on the economy. By this I do not mean that larger firms are lobbying for high-cost regulations, but rather that when major regulations befall them, larger firms generally are able to carry the load with greater ease than their smaller competitors. All else equal, the larger firms are less likely to exit the economy. Those thinking of entering with a new business are less likely to pay the price.

When major regulations befall them, larger firms generally are able to carry the load with greater ease than their smaller competitors.

The empirical element of the argument is seen in the annual count of major regulations (those with compliance costs of $100 million or more) adopted in recent years. Figure 4 shows the count for the years 1996–2016. Obviously, the count of major rules has increased systematically since 2000, and though not shown in the figure, the count is cumulative. That is, each major rule imposes at least $100 million in annual costs on the economy for as long as the rule is in force. It is my hope that this picture and the foregoing discussion will help to form refutable hypotheses for testing competing explanations for America's disappearing capitalism.

Final thoughts / I worry that America's regulatory-induced big-firm capitalism operates as part of a sleep-walking economy, where GDP growth is weak and the prospects for widespread wealth creation are less than stellar. While many forces interact to yield economic life, it seems clear that regulation is one of the major factors that influence the big-firm-dominated industrial organization.

With that in mind, I end this article with some sage advice from *Wealth of Nations:*

> The proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but the most suspicious attention. It comes from an order of men whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.

We are thus advised to beware of capitalists who seek and obtain advantage by way of government regulation. *R*

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REGULATORY REFORM

FOXES, HEDGEHOGS, AND REGULATORS

If experts' predictions are little better than laymen's, can we rely on expert regulatory analysis?

BY STUART SHAPIRO

The practice of policy analysis is often forward-looking. It attempts to answer questions such as: "How will the Affordable Care Act affect the health of the uninsured?" "How will a carbon tax affect fuel consumption and greenhouse gas emissions?" "Will charter schools provide a better education in communities wracked by poverty?" In other words, policy analysis attempts to answer some of the most vexing questions in the policymaking realm. We hope that those charged with answering these questions—often economists—are experts in their fields and that we can trust their answers.

Nowhere is this truer than in the world of regulatory policy. Over the past several decades we have put a great deal of hope in policy analysis, specifically cost-benefit analysis, as a means of improving regulatory decisions. Cost-benefit analysis is required before decisions are made on economically significant regulations. Fundamentally, these analyses are predictions about how regulations will affect individual decisions and the general welfare.

However, recent literature—most prominently the work of Wharton School management professor Philip Tetlock—has raised doubts about the reliability of experts' predictions. Tetlock has shown that experts often do little better than laymen in predicting the future. Since reliable prediction is the fundamental goal of policy analysis, the conclusions of Tetlock and others are concerning.

EXPERTS AND PREDICTIONS

The role of experts in setting policy in a democratic society has been debated since the time of the ancient Greeks. Some worry that supposed experts merely impose their own preferences on society, thereby undermining democracy. This worry is heard

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across the political spectrum, both from those who assume government bureaucrats are obsessed with their agencies' missions and intent on over-regulating industry, and from those who believe that regulators are "captured" by industry experts and therefore prefer to under-regulate.

What unifies these perspectives is that each implicitly assumes that experts are imbued with knowledge that makes their assessments of policy implications more accurate than those of non-experts. In a series of experiments and observations, Tetlock has cast doubt on this assumption. Additionally, he finds that simple algorithms—such as "Assume that current trends will continue"—typically outperform experts' predictions.

Hedgehogs and foxes / There are differences within the expert community. Adopting Isaiah Berlin's typology, Tetlock divides experts into "foxes" and "hedgehogs." The key distinction between the two is that hedgehogs focus on one thing that they know very well and try to use it to answer all possible questions. Foxes on the other hand are generalists, knowing many things and being naturally skeptical of grand theories. Foxes are better Bayesians (they update their predictions on the basis of new information) and they are less subject to hindsight bias (coming up with rationalizations for previous mistakes). As a result, foxes—while far from exceptional in making predictions—regularly outperformed hedgehogs in Tetlock's experiments.

THINKSTOCK (3)

In addition to Tetlock, several other scholars and writers have produced significant recent work on the nature of prediction. Statistician Nate Silver, formerly of the *New York Times* and now of ESPN's *FiveThirtyEight* website, made a name for himself predicting election results. He has used that success to look at the nature of prediction generally. Like Tetlock, Silver has found that in many fields, expert predictions have been found to be inaccurate and that the predictors who are most confident are also the most likely to be incorrect. He echoes Tetlock's praise of foxes and also emphasizes the importance of those making predictions acting as Bayesians.

Dan Gardner, a senior fellow at the University of Ottawa's Graduate School of Public and International Affairs and co-author with Tetlock of the book *Superforecasting* (see "Of Hedgehogs, Foxes, and Superforecasting," Fall 2016), shares many of these conclusions in his study of experts. He argues that better decisionmaking will require greater humility among experts and greater skepticism among their audiences.

Despite the many failures of prediction, Gardner and Silver both note that we can find some characteristics of those who make better predictions. Silver highlights the successful advances in weather prediction and Gardner praises George Soros as a "classic fox" who foresaw the economic crisis of 2008 among other correct predictions. This raises the question, do those who are charged with making predictions about policy have the characteristics of foxes, and if not, how can we construct an analytical process that uses these conclusions?

COST–BENEFIT ANALYSIS AND PREDICTING REGULATORY OUTCOMES

The role of analysis in U.S. policymaking has long been controversial. The broader the claims of the analysis, and the more that analysis advocates claim it is comprehensive and the best way to answer policy questions, the greater the controversy. In few arenas has this controversy been as heated and as relevant to actual policy decisions as in the use of cost-benefit analysis to evaluate regulatory proposals.

After initial, cautious steps in the Nixon, Ford, and Carter administrations, cost-benefit analysis became a formal part of U.S. regulatory decisionmaking in 1981 with President Ronald Reagan's issuance of Executive Order 12291. Economists argued that cost-benefit analysis would lead to regulations that achieved the goals of regulatory statutes at lower costs. Later, economists studying implementation contended that cost-benefit analysis would bring a broader perspective to regulatory decisions both because it was inherently broader than the mission-driven preferences of those who set policies within regulatory agencies, and because it assisted the president (who was responsible to the entire electorate) in his control of regulatory agencies.

While its implementation in the context of regulatory poli-

cymaking has changed over the years, cost-benefit analysis has clearly become a permanent part of the regulatory process. It has arguably made regulatory policymaking more transparent by forcing agencies to lay bare their estimates of the consequences of their decisions. But at the end of the day, the more important question is whether the cost-benefit analyses have been correct: i.e., has the addition of economists to the regulatory process led to better predictions of policy effects?

How accurate have the predictions of the costs and benefits of regulations been? The data on this are limited because there is little mandate for government agencies to retrospectively analyze the costs and benefits of their regulations. Nonetheless, academics have attempted to answer the question.

In a 2005 report to Congress on the costs and benefits of regulations, the Office of Management and Budget summarized some of this literature. It reported that of 47 analyses studied, 11 were roughly accurate, 22 overestimated the cost-benefit ratio, and 14 underestimated it. This is not a great record in terms of accuracy, but at least it does not show an overt bias toward over- or underestimation. Like many approaches to prediction, however, the record of cost-benefit analysis is far from stellar.

Cost-benefit analysis arguably has made regulatory policymaking more transparent by forcing agencies to lay bare their estimates of the costs of their actions. But have the analyses been correct?

Does this mediocre record mean that the economists conducting cost-benefit analysis are hedgehogs? Both Silver and Gardner are skeptical about the predictive power of economists. Gardner writes:

> Economists, in particular, are treated with the reverence the ancient Greeks gave the Oracle of Delphi. But unlike the notoriously vague pronouncements that once issued from Delphi, economists' predictions are concrete and precise. Their accuracy can be checked. And anyone who does that will quickly conclude that economists make lousy soothsayers.

Those who support and those who oppose economists having a role in policymaking implicitly take different positions on whether the economists are hedgehogs or foxes. Those in favor of cost-benefit analysis as a requirement for regulatory decisionmaking tout its commitment to comprehensively examining all aspects of a decision. By requiring agencies to quantify all of the effects of their decisions, the resulting prediction is likely to be more accurate. By putting this quantification in the hands of economists, advocates of cost-benefit analysis are arguing that this is the best way to ensure that regulatory policy predictions are made by foxes.

On the other hand, critics of cost-benefit analysis have focused to a large extent on those aspects of a policy decision that are systematically ignored by economists. They point out that which cannot be quantified is automatically given less weight in a cost-benefit analysis. And, these critics maintain, there is much that cannot be given its proper weight in the realm of regulatory policy. In other words, economists have a very particular view of the world and as a result focus inordinately on the efficiency of policy decisions—that is, they are hedgehogs.

At this point, after three and a half decades of strident arguments, it seems like the question of whether economists are hedgehogs or foxes will not be resolved. I suggest that, instead of continuing the debate, we consider what the regulatory policy process would look like without economists.

BEHAVIORAL PUBLIC CHOICE

Instead of thinking about whether economists are hedgehogs or foxes, we can look at who else would make the predictions about policy effects if economists and cost-benefit analysis were left out. These predictors would likely be agency personnel with expertise in the subject matter, and their superiors.

The academic literature has studied the motivations of decisionmaking agency personnel, and a review of the literature's conclusions does not generate confidence in the likely accuracy of their pre-analysis predictions. Anthony Downs, in his classic 1967 book *Inside Bureaucracy*, characterized agency personnel in one of five categories: climbers, conservers, advocates, zealots, and statesmen. Of those five types, only statesmen can be seen as possible foxes. The rest, to lesser or greater degrees, reflect varieties of hedgehogs.

Other studies tend to confirm that agency decisionmakers are, on the whole, best characterized as hedgehogs, although the studies reach that conclusion for different reasons. As James Q. Wilson persuasively argued, agency personnel tend to be dedicated to their missions; that is, few people go to work at the U.S. Environmental Protection Agency who don't believe in the cause of environmentalism to the exclusion of other policy concerns. William Niskanen, in his 1971 book *Bureaucracy and Representative Government*, viewed agency officials as less motivated by mission and more by the goal of procuring generous budgets. Finally, there is a long history of arguments that agency officials are routinely captured by outside interests. These characterizations make agency officials sound much more like hedgehogs than foxes.

Recent work in the new field of behavioral public choice (an outgrowth of behavioral economics) casts further doubt on the

predictive abilities of agency personnel. Government employees are subject to the same behavioral biases as the public. In fact, some have argued that because they are not disciplined by the market, public servants are more likely than others to make errors because of heuristics and biases. Additionally, as Wilson theorized, scholars of behavioral policy have hypothesized that government regulators will be biased in favor of government intervention in the market. As Gary Lucas and Slavisa Tasic put it in a 2015 law review article, "Bureaucrats who believe strongly in their agency's mission and other experts who are focused upon the particular problems addressed in their respective fields sometimes ignore relevant information and competing interests."

Jeffrey Rachlinski and Cynthia Farina argue that institutional design may be one remedy to a hedgehog-dominated policy process. They believe that current checks upon expert biases in government, including public participation in agency decisions and judicial review, are sufficient.

But the cure may not be sufficient. Concerns about agency bias persist decades after judicial review, executive branch deliberation, and public participation have been routine. Greater inclusion of economists in this world is another possible solution—even if the economists themselves are hedgehogs rooted in a commitment to economic efficiency. This view has been articulated by former Office of Information and Regulatory Affairs administrator Sally Katzen, who has touted cost-benefit analysis as a necessary corrective to agency biases. In an ideal world, we would have foxes working for the government and predicting policy effects. In the absence of foxes (or even in the absence of a hiring process that can identify foxes), we should have hedgehogs with competing views.

Recent work by Russell Mills and Christopher Carrigan supports this idea. They found that when agencies incorporate input from individuals from diverse professional backgrounds, their regulations are less complex and more comprehensible to the public. I would never argue that economists should be the only individuals making decisions within the government. But ensuring that economists are part of the team—even if they are blinkered by a particular world view—can act as a check upon the limited world view of others already involved in the process.

CONCLUSION

Making accurate predictions about the future is hard. More than that, recent research has shown that many experts—the people we trust most—are little better than laypeople at making predictions. The effect of this research on the policymaking process has not been sufficiently explored. This gap is important because the fundamental point of policy analysis is to accurately predict the effects of proposed policies. Furthermore, these predictions are often entrusted within the federal bureaucracy to experts: individuals who have studied policy analysis broadly or have expertise in a particular field.

One area of policy where there has been considerable debate about the role of experts (albeit not couched in that language) is regulatory policy. Tetlock's findings are disturbing because predicting the effect of regulations depends on experts. Supporters of cost-benefit analysis claim that economists have asserted the foxlike abilities of economists (again not couching it in this language) to bring a broader perspective to regulatory decisions. Their critics have said that economists have a narrow perspective and therefore are inherently biased against decisions that protect public health; in other words, economists are the worst kind of experts: hedgehogs.

As discussed above, determining whether economists are hedgehogs or foxes is difficult, if not impossible. Their record on predicting the effects of regulatory policies is mixed at best, suggesting that they do suffer from the problems of experts generally. It is tempting to look at these data and say that economists are hedgehogs and should be excluded from regulatory decisionmaking.

But their exclusion from the regulatory decisionmaking process would not improve regulatory decisions. It would leave regulatory policy in the hands of those who are even more clearly hedgehogs: experts in a particular area of policy who have dedicated their lives to the idea that government intervention in a policy area is the appropriate solution. Even if economists are little better, and biased in the opposite direction, their inclusion in regulatory decisionmaking has served to balance the influence of these experts.

The requirement for cost-benefit analysis has only rarely been framed this way, but it may provide a model for improving government decisionmaking more broadly. Economists may or may not have the qualities we want to see in experts. But we may be able to design policy analytic systems that mimic these qualities. Absent a fox, the best way to make policy might be to ensure that hedgehogs with many different biases are involved in the decisionmaking process. *R*

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TELECOMMUNICATIONS & TECHNOLOGY

THE INNOVATION WON'T BE TELEVISED

Facilitating tacit collusion via "most favored nation" clauses hurts the television market.

BY IKE BRANNON

All is not as it appears when it comes to the regulation of prices. Rules ostensibly created to protect consumers more often than not effectively serve the interests of the sellers. For instance, many states require that gasoline prices must be easily visible from the street, cannot be changed more than once a day, and must be above wholesale cost. While all this is done in the name of protecting the consumer, economic theory and abundant empirical evidence show that these requirements dampen price competition, causing prices to be higher than they otherwise would be. Gas station owners lobby vigorously in defense of these laws, confirming who they really help.

It turns out that the rules that govern negotiations between video programming networks (both broadcast television and non-broadcast networks) and the cable and satellite distribution systems (commonly called distributors) are similarly harmful to the market and serve to stifle programming innovation and diversity. This is especially harmful to the small, independent networks—that is, networks not affiliated with a national broadcaster, a major studio or entity owning numerous satellite or cable channels, or a multi-channel video programming distributor.

THE INDUSTRY

The amount of available video offerings has grown exponentially over the last four decades. In the early 1980s, most cable packages offered the local broadcast stations and a handful of non-broadcast networks. After midnight, most television stations went dark, a concept youth today find difficult to comprehend.

Today, of course, there are hundreds of video programming networks. Tens of billions of dollars are spent each year producing and acquiring the rights to shows, movies, sporting events, and myriad other types of content for distribution. Over time there has been massive consolidation in the cable and satellite TV industry. Today there are four major distributors in the United States through which most households get their video programming: Comcast, Charter, AT&T/DirecTV, and DISH. There are also a few mid-sized players like Verizon, Altice, and Cox. Despite the recent trend toward "cord-cutting," most people still access video programming networks via a cable or satellite distributor.

Two major factors drive distributors' costs: the capital and service costs for deploying and maintaining their distribution systems, and the cost of acquiring the content they provide via their service.

Distributors negotiate carriage rights with the programming networks and in most cases pay them a per-subscriber "carriage fee" per channel for their programming. Programming networks make their money both from the monthly fees from distributors and from the advertising they sell on their channels.

A network wants to be in as many homes as possible and attract as many viewers as possible. The more viewers it has, the more it can charge for advertising and the more it can demand in subscriber fees.

The vast majority of the successful channels are members of networks "families." Sometimes these are owned by one of the distributors: for instance, Comcast owns NBC, CNBC, Bravo, E!, and a few other networks. Large multimedia companies own suites of networks: Disney owns ABC, Lifetime, A&E, the Disney Channel, and ESPN, along with all of its sister networks. Discovery, Fox, Viacom, Time Warner, A&E, and AMC are other multimedia companies that have multiple networks. These entities negotiate the carriage fees for their entire lineup of stations at once, as a package.

With only a handful of cable and satellite distributors dominating the market, the major distributors can act as an oligopsony (i.e., a small collection of buyers who, together, dominate the market) and leverage their collective market power to pay prices

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THINKSTOCK (4)

Nielsen's 100 most-watched channels are owned by one of the major multimedia companies. Oligopolies—much like monopolies—extract higher prices from buyers and concomitantly sell less than the efficient amount. But in this market the programming conglomerates may actually sell more than the efficient amount via their insistence upon the carriage of their entire bundle of networks, including lesser-rated networks that are still paid far more than their independent, comparably rated competitors.

Table 1 compares the fees paid by distributors to selected independent channels as well as to comparably rated channels owned by oligopolies. The table makes clear that ratings and household delivery do not directly translate into the value of subscriber fees that distributors will grant to independent networks. The four independent networks shown in the table receive a fraction of the monthly subscriber fees paid to networks of similar or lower Nielsen ratings owned by large multimedia companies. The bargaining power of the large programming conglomerates plays an important role in determining subscriber fees and continued carriage of many programming networks. They effectively amplify their bargaining power by bundling multiple channels with a highly rated channel like ESPN.

that would be lower than if there were real per-channel competition. An effective oligopsony would result in fewer program networks and fewer programs would be made, but—as I'll explain in a moment—the market currently does not function that way.

Added to the lack of true per-channel competition, there is no reason to believe much or any of the lower costs to the distributors would be passed on to consumers: the lower cost to acquire networks results in higher profits for the distributors.

What mitigates this suboptimal outcome—for the most part—is that the oligopsonistic distributors have to negotiate with a small group of multimedia companies that own most of the networks and function much like an oligopoly. Approximately 90 of

While oligopolies and oligopsonies by themselves can lead to suboptimal outcomes, taken together—a situation economists call a bilateral oligopoly—each side's market power is tempered by the other, and the net result often approaches the efficient market outcome. Such an outcome is good for consumers, as they get access to what might be construed as the "right" amount of programming the market wants while not paying too much for it. And it's good for most networks, too, because their collective market power gives them a better outcome than if the cable

and satellite distributors could exert their oligopsony powers unchecked.

INDEPENDENTS AND MFN

This works for the program content companies with multiple network offerings that are part of the oligopoly, but it doesn't work out well for independent networks whose rights are sold alone by their company, unbundled with any other offerings. The current situation makes their existence precarious.

They are most emphatically not a part of any oligopoly: they have no market power themselves and would not add any discernible market power to the oligopoly. Instead, they find themselves negotiating by themselves against the cable and satellite distributors. What's more, they must do so burdened by the terms intended to govern the bilateral oligopoly—particularly the so-called "most favored nation" clause (MFN)—that work to their detriment.

MFN is a concept borrowed from international relations and its use goes back centuries. Fundamentally, an entity receiving this benefit is accorded the same privileges given to other trading partners—or in this case, other customers. In the context of television, it means that any price or provision a seller provides to one buyer must be made available to other buyers. There are a variety of MFNs, including the predominant one used with independent networks. Economists refer to this MFN as an *unconditional* MFN because the distributor receives a benefit—the lowest price and best terms—without giving any consideration in return.

In the current video programming market, this means that the price a cable or satellite distributor pays a program network has to be made known to other distributors as well, and those other distributors must have the option of paying that price if they choose to do so. If Comcast pays the Tribune Corporation 13¢ a month per customer to carry the independent network WGN on its system, Tribune has to let every other distributor pay that same rate as well.

If Charter told Tribune it only wanted to pay a dime a month to carry WGN, but in return Tribune would get a favorable channel placement for WGN, the loss in revenue for Tribune would be much more than a 22% reduction in monthly rights fees from that one cable company. *All* distributors with an MFN would get to reduce their payments by the same amount and on the same effective date, and they would *not* have to match the favorable channel placement.

MFNs often implicate more than carriage fees; they can affect other important non-monetary provisions such as whether a network is carried in high or standard definition, its channel placement and service tier (e.g., basic, extended, etc.), channel guide menu placement, and whether and under what conditions a network can provide content to "Over The Top" (i.e., internet-based) distributors. Some video distribution contracts involving independent programming networks even impose an MFN on MFNs.

At one level, this arrangement would appear to give an independent network a modicum of leverage: a rate reduction sought by only one distributor has a magnified effect on a network's revenue, and the distributor knows that the network simply does not have the option of acquiescing because the cost to the network of doing so would be too high. Essentially, the MFN acts just like leverage does in an investment: it amplifies the economic losses from a reduction in monthly payments, undermining any security in existing agreements.

However, that leverage is a double-edged sword: a distributor can also choose to simply not negotiate with an independent network, make a legitimate threat to do without it, and drop the network entirely. A distributor might have trouble doing without Disney/ESPN's channels, but it can do without an independent network like rural issues–oriented RFD and not engender meaningful consumer unrest. Substantial barriers to substitutability among distributors mean that consumers are very unlikely to seek out a favored independent network carried on a different distribution system. In short, changing providers is a hassle and few people will do so for an RFD, or any other single station for that matter.

The primary reason to have an MFN is that it helps to enforce the bilateral oligopoly. Oligopolies often dissipate because one or another member cheats the cartel and sells at a lower price, but the MFN prevents that from happening. However, the oligopo-

Table 1:
RATINGS AND PER-SUBSCRIBER CARRIAGE FEES FOR BUNDLED AND UNBUNDLED CHANNELS

National Ranking	Network	Owner	Monthly Fee ($)
10	Investigation Discovery	Discovery	0.11
11	TNT	Time Warner	2.09
12	Hallmark Channel	Independent	0.08
13	Food Network	Scripps	0.22
14	AMC	AMC Networks	0.50
61	IFC TV	AMC Networks	0.22
62	POP	CBS / Lionsgate	0.03
63	ReelzChannel	Independent	0.045
64	American Heroes	Discovery	0.10
65	Destination America	Discovery	0.10
75	FOX Business Network	Fox	0.23
77	NBA-TV	NBA	0.31
78	RFD	Independent	0.05
79	UP	Independent	0.05
80	Discovery Family Channel	Discovery	0.15
81	FX Movie Channel	Fox	0.20

listic cartel is not in the best interests of independent networks or their viewers, as it gives distributors too much power over the independent channels.

The independent networks have no market power—they're too small by themselves—so they get hurt by the oligopsony that's strengthened by the MFN and its market-wide control of price and other essential business terms. In short, MFNs act as an effective substitute for collusion among the large distributors that accomplishes the same result—to the detriment of the independents.

MFNs also preclude any sort of creative pricing arrangement. For instance, an independent network may want to make a deal with Verizon whereby the independent accepts a lower carriage fee in exchange for the network being featured prominently in the "skinny" video programming packages that Verizon markets to tens of millions of wireless customers who use iPads and smartphones to access video. However, the MFN precludes such a combination because other large distributors would demand the same low carriage fee on all their platforms—while forgoing the other part of the bundled offer. (Of course, this specific example is almost irrelevant these days because the contracts of most independent networks explicitly prohibit the stations from offering their content in real-time to distribution vehicles like Hulu, Netflix, or other streaming venues.)

The academic literature on MFNs suggests that they do lower the transaction costs of reaching an agreement while also reducing the risk of a lack of agreement between buyers and sellers, a point made succinctly by Martha Samuelson, Nikita Piankov, and Brian Ellman in a report published by the Analysis Group. However, Bill Toth, writing in the *Columbia Science & Technology Law Review*, finds that MFNs can result in suboptimal monopolistic outcomes if there is an uncoordinated group of independents that are not a part of the bilateral monopoly. Essentially, the presence of network effects and economies of scale in the market serve as a natural barrier to entry, discouraging new channels and innovation.

WHAT TO DO?

In short, economic theory indicates that the strictures in place to strengthen the powers of the oligopoly result in an optimal market outcome in the negotiations with the oligopsonistic multimedia companies. But those strictures yield a suboptimal result when the oligopolies are negotiating with independents: the price they arrive at is suboptimal, which results in fewer independent networks and fewer choices for consumers. An unfortunate additional byproduct is that no commensurate savings accrue to consumers.

The evidence supports the theory. The independent networks receive significantly lower carriage fees compared to networks with similar or lower ratings that are owned by large multimedia companies with multiple other networks or networks that are vertically integrated with a large distributor.

How can this be fixed? One way would be to simply tell the independents to bow to reality and form their own coalition, or else nudge them to align (or be acquired) by one of the large media conglomerates. But the former won't work at present; there simply aren't enough independents with sufficient combined ratings for this to work well, despite the healthy ratings of a number of independents. The latter isn't exactly an ideal situation either. If the only avenue of success for a new network is to sell itself off to one of the large media companies, it's not clear that would bode well for innovation in the sector. While such a strategy works for internet startups, there are myriad different potential buyers for such entities, and not just a handful of oligopolists.

MFNs act as an effective substitute for collusion among the large distributors because they establish market-wide control over independent channels' prices and other essential business terms.

There is no realistic hope that the video distribution market will be disciplined by significant competitive entry. The legal and economic barriers to entry are too high for major new cable or satellite systems to enter the scene on a national basis.

Nor will Over the Top internet-based delivery overturn this closed system because there has been no meaningful entry into the distribution side of the Over The Top market. Instead, the current oligopolists are taking control of Over The Top. Large distributors often significantly restrict independents from distributing their content via alternative distribution methods, enforced through MFNs.

The logical way to fix this closed market is to simply eliminate unconditional MFNs, or at the very least end or dramatically limit their use against independent networks. Allowing the additional lever of MFNs to enhance market power for the distributors that already have a surfeit of it makes little sense and hurts the independents. It also dampens the incentives for new networks to be formed, except for those conceived by the established multimedia entities. The Federal Communications Commission has considered such prohibitions, but has yet to take such a step.

While a free and unfettered market should be preferred whenever possible, an imperfect market—such as one with a discrete number of buyers and sellers, like the market for video programming—will not necessarily lead to the economically efficient outcome. In such a situation the regulator should step in and try to

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nudge the market players toward something closer to an efficient outcome, using as light a touch as possible. In this market, that would entail eliminating unconditional MFN clauses, or at least prohibiting their application to independent networks.

Promoting multiple, diverse independent voices has been a cornerstone of U.S. communications policy since the enactment of the Communications Act in 1934. Yet today's trends are headed in exactly the opposite direction: media consolidation has been occurring at an ever-increasing pace, as witnessed by transactions such as AT&T's acquisition of DirecTV and its proposed acquisition of Time Warner, Comcast's acquisition of NBCU, and the recently announced acquisition of Tribune by Sinclair, to name just a few.

In the national video marketplace, barriers to entry are extremely high. In addition to raising the tens of millions of dollars necessary to obtain or develop programming, a new network needs to obtain the necessary carriage agreements with all of the major distributors. A programming network cannot be national in scope unless it achieves economic terms of distribution with all of the large distributors, because delivery of video to the home is not readily substitutable. This closed distribution market restricts consumer choice to live linear programming from the large incumbent companies. Otherwise, consumers are forced to wait for access to recorded programming, also provided by incumbents on their video-on-demand systems. The tight arrangement among the major players in the video distribution industry also limits competition from new entrants such as independent programming networks. Broadcasting directly via the internet is a nascent business that one day may disrupt the large cable companies, but at the moment the potential reach—and revenue—from such a strategy lag what is achievable via cable or satellite.

As a result of these and other marketplace factors, entrepreneurs are starting fewer new independent networks and the existing ones are increasingly being acquired or going out of business. Ed Conard, the founder of Bain Capital, pointed out in his book *Unintended Consequences* that a major hindrance of today's economy is that a growing proportion of savings is seeking safety first and foremost. The amount of capital available for higher risk/higher return projects has rapidly diminished since the Great Recession. The restrictive covenants governing the television industry today serve to exacerbate this problem.

The incredible advances in information technology over the last two decades have made it less costly than ever before to create new content. Unfortunately, the oligopolistic structure of the industry, as enforced by MFNs, makes such creation almost impossible by curtailing competitive distribution. As a result, consumers endure increased prices and diminished content diversity. *R*

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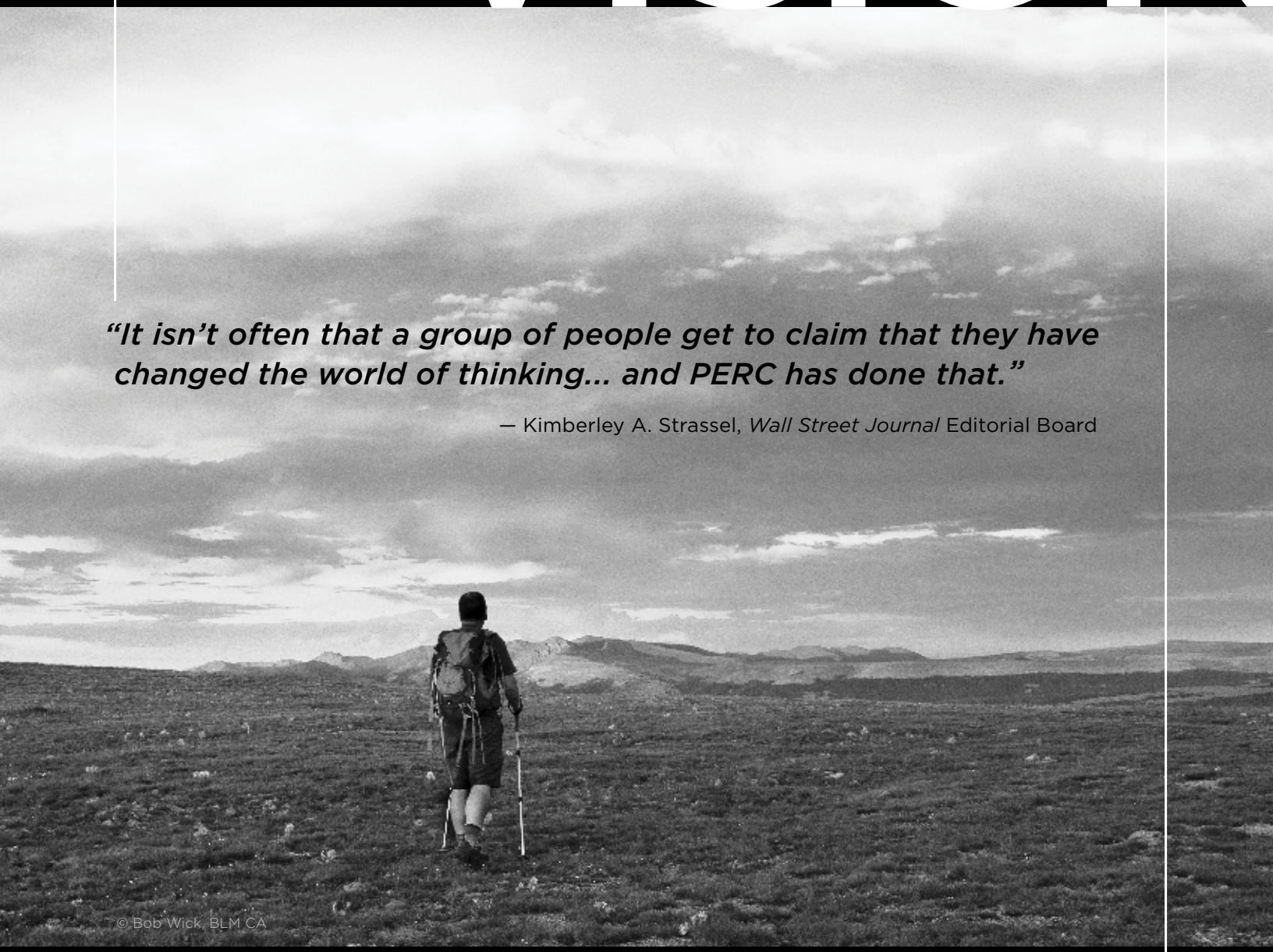

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TELECOMMUNICATIONS & TECHNOLOGY

REDESIGNING SPECTRUM LICENSES

"Depreciating licenses" would encourage innovation and investment.

BY PAUL MILGROM, E. GLEN WEYL, AND ANTHONY LEE ZHANG

Innovation in the wireless communications network offers enormous growth potential for the U.S. economy. It would not only enable improvements to traditional services like those linked to mobile phones, but also promote new services involving the "internet of things," self-driving cars, wireless factories and warehouses, and more. Yet harnessing the full benefits of technological progress requires well-functioning spectrum rights markets that encourage innovation, competition, and investment. In this article, we propose replacing the existing license structure with a new system of "depreciating licenses" that would allow markets to perform better along all these dimensions.

Existing license designs present regulators with a stark choice between encouraging entry and innovation or ensuring that licensees' complementary, long-term investments are secure. The 10- or 15-year licenses typically sold to wireless service providers with an expectation of renewal protect their large investments in the physical system infrastructure. However, they effectively give incumbents control over critical parts of the spectrum, allowing them to demand a share of returns from new uses, which blocks or delays innovation. In contrast, unlicensed spectrum or short-term licenses for small geographic areas encourage entry and innovation, but provide lower incentives for long-term investment.

Attempting to balance the benefits of long license terms for investment with the benefits of short licenses for innovative entrants, the Federal Communications Commission has recently proposed using a three-year license term for priority access to the 3.5GHz band. The apparent goal is to provide some protection for long-term investments while still allowing relatively quick turnover of spectrum users and uses as needs and technology change.

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This intention is laudable, but the FCC can do much better. As industry groups have recently highlighted in a petition to change the FCC's proposed rules, three years is not long enough to recoup some kinds of infrastructure investments in wireless networks. At the same time, the recent FCC incentive auction highlights how long renewable licenses (in this case, for TV broadcast) have sometimes delayed valuable changes and incurred huge costs. For markets to work best, we need a new kind of license, carefully designed using economic theory, that provides enough protection to secure long-term investments, but not so much as to blockade new entry and preclude value-increasing innovation.

We propose such a license: the "depreciating license" based on ideas two of us have developed in our academic work along with University of Chicago law professor Eric Posner. The licenses are of unlimited duration, but licensees must declare a price at which they are willing to sell their licenses and pay a license fee based on that price. The unlimited duration of these licenses provides strong protections for long-term infrastructure investments to support valuable uses, but the license terms also allow valuable innovations to emerge quickly by taking advantage of a liquid secondary market for spectrum.

Although depreciating licenses are a theoretically ideal solution, many of the same benefits can be achieved in another way that may be more consistent with traditional FCC policy and practice: using the "foothold auction" system, which modifies standard auction rules to provide advantages to incumbent licensees.

WHY MARKETS NEED SMART LICENSE DESIGN

In a hypothetical "perfect" market, bargaining among parties would result in licenses migrating to their economically most efficient uses at every point in time, regardless of how they were initially distributed. The work of Ronald Coase is often misinterpreted as suggesting something similar might happen in actual practice. Yet Coase rejected this interpretation of his own work. Economic theory, empirical analysis, and common sense

all clearly suggest this conclusion is false; the rules governing transfers of rights can affect economic efficiency.

There are several potentially important problems with traditional systems of spectrum licensing. One is that some licensees might hoard spectrum that they do not plan to use. They could do this either to block entry by competitors, or to "tax" or preempt future innovators who may need spectrum access. A second problem, familiar from land reallocation, is that one or a small number of holdouts may try to extort high payments for cooperating in large-scale reassignment.

These problems were illustrated dramatically by the time, effort, and cost required to reallocate spectrum used for over-the-air television broadcast. Some such spectrum was recently reallocated by the FCC's incentive auction. The success of that effort teaches another important lesson: market performance can depend heavily on license design. In legislation enacted in 2012, the government decided that TV broadcasters that chose not to sell their broadcast rights could nevertheless be required to shift to a different broadcast channel, greatly reducing the holdout problem.

DESIGN OF PRIORITY ACCESS LICENSES FOR THE 3.5GHZ BAND

The 3.5GHz band, currently used for naval and other military radars, along with certain satellite earth stations, is soon to be shared with other uses. To accomplish this, the FCC has mandated the use of a "Spectrum Access System" in the 3.5GHz band. This system acts like a traffic signal for wireless transmissions, allowing higher-priority uses to preempt lower-priority uses.

Access rights to this band are to be divided into three tiers. The highest priority would belong to the incumbent military uses, and upon request these users would be able to block any other user. The lowest priority tier, called General Authorized Access (GAA), would be for unlicensed uses. Any device satisfying use-sharing protocols can operate using GAA at no cost, but must yield when higher-priority uses are present. There would also be a middle-priority tier: the holders of a "priority access license" (PAL) would have higher priority than unlicensed users when the band is too congested to serve all comers.

The frequency at 3.5GHz is well-suited to a variety of uses, and the heterogeneity of uses has led to controversy over the design of the PALs. A central issue of contention has been the choice of license term limits. Short license terms with no expectation of renewal facilitate flexible reassignment of spectrum licenses. Parties with new uses would have frequent opportunities to compete for short-term licenses in efficient auctions, rather than in a secondary market burdened by the spectrum hoarding and holdout problems. On the other hand, with short term limits, licensees that invest in developing large areas run the risk of losing future

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license auctions, leaving their investments stranded or diminished. By providing greater security for the network investments needed to use spectrum efficiently, longer term limits promote these investments.

Related to term limits is the question of whether licenses can be renewed. In the past, spectrum licenses have had 10-year or 15-year terms with the expectation that they could be renewed upon expiration. Licenses with a strong expectation of renewal provide good incentives for investments to maintain and upgrade networks. Whatever the term, if there is no expectation of renewal, a license eventually becomes a lame duck, with little time left in its term. The 3.5GHz proposal allows parties to acquire up to two consecutive three-year licenses when PALs are initially assigned, but provides no assurances for renewal thereafter; as a result, PAL holders cannot capture the full return on investments that can enhance the value of the spectrum band beyond a six-year horizon.

Another contentious issue is the geographic scope of licenses. Licenses covering small geographic areas facilitate localized use of spectrum. For example, the owner of a factory or warehouse might purchase a PAL for the area around its facility, leaving nearby areas available for licensing by others. The proposal for 3.5GHz defines licenses for each of the more than 74,000 U.S. census tracts, which would allow entrants to purchase licenses for highly localized uses.

With so many potential uses, users, and licenses, some observers have expressed concern about the feasibility of an auction that is both flexible enough to efficiently assign licenses and simple enough to attract robust participation. Geographic granularity also poses a challenge for parties who prefer to aggregate PALs covering larger geographic areas. For instance, a mobile carrier might argue that its customers want consistent wireless coverage throughout its service area. Even without larger-area licenses, consistent coverage can be provided by using the unlicensed part of the band and purchasing PALs where the band is most congested.

Ideally, instead of designing licenses to support any one specific paradigm, licenses should be flexible enough to accommodate alternative usage patterns. The market should reassign spectrum licenses to more valuable uses, both to correct initial assignment mistakes and to adapt to technology as it evolves over time. Recent work in economic theory suggests an innovative license design that takes a large step toward this goal.

DEPRECIATING LICENSES

We propose to assign priority access rights for the 3.5GHz band using "depreciating licenses" sold on a depreciating license exchange (DLE). The DLE is a decentralized trading exchange that allows spectrum reassignment to occur at any time, minimizing holdout and hoarding problems. Depreciating licenses are characterized by some fixed annual depreciation rate—we suggest approximately 10–20%—and are initially sold to interested parties in a one-time auction.

Depreciating licenses can be described in several equivalent ways. From one perspective, a depreciating license with a 10% depreciation rate is a perpetual license that carries an annual fee equal to 10% of its "value" as declared by the licensee. What disciplines the declared value is that it doubles as an offer: the licensee must be prepared to sell her license to any party who is willing to pay the declared value.

From a second perspective, the licensee is granted a depreciating stake in a perpetual license, with 10% of the right reverting annually to the FCC. To continue to use the license, the incumbent licensee must purchase the missing 10% each year at a price of x, which the incumbent licensee herself determines. However, when she declares x, she commits to sell her license to any buyer during the next year at a price of $10x$, which becomes an upper bound on the licensee's "ask price" for that year.

These rules create a tension: a licensee can pay a reduced license fee by declaring a lower value x, but must then be willing to sell the license for the corresponding lower price. If a licensee tries to hoard spectrum by claiming a high value, she must pay a high license fee every year. The balance of these effects encourages the incumbent licensee to quote a price x that is roughly equal to 10% of her actual value.

The DLE / Operating such a system would require creating an exchange platform on which licenses can be bought and sold. The platform would include a searchable database listing the prices for the licenses for each area. This exchange format would replace the usually illiquid and haphazard secondary market for spectrum licenses with a much more liquid market, like one for commodities or stocks. All licenses would be available for purchase at posted ask prices at any point in time, allowing purchasers to access all licenses and buy the lowest priced ones.

There could be posted bid prices as well. Licensees who make significant unrecoverable investments in spectrum could choose to post higher ask prices, paying somewhat higher license fees to protect the value of their investments. Their licenses would be sold only if buyers arrived with sufficiently high values to want to purchase despite the high ask prices and the associated high annual license fee. If such a buyer appears, the licensee would be paid her ask price ($10x$), allowing her to recover much of the value of her investments. Furthermore, because the license would effectively be renewed annually, it would never become a lame duck, so the same protection would apply to new investments made to renew or upgrade any networking infrastructure.

The DLE would be self-regulating. It would promote license reassignment in a manner that would be responsive to changes in the competitive and technological environment surrounding spectrum use, without requiring new legislation or discretionary government interventions like "incentive auctions" or eminent domain. A licensee who finds the fees too high or wishes to sell her license could do so at any time, either immediately by announcing a new ask price lower than the highest bid price in the register, or by gradually lowering her ask price and paying reduced license fees

until a willing buyer appears. New entrants likewise could either purchase spectrum instantly at the prevailing ask prices or submit bids and wait until an ask price drops below their willingness to pay for spectrum use. Moreover, even if technological innovations eventually require the FCC to redesign licenses—for example, if the FCC wishes to change the permitted uses in the band—the FCC could rely on the prevailing ask prices to assess the economic values and possibly to make its purchases.

Depreciating licenses would be straightforward to administer. The only infrastructure required would be a standard market platform like eBay or Airbnb, which would be responsible for collecting and cataloging bid and ask prices from potential buyers and current licensees, collecting license fees, and facilitating license transfer when bid prices exceed ask prices. As in any traditional example, a license would be transferred when a buyer and seller in any market post compatible bid and ask prices. A bidder that requires coverage of a larger area could see the relevant prices and buy all the relevant licenses at the same time. Once the exchange infrastructure is in place, this system could be significantly easier and less costly for both the operator and participants than the current system of periodic auctions.

A PRACTICAL ALTERNATIVE: FOOTHOLD AUCTIONS

This infrastructure, however, is different from what is currently implemented using well-established FCC authorities. Could a similar economic outcome be obtained through smaller changes to the existing FCC infrastructure and auction rules?

The depreciating license exchange can be approximated using a "foothold auction" system. As in the exchange design, depreciating licenses with some fixed annual depreciation rate could be initially sold in a one-time auction. Thereafter, instead of the continuous license reassignment of the DLE, licenses could be reassigned in auctions that take place, for example, once every three years. To make these reassignment auctions approximate the DLE outcomes, any current licensee would be given a "foothold" of refundable bidding credits in the auction. The size of the foothold is determined by the licensee's stake in the license after depreciation, so 10–20% annual depreciation rates correspond to three-year footholds of roughly 50–70%. For example, if auctions are held every three years and the goal is to mimic a depreciation rate of 10%, then an incumbent licensee who loses an auction for her own license would be paid 70% of the final auction price as compensation for relinquishing her remaining stake in the license. This compensation might be awarded in cash or, more consistent with existing FCC practice, in transferable credits that can be used to purchase other licenses. Similarly, incumbent licensees who win auctions would pay only 30% of the auction price, the rest being covered by bidding credits.

The foothold auction implementation of depreciating licenses would forgo the continuous decentralization and simplicity benefits of the DLE, and would not provide continuous information about license values. It also would navigate the tradeoff between flexibility and stability more poorly than the DLE: at the same depreciation rate, foothold auctions would lead to slower license turnover without giving better investment incentives. Despite those drawbacks, foothold auctions would promote relatively easy and frequent reassignment while securing complementary investment. Given that the awarding of bidding credits to incumbents is already common, the most significant difference between foothold auctions and the FCC's current auction system is that some of these credits would be transferable or refundable if the incumbent loses.

OTHER CONSIDERATIONS

The use of depreciating licenses or the related foothold auction system would resolve and simplify many of the issues associated with license design. First, the issue of renewal expectations would not arise, as licenses would have indefinite lengths. In effect, the licensee would renew her license continually at a market-determined price. In that respect, our auction implementation of depreciating licenses is closely related to proposals suggesting that licensees should be allowed to renew licenses by paying a fee based on the license's initial auction price. However, rather than using the *initial* auction price to set the renewal fee, our system would require licensees to pay a fraction of the *current* auction price at the time of renewal. This accounts for the possibility that unforeseen valuable uses of spectrum may emerge or that, conversely, there would be few such uses, in which case the licensee could pay less to renew. In short, these designs would adapt to market conditions rather than getting stuck with obsolete prices from past auctions.

The combination of depreciating licenses and unlicensed access (GAA) tremendously simplifies auction design. Indeed, the main reason for the relatively complex auctions traditionally used for spectrum licenses is that some licenses may be substitutes or complements. For some bidders in FCC auctions, licenses were complements: these bidders may have wanted to acquire licenses only if they could fully cover a large area. With unlicensed uses to fill in the gap plus the possibility of acquiring more PALs on the DLE, the strongest complementarities would be largely eliminated.

For other bidders, licenses may be substitutes: a small, new entrant may wish to establish a service in one or two cities, picking among them depending on the price. For such an entrant, substitution in the auction would be amply replaced by the posted prices of the DLE. Thus, with depreciating licenses, there would be little need to adapt auctions to accommodate substitutes and complements. Even a simple simultaneous sealed-bid auction, or a simultaneous ascending auction with no switching, could be easily run for very many licenses, and would be manageable for even relatively inexperienced bidders. The same auction solutions could apply with the alternative triennial auction.

The FCC could also manage the tradeoff between licensed and unlicensed spectrum use by setting reserve prices for depreciating PALs through its own bids. For example, by bidding x, y, and z

for three licenses, with $x < y < z$, the FCC would effectively set the low reserve price x if just one PAL is purchased, with the other two open for additional GAA use; a medium reserve price y in case two are purchased and just one is left for additional GAA use; and a high reserve price z if all three are purchased. In this way, reserve prices would increase as more PALs are sold, reflecting the increasing social cost of excluding more spectrum from unlicensed use. Such bids would also provide some insurance to a licensee, as at any time she could sell her license to the FCC at the reserve price, in which case her PAL would be converted to additional spectrum for GAA use.

Finally, the DLE design offers an exciting possibility for the determination of geographic license areas: incumbent licensees might be given permission to decide those areas themselves. They could combine several licenses that were previously fragmented and post a value only for the combination, or a buyer could purchase a large geographical license and carve it up. Allowing for the market rather than license designers to determine the appropriate geographical scope of licenses is a potentially important advantage of a DLE.

CONCLUSION

In this article, we have focused on the 3.5GHz band because of its immediate policy relevance. But depreciating licenses appear to have wider promise for public asset leases in which costly investments in developing the resource must be balanced against the flexibility to allow innovative new methods. For example, conflicts over the use of public lands (for grazing, farming, mining, etc.) have been common in American history. Each use requires investment, but the highest-value use of lands has changed frequently and the control of past licensees has often blocked innovative new uses. Every application raises its own special issues, but the depreciating license approach for this band provides another chance for the FCC to bring innovative market-based solutions to an important policy problem. *R*

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SPORTS

BOSTON TAKES A PASS ON THE OLYMPIC TORCH

Scholarly research does sometimes have a positive effect on public policy.

BY ANDREW ZIMBALIST

Public policy researchers generally resign themselves to gathering knowledge for its own sake, with little hope of affecting government decisions. For the most part, policymakers seem to use research only to support their intended course of action, not to determine that course. It is rare when the fruits of scholarship have actually changed policy. Arguably, the defeat of the Boston 2024 Olympic bid was such an uncommon occasion.

In February 2014, the U.S. Olympic Committee (USOC) kicked off a quadrennial ritual by sending letters to mayors around the country inviting their cities to bid to host the 2024 Summer Olympic Games. With a big push from John Fish, the CEO of Suffolk Construction, New England's largest construction company, a private group from Boston entered the fray. This group soon found itself to be one of four finalists, along with groups from Washington, DC, San Francisco, and Los Angeles, seeking to get the nod from the USOC to be the U.S. representative in an international competition to host the 2024 Games. The International Olympic Committee (IOC) would then make the final selection from competing cities from around the world in 2017, seven years before the actual Games would begin.

BUSINESSMEN'S BID

Although Boston Mayor Marty Walsh signed on to the city's bid, there was no city council discussion of the matter, much less a vote to pursue the Games. Similarly, there was no discussion or debate in the Massachusetts legislature. Boston had become a candidate whether residents liked it or not.

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Massachusetts' governor at the time, Deval Patrick, liked it. He formed a commission to look into the feasibility of Boston hosting the Games. State senator, and soon-to-be state senate president, Stan Rosenberg contacted me and asked if I would be willing to serve on the commission. At the time, I had published extensively on the economics of stadiums and mega-events and had consulted with a variety of government bodies on the subject. I told him that I would be pleased to serve, provided that the scheduling worked out. The senator then sent to Governor Patrick my curriculum vitae, along with a cover letter recommending me strongly. I also suggested to Rosenberg that he recommend Holy Cross economist Victor Matheson and Harvard planning and development professor Judith Grant Long, each of whom had done important studies on sports mega-events.

As it turned out, Patrick selected none of us for the commission. Rather, he chose Fish and a coterie of business leaders to examine this important issue. Not surprisingly, by the end of February 2014 the commission was ready to announce that it was eminently feasible for Boston to host the Games.

Big news came on January 8, 2015: the USOC, in a tightly split vote, picked Boston to be the U.S. representative in the international competition for the 2024 Games. At the time, there was a certain euphoria in the Boston construction industry and even the electorate, which a survey showed to be 51% in support of the city hosting.

The timing of the announcement, however, was a bit infelicitous because it coincided with Gov. Charlie Baker's inauguration day, and Baker was not a gung-ho supporter of the Olympic bid. More infelicitous still, Boston 2024—the Olympic organizing group led by Fish—had submitted to the USOC its plans for hosting the Games, but the group refused to share the bid documents with the public. Further, Mayor Walsh had signed a "joinder agreement" with the USOC that committed Boston to accept all the terms of the USOC and IOC if the city would be selected as the host. One such term was that the city would provide a financial guarantee to cover any deficits in the event of a cost overrun or revenue shortfall.

Since 1980, the Summer Olympics have experienced an average cost overrun of 252%. The 2012 Games in London alone had a nearly threefold overrun, with a final cost in excess of $18 billion. Given that background and the fact that the entire Boston city budget was only $2.7 billion, it was not a trivial matter that Walsh had signed this agreement.

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When, under intensifying public pressure, Boston 2024 finally shared parts of its bid documents and its joinder agreement, many other troubling items were revealed. For instance, the joinder agreement contained a "gag order" that stipulated the following:

> The City, including its employees, officers, and representatives, shall not make, publish, or communicate to any Person, or communicate in any public forum, any comments or statements (written or oral) that reflect unfavorably upon, denigrate or disparage, or are detrimental to the reputation or stature of, the ICO, the IPC, the USOC, the IOC Bid, the Bid Committee, or the Olympic or Paralympic movement.

So not only had Mayor Walsh potentially committed Boston to spending billions of dollars it did not have, but he also seemingly pledged to curtail the First Amendment rights of all city employees.

The problems did not end there. Another IOC requirement was that the

city clear all its public billboards so they would be available for IOC marks as well as those of IOC sponsors. Still another requirement was that all activities connected to constructing the Olympic venues and infrastructure, the sale of tickets, and income to the athletes would be tax-exempt.

THE OPPOSITION

As those and other facts leaked out, public opinion in Boston and Massachusetts began to shift. The information was provided primarily by a citizens group known as No Boston Olympic (NBO). NBO was led by three young individuals with deep roots in Boston politics and the corporate community: Chris Dempsey, Liam Kerr, and Kelly Gossett.

I was fortunate to be contacted by them and asked to speak at their first public meeting, held at a church in Back Bay on January 14, 2015. For the event, NBO rented the church's main hall for $700. Five days earlier, Boston 2024 had held its first public meeting championing the bid at the Boston Convention and Exhibition Center. The contrast in resources between the two groups was evident throughout the coming months. By the time the USOC pulled the Boston bid in late July, Boston 2024 had spent approximately $15 million on its campaign to win the Olympics. NBO had spent under $10,000. Put differently, NBO was outspent 1,500 to 1, and yet it ultimately won the day.

Complicating the task for NBO was that Boston's heaviest hitters from industry, finance, and government were lining up behind the bid. But facts matter and NBO had them on its side. NBO also had energetic volunteers, social media, and a vibrant Boston press that was willing to cover both sides of the story. NBO members pushed ahead, updating the group's website, tweeting, and group-emailing on a daily basis, appearing regularly on radio and television shows, speaking to state lawmakers and other political bodies, meeting with the governor, and making strategic phone calls.

The research and writing that I and other academic economists had done on mega-events over the years moved off the dusty office shelves alongside scholarly journals and into the mainstream media. I was invited to give numerous public talks in greater Boston and throughout the state, to appear on radio and television shows, to speak before the State Senate, the Boston planning council, the NAACP, and meet with members of the city council and the governor. I coordinated my activities with Dempsey at NBO.

As the opposition to Boston 2024 began to gain momentum, the record snowfall of February 2015 landed. The snow forced the closing of the Massachusetts Bay Transit Authority system for two days and dramatized the need for Boston to take care of its basic transportation infrastructure before it hosted a 17-day extravaganza.

The Boston 2024 bid had more unpleasant surprises. The initial plan called for constructing the beach volleyball venue in the middle of Boston Common. While this might have produced nice images for international television, it was viewed as heresy in Boston. The Common is enjoyed by thousands of Bostonians every day for strolls and recreation. To make room for the beach volleyball facility, dozens of trees would have to be felled and months of pre- and post-Games disruption would render the Common unusable.

The bid also called for $5.2 billion in public transportation infrastructure investment. Bid supporters claimed that those investments were already planned and funded. It turned out, however, that they were little more than unapproved and unfunded conceptual designs. Further, Bill Straus, the co-chair of the state legislature's transportation committee, said on local television that the actual costs of the projects would exceed $13 billion.

The partial release of the initial version of Boston 2024's bid revealed more bad news for the Olympic boosters. The bid identified the Columbia Point area of southeast Boston as the future home of the Olympic Village. The Widett Circle area, south of South Station, would be the location of the Olympic Stadium. Among other problems with these sites, the bid claimed that the existing property owners had been contacted and were on board with the repurposing of their land. Upon learning of the bid's intentions, the affected landowners stated that they knew nothing about the plans.

The boosters also contended that there would be no new public money required to host the Games. To arrive at this result, a variety of unrealistic assumptions on the cost and revenue sides of the Games had to be made. One of those involved ticket sales. Despite proposing smaller and less elaborate venues than in London 2012, Boston 2024 projected ticket revenues 15% above those of London. Further, the bid identified no developers who were interested in building the proposed venues, nor found any community ready to host either the Velodrome or the Aquatic Center, and counted on Harvard and MIT to host various competitions while the schools disavowed any interest in doing so. These contradictions and inconsistences were enough to shift public opinion. By the end of March, only 36% of polled residents supported Boston 2024.

Boston 2024 needed a reboot. It came in the form of a new leader: Steve Pagliuca, co-owner of the Boston Celtics and CEO of Bain Capital. Along with Pagliuca came the promise of a new plan, dubbed "2.0." While Pagliuca cut a friendlier figure than Fish, the economic fundamentals of the Boston bid were already too far gone for effective rescue.

THE OLYMPIC FLAME AND RED INK

Cost overruns have been a ubiquitous feature of the Summer and Winter Games, even those held in economically developed countries. Of course, it is possible to have a cost overrun and still have a positive cash flow. But Olympic reports of positive cash flows should be taken with grains of salt.

Consider the Winter Games in Sochi in 2014, which reported a positive cash flow despite a final cost in the range of $51–67 billion. The positive balance came from a massive financial transfer from the Russian treasury to the books of the Sochi organizing committee. Other Games have also reported a positive cash flow. This usually results from the official report only considering the

operating budget of the Games, not the larger budgets for venues or infrastructure.

One striking exception to this pattern was the Los Angeles Games in 1984. The previous three Summer Games were financial or political debacles. Mexico City 1968 was plagued by political repression, militant protest, and air pollution. Munich 1972 was haunted by the terrorist operation at the Israeli compound of the Olympic Village. Montreal 1976 suffered from incompetence and corruption, resulting in a final cost that rose to more than nine times the original estimate.

When the bidding took place in 1978 for the 1984 Olympics, the IOC received only one bid, and Los Angeles recognized and took advantage of its position. The IOC had to choose between accepting the city's terms or having no host. Those terms included that the city would not financially backstop the Games and that it would use old venues left over from when it hosted the 1932 Olympics, as well as using dormitories at UCLA and USC to house the athletes. The IOC accepted.

When the bidding took place in 1978 for the 1984 Games, the IOC received only one bid, from Los Angeles. The IOC had to choose between accepting the city's terms or having no host. L.A. took advantage of its position.

With those conditions, together with innovative and effective marketing of corporate sponsorships, Los Angeles 1984 was able to turn a modest surplus of over $200 million. And even in that case, the federal government chipped in some $78 million.

Other recent American experiences in Lake Placid (1980), Atlanta (1996), and Salt Lake City (2002) were decidedly different. Lake Placid 1980 experienced cost overruns of 321% and ultimately required a bail out. The State of New York contributed $63 million (17% of total costs) and the federal government spent $179 million (50%). Thus, public funding was over two-thirds of the total and this allowed the Lake Placid operating committee to claim that it had balanced its books.

Atlanta 1996 had a cost overrun of 147%. Nonetheless, the Atlanta Operating Committee reported a balanced budget. Approximately one-third of all spending—$823 million—came from taxpayers. Of that, $609 million came from the federal government. Moreover, the construction of the Athlete Village and the Olympic Stadium in Atlanta required the demolition of two low-income, minority communities. That, in turn, led to increased homelessness during the Games and a repressive response from local government to improve the optics for the Olympics.

According to a 2001 Government Accountability Office report, excluding the additional security costs necessitated by the September 11, 2001 terrorist attacks, the federal government planned to spend $342 million on the 2002 Salt Lake City Winter Games. The Salt Lake City municipal government planned to spend $75 million and the Utah state government committed an additional $150 million. The final public bill was considerably higher.

WINNER'S CURSE

The United States is hardly alone in this Olympic experience. So why are the Games such a bad deal for host cities and countries?

The answer to this begins by observing the economic structure of the Olympics. The IOC is an international monopoly that, every two years, auctions off to the world's cities the "privilege" of hosting either the Winter or Summer Games. The IOC wants potential Olympic host cities to think they are entering a competition, much as marathon runners might line up at the starting line or swimmers might stand on the starting block. IOC president Thomas Bach is fond of calling the bidding process a "great race" and a "fascinating competition" in which the "best" city wins the right to host the best games in history—a prize even more glittery than the shiniest gold medal and rarer than a world-record performance.

Cities that approach Olympic bids as a competition might win the IOC's race, but they are likely to lose in the long run. Reframed not as a race but as an auction, the dynamics inherent in the IOC's process become clear.

Picture an auction room with the IOC at the podium, gavel in hand. Before even beginning the auction, Bach and his team have spent a good deal of time convincing as many well-known bidders as possible to enter the auction room. Status-conscious bidders want to see other bidders of their social circle. If you see bidders that you consider beneath you, you might think you have a better chance of winning, but you might start to doubt that you actually want to win!

With the cities in the room, bidding paddles in hand, the IOC can begin an auction process that maximizes its benefit. The highest bid (in terms of ease, comfort, opulence, and general impressiveness) wins.

Economists often refer to the likely outcome in this type of auction as a winner's curse. Imagine five cities from around the world bidding against each other. Four of them believe that the economic value of hosting the Games is, say, $8 billion or less. The fifth city believes it is $12 billion and the city's bid, accordingly, boasts more trappings of IOC worship, fancier facilities, and so on. This bid is the outlier and, likely, overly exuberant. The city has overbid and, though a winner, is cursed because it has committed to spending more than the Games are worth.

In reality, the outcome for the winner is bound to be worse still because of ubiquitous cost overruns and because the bidders

usually represent particular interests in the private sector that will benefit from the largesse: construction companies and unions, insurance companies, architectural firms, investment bankers who float the bonds, etc. These groups will benefit handsomely from hosting, while the city and its taxpayers will pay the bills.

THE AFTERMATH

Because of these dynamics, the typical host of the Summer Games experiences costs on the order of $15–20 billion, yet receives only $3–5 billion in revenue—not a very salubrious financial balance. The IOC propaganda machine will claim that any short-term financial losses will be offset by long-term gains. Most notably, the host city will be put on the world map, occasioning growth in tourism, trade, and foreign investment. Those are nice thoughts, but there is little evidence from academic research that they ever materialize.

First, most Olympic host cities are already on the world map. People and businesses that have the resources and interest to travel internationally already know about the city and its allurements. Second, Olympic hosts often experience a decrease in tourism during the Games as travelers stay away from the congestion, inconvenience, high prices, and security issues. Hotel occupancy may drop even more because most cities expand lodging capacity appreciably in anticipation of an elusive tourism bonanza. Third, the tourists who do attend the Games return home and tell their friends, neighbors, and relatives about the exciting 100-yard dash or swimming relay they watched; they rarely tell stories about the cultural or culinary attractions of the host city. Thus, tourism loses its most effective propagator: word of mouth. Fourth, exposure on the world stage does not necessarily burnish a city's image; instead, it may tarnish it—just ask Mexico 1968, Munich 1972, Montreal 1976, Athens 2004, Sochi 2014, and Rio 2016.

The long-term effects, in fact, may well be negative. After spending billions of dollars on Olympic-related construction, the host city then faces the challenge of what to do with the venues after the Olympics leave town. While most cities develop some plans for future use, these are not always easy to implement. Beijing 2008's "Bird's Nest" stadium has been converted into a museum for tourists to visit at $12 a pop, but there is little interest. Meanwhile, the facility costs millions of dollars annually to operate and maintain. Rio's Olympic Park has many venues that were slated for post-game use, but there was either no money to convert them or there were no private developers willing to take on the responsibility of remodeling and management. As in Athens (2004), most of Rio's venues are now falling into disuse. London's $700 million Olympic Stadium has been converted (at a $400 million additional public expense) into a new stadium for the West Ham soccer club, but West Ham had a perfectly good stadium beforehand.

What is true about these white elephants and dozens of others is that they cost millions of dollars to maintain and they take up valuable urban real estate. In fact, hosting the Summer Games generally encumbers 5,000–8,000 acres of land for 35+ sporting venues, the Olympic Village, the media village, the international broadcasting center, the ceremonial green space, the access roadways, and the parking lots. Commandeering so much land invariably means pushing businesses and people out of the way. Beijing 2008 reportedly evicted over one million residents to make room for Olympic construction. Rio 2016 evicted 77,200 *favelados* (shanty town residents).

In Boston, space issues had a particular resonance. Boston is a tightly packed, densely settled city. Original plans to put almost all the venues within Greater Boston and have a "walkable" Games were quickly abandoned. But, even in Plan 2.0, Boston 2024 set its sights on building both the Olympic Village and the Olympic Stadium in Boston proper.

The budgets for the Olympic Village and Olympic Stadium were even more fanciful and financially destructive for Boston. The tax subsidies to be offered to the prospective developers at Widett Circle were estimated at $269 per square foot and at the Columbia Point Olympic Village at $199 per square foot. Contrast those bloated subsidies with ones offered by the city to the developers at Fenway Center at $4 per square foot or at the Vertex Pharmaceutical complex at $11 per square foot. That is, the city was being asked to offer subsidies 20 or more times what they had previously handed out for similar development deals.

Exposure on the world stage does not necessarily burnish a city's image. Instead, it may tarnish it—just ask Mexico 1968, Munich 1972, Montreal 1976, Athens 2004, Sochi 2014, and Rio 2016.

Even assuming that Boston 2024 could find willing developers at these subvention levels, it is uncertain whether the city council would have gone along with the incentives. If economically viable projects can be induced with subsidies of 5% or even 1.5% of the level offered for the Olympic Stadium and Village, why forgo the tax revenue and give up some of the few remaining developable plots of real estate in the city? That question becomes even more pressing because the Boston 2024 plan involved adding 4,000 housing units at Widett Circle and 2,700 units at Columbia Point post-Olympics, but the plan had no space or financial allocation for schools, health clinics, or police stations.

The Boston 2024 plan also relied upon quixotic cost assump-

tions. For instance, Boston 2024 intended to build a 20-acre-plus deck over the railyards at Widett Circle on which it would build the stadium. It budgeted only $10 million for the air rights to those 20 acres. Yet, based on air rights at Hudson Yards in New York City and the Fenway Center development over the Massachusetts Turnpike, the air rights were worth more than $300 million. Boston 2024 projected that the deck itself would cost only $785 million to build, but based on the construction costs of the decks at Hudson Yards and Fenway Center, a more realistic projection would have been $1.4 billion.

The Widett Circle and Columbia Point projects did include a 10% contingency fund, but projects at similar early conceptual stages typically contain 20–30% contingency budgets. Given the typical cost overrun of a Summer Olympics, a 10% contingency hardly seems adequate. Boston 2024 projected transportation costs at $50 million during the Games, even though Atlanta 1996 spent $150 million (in 2016 prices) on this operating expense.

The proposed Boston Olympic Stadium, designed to hold 69,000 in Bid 2.0 (up from 60,000 in Bid 1.0), was to have been a temporary structure, but it was still projected to cost $175.5 million. Even that number was likely to be wildly optimistic; a similar temporary Olympic Stadium that was envisioned as part of Chicago's unsuccessful bid for the 2016 Games was budgeted at $392 million (in 2016 dollars). Overall, a report on the Boston plan that was prepared by the Brattle Group estimated that Plan 2.0 understated likely costs of hosting the 2024 Games by $2.9 billion, before considering indirect and opportunity costs.

TIME RUNS OUT

As NBO was able to uncover the risk, expense, and disruption of Boston 2024's plans, the bid's boosters were put firmly on the defensive. Try as they might, each new change in their promotional strategy found no success in luring back popular support. The USOC, knowing that a Boston bid without support of the residents had no chance of winning over the IOC, began to express frustration and to set deadlines for a final proposal from Boston 2024.

With their back against the wall, Boston 2024 agreed to a public referendum in November 2015—something they had opposed from the outset. They also agreed to a public debate on hosting the Games, with Pagliuca and Dan Doctoroff (a member of the USOC executive committee and the leader of New York City's failed bid to host the 2016 Olympics) on the pro- side, and Dempsey and myself on the opposed. Boston 2024 had previously refused a head-on debate.

The Boston Fox TV affiliate carried the debate live in the early evening of July 23, 2015. After an hour of lively exchanges, Shirley Leung, a *Boston Globe* reporter and supporter of Boston 2024, commented during the post-debate show that Dempsey and I had come out on top.

Time was running out on Boston 2024. The USOC issued an ultimatum: Governor Baker, who had not embraced hosting the Games, must throw the state's support behind the bid by July 27 or else it would be rejected. Baker stood his ground and the USOC pulled Boston's bid on that day.

The next day, *PBS NewsHour* carried a report on the demise of Boston 2024's bid. The segment included an extended give-and-take between George Hirthler, a longtime Olympic campaign strategist, and myself. It began with program host Judy Woodruff asking Hirthler what went wrong with the Boston bid. He replied:

> What went wrong, Judy, was the public narrative that was pretty much controlled by Professor Zimbalist and the cohort of—his cohort of colleagues at No Boston Olympics.
>
> They kept the public conversation completely focused on the financial risks of the Games. So the public never had a chance to consider what it would be like to have athletes from 200 countries around the world living in an Olympic Village in their midst. The Games would have been extremely walkable for 90% of the fans who came into the Boston [area].... Professor Zimbalist and Chris Dempsey and the others came in and attacked every single number and kept the public conversation completely focused on risk and fear.

Woodruff interjected: "Well, I do want to move on to the larger question we raised here [on Olympic costs and benefits] but, Professor Zimbalist, let me give you an opportunity to respond." And I obliged: "I just want to thank George for making me out to be so powerful. I don't think we had nearly that impact."

While Hirthler undoubtedly overstated the case, it is clear that academic research played a role in defeating Boston 2024. The same research helped to reduce the field of competing cities from six down to two for hosting the 2022 Winter Olympics. Subsequent to the USOC pulling Boston's bid, Dempsey and I were contacted by opposition groups to the Budapest, Hamburg, and Rome bids for the 2024 Games. Each of those cities ended up pulling its bid as well. Ultimately, Paris was awarded the 2024 Games. Los Angeles, with another shrewd bid reminiscent of the 1984 Games, won 2028.

The business model of the IOC is under challenge. Fewer and fewer cities believe that throwing an extravagant 17-day party for international athletes and media will promote their economies. Scholarly research and facts matter. *R*

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ENERGY & ENVIRONMENT

THE NEED FOR ELECTRICITY RETAIL MARKET REFORMS

An innovative 21st century retail electric power market is within reach, but won't emerge until we ditch 20th century regulations.

BY MICHAEL GIBERSON AND LYNNE KIESLING

School budgets always seem tight, so you might be surprised that state regulators would seriously consider a proposal that would *increase* school operating costs by millions of dollars as part of an effort to boost monopoly electric utility profits. Yet Michigan legislators came close to adopting such a proposal in 2014 when they considered ending the state's customer choice option for retail electricity consumers.

School administrators working with the nonprofit Michigan Schools Energy Cooperative (MISEC) told legislators that retail energy choice helped them save almost $15 million in 2013. MISEC has helped Michigan schools save over $120 million since it was formed in 2000, the year the state first allowed customer choice. Eliminating customer choice meant schools would have to cut services elsewhere.

Ever since Michigan allowed retail customer choice for electric power, the state's regulated electric utilities have pushed to return to the comforts of being regulated monopolies. In 2008 the utilities convinced regulators to cap the popular option at just 10% of the market. Average retail power prices were just below the national average when customer choice began in the state, and were still below the national average in 2008. Now, however, Michigan prices are above the national average and the waiting list of retail customers wanting to choose their own electric suppliers has grown into the tens of thousands. Those whom regulation excludes from the market are clamoring for choice.

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WHATEVER HAPPENED TO DEREGULATION?

The Michigan experience exemplifies the last two decades' half-hearted push into customer choice reforms for electric power. The hope of reformers in Michigan and elsewhere was to bring to electric power the same burst of innovation, better prices, and customer-oriented growth that had resulted from the deregulation of airlines, trucking, financial services, and other industries in the late 1970s and 1980s. There is some evidence that it is working, too, if you look in the right places—Michigan schools, for example.

The customer choice movement was strongest in states with especially high power prices in the 1990s, like California, New

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York, and Massachusetts. A few moderate-priced states with well-organized industrial energy consumers, like Michigan, Ohio, and Texas, also pursued reform. If regulated monopoly was the problem, then reform meant allowing competition and giving customers the ability and responsibility to choose their own electricity supplier. By early 2001, about 20 states had begun reforms and millions of electric power consumers gained at least some freedom to choose their retail supplier.

Yet when California's newly restructured system fell apart in 2000–2001, the push for deregulation stopped faster than it started. (See "Special Report: The California Crisis," Fall 2001.) States that had not initiated reforms simply abandoned deregulatory proposals. Others froze reforms, limiting competition to a fraction of mostly industrial and commercial customers. Only 15 states continued to push for competition, more cautiously than before.

The passage of time has given us perspective on the California market meltdown, and we now have experience with retail competition from the states that stayed the course. The industry has also changed much in 20 years, with new and better technologies for power generation, communication, and coordination now available. We have a deeper understanding of the resource

opportunities and environmental tasks we face, and reasons to appreciate both the role of policymakers and the wisdom behind limits placed on their reach.

It is time to take a fresh look at the case for retail electric power competition. Vast advancements in digital technology provide the basis for dramatic change in the electric power industry. For these developments to emerge, however, the distribution grid must transition from its one-directional, utility-to-consumer flow to support multi-directional flow. Homes, small businesses, office parks, and other utility customers are already shifting from pure consumers to being hosts for distributed energy resources on a small scale, with technologies like microgrids, rooftop solar, and electric vehicles. The potential for distributed generation and greater customer interaction is much larger than 20 years ago.

The technology for this transformation already exists. Computers and telecommunication technology are merging with distributed energy systems. At the leading edge, programmable thermostats have given way to smart home energy management systems that enable consumers to automate changes in their appliance and device settings. Great possibilities arise from the "internet of things," a vision of device-to-device coordination working automatically to achieve consumer goals at low cost. This vision enables smarter energy use that can produce both environmental benefits and consumer savings.

THE CHOICE BETWEEN MONOPOLY AND COMPETITION

The historical logic of utility regulation was as follows: the electric utility industry offered significant economies of scale—the larger the utility, the lower the average cost of producing power. If competition were to be permitted, the largest of the competitors could undercut its competitors and become a monopolist, and would then be in a position to raise prices and obtain excess profits. By granting a state-protected monopoly territory, the state enabled the utility to achieve economies of scale, but in exchange the state asserted authority to regulate utility rates to protect consumers.

Utility regulation also had an economy-of-scope rationale. The need for continuous close matching of the quantity of electricity produced and consumed on the grid provided significant economic and reliability benefits from vertical integration across the retail, "wires," and generation sectors of the industry. Transaction costs would have overwhelmed any early attempt to develop a large-scale local distribution system involving multiple generating companies and many competitive power retailers on an interconnected grid.

Technical advance has undermined both the economies-of-scale and economies-of-scope rationales for monopoly in electricity. For many years, building larger generating units and larger distribution networks lowered average costs. But beginning in the 1970s the trend toward lower average costs from bigger and bigger utilities came to an end. Smaller generation units were developed that were as cheap or cheaper when matched to the right location, and the recent advances in natural gas drilling that have lowered natural gas prices have amplified that trend. Advances in digital technologies have significantly reduced the transaction costs of continuous coordination among many generating firms.

Perhaps only the power delivery system—the distribution and transmission grid—still shows natural monopoly characteristics. It is no longer necessary for all power production and delivery assets to be owned and managed by a single company. Yet electricity distribution utilities are still substantially subject to monopoly-based regulation.

The internet, with all of its dynamic possibilities, was in large part made possible because telecommunication companies were freed from such monopoly-based regulation. Critical to the internet's dynamism is its openness to experimentation and learning. The internet allows permissionless innovation: within very broad technical and contractual limits, just about anyone can try just about anything.

Economic regulation, however, is fundamentally a permission-based system. Because any new development or change in regulated service requires approval from the utility commission, regulation tends to slow or stifle innovation. Legal entry barriers, bureaucratic procedures for cost recovery, and the risk aversion of both regulator and regulated, all undermine processes that enable innovation. Perhaps ironically, while the most dynamic sectors of the economy are powered electrically, the electric power industry remains largely stuck with 20th century ways of doing business. These old ways discourage innovations that could help the industry better meet the needs of 21st century electric power customers.

The public policy choice to grant monopolies to vertically integrated electric utilities always faced tradeoffs between the innovation and value that would have resulted from competition and the lower costs and more reliable supplies from a regulated monopolist. For many years, both consumers and regulated monopolies seemed better off from the system. This conclusion is no longer true. The costs of blocking competition are growing larger and the benefits smaller. The reasons to prevent customers from picking their own suppliers have faded.

What next? Delivery of electric power is likely to remain mostly a monopoly for the foreseeable future. Allowing competition to grow elsewhere requires isolating the regulated monopoly from competitive sectors. The first step, then, is to quarantine the monopoly. Second, the regulated distribution monopoly must be organized to support transactions among many suppliers and many consumers. Third, the role of utility regulators must shift from market overseer to something more akin to referee.

QUARANTINE THE MONOPOLY

What of the 15 years or so of experience with retail choice in the states that stuck with reforms after the California market

disaster? The results disappoint some market advocates. While retail competition for industrial and large commercial customers is strong, at the residential level markets remain weak in most of the 15 states that allow retail choice. Only in Texas has retail rivalry been robust for residential consumers. While the reasons for weak competition are debated by industry insiders, the Texas exception is telling. Texas, much more clearly than in any other state, has "quarantined the monopoly."

The phrase "quarantine the monopoly" was devised by William Baxter, an assistant attorney general for the U.S. Department of Justice and the primary architect of the 1982 settlement of the federal government's antitrust case against the AT&T monopoly. One of Baxter's principal concerns about AT&T was that the company would have incentives and opportunity to extend its monopoly into related markets to the detriment of competition. In response, he proposed limiting the harm to competition in related markets by isolating the regulated monopoly as much as possible from these markets. This policy of quarantining the monopoly has become known as "Baxter's Law" (and also as the Bell Doctrine).

Most restructured states have failed to effectively quarantine the monopoly in electricity in large part because the incumbent monopolist's role as a default provider created a cost of entry that deterred competitors.

Texas very clearly quarantined the "wires" monopoly when it restructured its retail power market. Over most of the state, the large, vertically integrated utilities were spun off into separate energy retailers, generation resources, and wires companies. Only the wires companies retained status as regulated monopolies. Texas also chose not to have incumbent default service, which other restructured states retained and which keeps the incumbent in the retail market, even if the generation cost is a pass-through.

With these changes, competition has emerged quite robustly in Texas. Most residential customers in the competitive markets in Texas can choose from over 40 different potential retail energy providers and have over 200 different products to choose from. Over 90% of customers have switched providers at least once since competition began. Consumer products offered include both long-term and short-term fixed rates as well as variable rates, renewable content varies from a few percent to 100%, and consumers with solar panels on their property can sign up for "net metering"–style offers from competitive retail suppliers. The Public Utility Commission of Texas reports electric rates in areas open for retail competition have fallen by about 30–40% compared to the regulated price that prevailed prior to opening the market.

Most restructured states have failed to effectively quarantine the monopoly in electricity in large part because the incumbent monopolist's role as a default provider created a cost of entry that deterred competitors. In Michigan, some customers jumped at the chance to dump the former monopoly provider, but regulated "default service" rates offered by the incumbent utility made it difficult for competitive providers to gain much of a foothold.

Ohio provided for retail competition in 2001, requiring investor-owned utilities to unbundle their services and charges for generation, transmission, and distribution; customers were allowed to choose their own retail supplier. But unbundling services into affiliated companies does not provide the needed quarantine around the monopoly, and competition in Ohio has suffered because of it. After a very slow start, just over half of Ohio residential customers have switched from the utility-offered default service, but most switching has been through customer aggregation programs run by local governments rather than competitive suppliers. Municipal power purchases on behalf of end customers is a far cry from the dynamic retail marketplace needed to promote customer-serving innovations.

The results in other states vary, but a survey of ongoing state legislative and regulatory efforts suggests unhappiness with the current half-way reforms now more than 15 years old. New York, while engaged in a multi-year regulatory push to re-imagine the future of competitive retail power in the state, has simultaneously been imposing tighter, more cumbersome controls on existing competitive retail suppliers. Illinois, too, has been talking about grander visions for a dynamic future, but retains policies like incumbent default service that stifle competitive entry. Connecticut offers customer choice, but it recently banned competitive suppliers from offering contracts with market-based variable pricing.

As Baxter feared with the AT&T monopoly, states that left regulated electric monopolies in the retail supply business have seen these monopolies grow at the expense of competition. Quarantining the monopoly appears to be the single most effective approach to bringing about robust retail competition. It may be the *only* effective approach.

BUILD PLATFORM MARKETS

Once the delivery system monopoly has been quarantined from generation and retailer interests, two policy issues remain: what rules should govern regulated delivery service, and what rates should apply. The delivery company will remain a local

monopoly, and therefore its terms of service and rates will continue to be regulated by the state government. To support the growth of competition and innovation, the rules and rates should be as neutral as reasonably possible with respect to producer and consumer technologies, retailer business models, and customer classes.

Environmental policy goals and other social policy goals are best dealt with directly rather than trying to engineer distribution rules to achieve policy outcomes. The regulated distribution system rules should not operate to discriminate in favor or against, say, renewable power technologies or customers with self-generation capability. Interconnection standards should be developed and harmonized across distribution utilities within a state and across states. Widespread standardization of technical requirements will minimize regulatory barriers to entry for distributed energy resources and other customer systems such as electric vehicles or residential batteries. The primary policy goal in developing such standards should be to support permissionless innovation while ensuring that customer equipment does not hamper system performance.

The primary goal in developing interconnection standards should be to support permissionless innovation while ensuring that customer equipment does not hamper system performance.

The wires company is the physical platform for delivering power to and from retail customers. This physical platform should be complemented with a market platform to help buyers and sellers on the grid come together in ways that coordinate the use of the power delivery system. This local delivery system integrated with an energy market is best conceived as a platform market.

One proposal for platform market organization is the Independent Distribution System Operator (IDSO) model: an independent entity charged with planning functions and operational control of the distribution grid that is separated from ownership of the distribution system assets. The proposal resembles the integrated wholesale markets and transmission system operations of regional transmission organizations such as the New York Independent System Operator (ISO), PJM, and the Midcontinent ISO. IDSOs are recommended for distribution utilities with a high degree of distributed energy resource penetration as better able to offer non-discriminatory access and transparency while reducing market power concerns.

The IDSO split of asset ownership and control is especially critical if the distribution utility has not been well quarantined from generation and retailing interests. The critical independence is from economic interests in specific generation assets or retailer services. The rules governing the platform market and use of the grid will be important to fostering innovation.

As an illustration of this point, consider the potential of smart meters and the data they make available. Utilities frequently wish to monopolize control over customer-related data, but consumers can benefit from (carefully managed) sharing of data with energy retailers and other service providers. Smart meters can be important innovation enablers that lower costs and aid in achieving customer goals. Both the value of electrical energy to consumers and the cost to suppliers can vary dramatically over the course of a day. Smart meters can track how much electricity is flowing across the instrument throughout the day and share that information with retail suppliers and customer energy management systems, enabling more sophisticated market and energy consumption strategies. The old analog meters, read manually once a month, would block many potentially valuable business models. A smart-metered distribution utility that withholds detailed data even from the consumer can just as easily block potentially valuable services.

While most distribution utility costs reflect capital investments, reliable operation of the distribution system requires energy consumption and may involve some transactions between the distribution utility and energy suppliers (or flexible consumers). The IDSO model readily lends itself to transparent, competitive procurement processes. To the extent the distribution system does engage in the procurement of services from energy market participants, such services must be obtained through a transparent, competitive process so as to avoid creation of any conflicts of interest. The distribution platform utility should not itself be a market participant.

DISTRIBUTION UTILITY RATES

The clash of public goals can lead to politicized utility rate cases. Efficiency advocates, renewable energy supporters, and other environmental interests join industrial and commercial consumers and state consumer advocates to lobby public utility commissions into tilting the rate design one way or another. "Not-In-My-Back-Yard" activists show up to protest planned projects. Utilities want to boost their rates of return. Sometimes, regulatory decisions spill over into court cases. The consequences can be large enough to justify these efforts, but the product is not necessarily reliable power at the most reasonable cost.

Policies governing rate cases must shift to support retail competition. There are two parts to this issue: first, how costs of the regulated "wires" utility and related wholesale costs are recovered

from retail power suppliers; and second, how retail power suppliers recover their expenses from end-use customers. The better the rules governing regulated utility rates, the more dynamic the retail energy market will be.

Quarantining the monopoly dramatically shrinks the rate case challenge because distribution system expenses are only one-quarter to one-third of the typical electric bill, but the remaining monopoly will still have regulated rates. Such rates should be designed to recover revenue requirements while remaining as neutral as possible toward the diverse business plans of grid users.

Decoupling the distribution utility's revenue recovery from energy sales is one step toward neutrality. Decoupling provides for periodic rate adjustments to ensure the utility recovers its revenue requirement, neither more nor less. Energy efficiency advocates promote decoupling as a way to remove a bias toward energy sales created by traditional rate designs. From the point of view of supporting competition, the value of decoupling is a way of further quarantining the monopoly. If increased throughput boosts a utility's rate of return, then the utility's interests will be biased toward some customer plans and against others. Decoupling enhances the quarantine by reducing that bias.

In addition to paying for use of the regulated grid facilities, retail power suppliers must acquire and pay for balancing energy and other distribution grid support services through the IDSO's platform market. Efficiency will be enhanced by pricing that balances energy and grid services in ways that reflect real-time conditions on the grid. The best such pricing method is distributed locational marginal pricing (DLMP). While DLMP introduces some complexity to the market, it is far superior to simpler alternatives.

To further support competition, the regulated rates and platform market expenses should be recovered from retail power suppliers rather than directly from end-use consumers. The retailer may simply pass through the utility charge as a few lines on its bill or it may bundle in the charge in some manner. Innovative approaches to consumer rates will be enhanced if the manner in which retailers pass through distribution charges is not dictated by regulators.

Individual consumers need not be exposed to continuously variable, sometimes unpredictable market prices in order to achieve economic efficiency. So long as competitive retail suppliers must cover the costs of grid-usage by their customers, retail suppliers will have the incentive to offer contracts that work to encourage efficient use of the grid. Of course, automation via transactive technologies makes dynamic prices easier for customers to manage as well.

Advanced technologies such as digital smart meters enable rate designs that send more accurate price signals for both energy use and distribution system use. Instead of the still-common bundled flat rate, competitive retail suppliers could offer customers time-of-day sensitive rates, market-price rates, and other dynamic rate designs. Some competitive retail suppliers in Texas have offered customers "free nights and weekends," policies reminiscent of early cell phone rates. Dynamic energy pricing can allow customers to lower their bills by shifting their consumption (e.g., running the dishwasher) from times of day when the grid is at its peak use and costs are high. When customers are encouraged to shift consumption away from peak, overall system efficiencies are improved, which lowers prices for even those consumers who subscribe to flat-rate services.

Automation and digital communications technology reduce transaction costs and make possible more granular, time-specific "wires" charges reflecting real-time costs of system resource use. Such an approach can promote overall system efficiencies and reduce cost-shifting among customers better than increasing fixed-cost allocations or raising demand charges—regulatory tools sometimes employed in response to growing levels of distributed energy resources.

THE ROLE OF THE REGULATOR

The role of the regulator will necessarily change. The regulator will remain engaged in cost-of-service regulation for the distribution system and therefore retain oversight over capital spending and service offerings. Standard cost-of-service rate regulation provides for a reasonable rate of return on capital investment, but it simply passes operating expenses on to customers without offering the utility other profit opportunities. As a result, regulated utilities can be biased toward "asset heavy" solutions to potential system concerns. The potential inefficiency is reduced when the regulated monopoly is limited to the wires-based portion of the system, but it remains a concern. Regulatory oversight of capital investment by the utility continues to be an important task.

However, regulator responsibility with respect to other expenses will shift toward ensuring a smoothly operating, competitive market. Most significantly, regulators will oversee the rules of the platform markets. This aspect of the regulatory mission should be guided by three interrelated principles: innovation, competition, and dynamism.

Many state regulators have found it valuable to establish online information clearinghouses for competitive retail offerings like powertochoose.org in Texas and papowerswitch.com in Pennsylvania. Centralizing and standardizing the presentation of consumer information makes it easier for customers to shop.

Such systems are not without controversy. Some competitive retail suppliers in Texas have carefully designed rate offerings to appear first in most search results, even though few customers will achieve an average rate as low as advertised. The standardization of information presented on state websites may overly focus consumer attention on price or customer ratings and inadvertently impede the ability of competitive retail suppliers to innovate on other product margins. Nonetheless, information clearinghouses appear to encourage competition.

THE RELIABILITY CHALLENGE

Utilities have pushed back against unbundling of vertically integrated companies by raising reliability issues. Reliability concerns were frequently front-and-center when retail restructuring debates began two decades ago. Similarly, with the debate over implementation of the Public Utility Regulatory Policies Act a decade and a half earlier, reliability concerns were frequently cited in defense of the established way of doing things. With each step toward competition it has become clear that reliability can be preserved on the system outside of vertically integrated monopoly control.

With the right rules governing retail markets, price signals will help coordinate customer actions and system needs. Operators should find reliability easier to manage.

Reliability remains a priority for the distribution company and for the regulator. Many reliability practices would remain the same as today, from proactive tree-trimming to participation in the electric utility industry's mutual assistance network for post-storm service restoration.

However, the information and communications technologies constituting the smart grid open up exciting possibilities. Smart grid technologies and their transactive nature mean that reliability need not be a "one size fits all" kind of service. A home energy management system could selectively turn off power to certain rooms or appliances during grid emergencies or during times of high prices, with no effort from or disruption of the homeowner. Smart grid technologies make it feasible for a retailer to offer contracts that interact with the consumer's energy management system. Rather than the coarse tools of brownouts or rolling blackouts in emergency conditions, a smoothly managed curtailment of low-value power consumption would be the first response. With the right rules governing retail markets, price signals will help coordinate customer actions and system needs; operators should find reliability easier to manage.

CONCLUSION

Can it work? Yes. While no one-size set of policies will fit everywhere, several states have shown that greater consumer choice in electric power works.

States including Pennsylvania, Maryland, and Illinois are taking further steps toward empowering consumers. In Texas, most consumers can choose from among hundreds of different power contracts featuring a range of environmental and other attributes. Consumers with residential solar can sign up for a net metering contract through a competitive retail power supplier—no contentious state policy battle necessary.

The wires remain regulated by the state utility commission, as do a number of other features of the electric industry, but within the bounds of the rules consumers find a wide range of choices. Among the innovations around the distribution edge are product offerings that bundle in smart home thermostats or other home energy management options with electric power service.

Current business models and regulatory practices governing electric utilities discourage innovation and make it more difficult for energy resources to flow to consumers in an effective, efficient, value-maximizing manner. But innovation is happening around the edges of the distribution utility, and pressure is building for a new wave of regulatory reforms.

Will such reforms boost consumer choice or lead to a more politicized electric industry? There is an opportunity to cut back monopoly power, promote greater customer choice and customer responsibility for energy production and use, and let consumers get more of what they want from the electric power industry. Building an open, competitive distribution grid will do the most to broaden the opportunities for development of an innovative, dynamic, consumer-focused electric power industry. Supporters of economic freedom should engage this reform effort. *R*

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ENERGY & ENVIRONMENT

MOVING FORWARD WITH ELECTRICITY TARIFF REFORM

Pilot programs and other experiments have shown the promise of "prosumer" changes.

BY AHMAD FARUQUI AND MARIKO GERONIMO AYDIN

For the better part of the past century, residential customers in the United States and many other countries have paid for electricity through a two-part tariff that has collected most of the revenue through a flat volumetric charge—that is, flat electricity rates paid in cents per kilowatt hour (¢/kWh). In contrast, a large share of the cost of producing and delivering electricity does not vary with the volume of electricity consumed. By not being cost-reflective, such tariffs have neither promoted economic efficiency nor equity in customer bills. Although these limitations have been recognized by the industry, tariff reform has been desultory, characterized by fits and starts mostly driven by energy crises and technology advancements.

Since the 1980s there have been four waves of tariff reform. In the now-ongoing fourth wave, there is an opportunity to move ahead with efficient cost-reflective tariffs because of the widespread deployment of smart meters. The need for cost-reflective tariffs has become pressing because of major shifts in the industry, including a slowdown in utility sales growth and trends toward more distributed generation.

We are on the cusp of a fifth wave of tariff reform that will see residential customers engaging in a "transactive energy" marketplace, akin to how larger entities engage in wholesale energy and capacity markets today. But we cannot reach the full potential of that future without first implementing efficient and cost-reflective tariffs. In this article we discuss ways in which the industry can make the most of our smart grid investments thus far, move forward with tariff reform, and set the stage for a successful transactive energy future.

Advancements in today's electricity industry have led many to question the sustainability of the traditional utility business model. Individual consumers can install rooftop solar panels and other distributed generation that reduce the quantity of energy incumbent utilities provide. These so-called "prosumers" can even send surplus power "backwards" through the distribution grid and into wholesale markets.

In some states, retail choice and community choice aggregations give consumers the opportunity to bypass their incumbent utility to better customize electricity services and supply based on preferences for cost, environmental attributes, and local community development. Even some of the smallest electricity customers are developing an appetite for customizing electricity usage and production to best suit their needs, and they are supporting and investing in novel tools and methods to do so.

This article focuses on retail tariffs that are charged by vertically integrated utilities or regulated transmission and distribution utilities providing default supply service to customers. Expansion in consumer options for power supply has clashed with the traditional volumetric method of recovering costs that essentially assumes no customer choice. A volumetric charge does not faithfully convey to the customer the actual cost structure of power supply, which is mostly a combination of fixed costs, costs dependent on peak electricity demand, and costs dependent on system conditions at the time and location of energy consumption.

Historically, the traditional volumetric charge was a sufficient cost recovery vehicle for utilities in a world with limited customer-side technology, limited customer options for power supply beyond the incumbent utility, and steady load growth. Today, that charge inadvertently creates a mechanism for prosumers and departing loads to bypass the fixed and demand-based (and peak use–based) costs of being connected to a larger system. The volumetric charge also creates a barrier to taking advantage of new

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technologies that can help utilities allocate costs to consumers more efficiently and fairly based on their consumption patterns.

WHAT WE LEARNED IN THE FIRST FOUR WAVES OF TARIFF REFORM

Since the late 1970s the industry has experimented with alternative rate structures to not only allocate costs to customers more efficiently, but also to empower customers to adjust usage patterns to avoid highest-cost electricity production. The industry's primary focus has been on developing time-varying energy charges ("energy-only time-of-use" [E-TOU] charges). In recent years utilities have also experimented with raising fixed charges so they reflect the costs of metering, billing, and customer care.

A third rate component—peak-based demand charges—has been in place for small and large commercial customers around the globe for the better part of the past century. In recent years utilities have experimented more with introducing demand-based charges to residential customers. Demand charges are based on peak electricity consumption and they reflect the costs of building electricity infrastructure to sufficient capacity to meet maximum consumption levels. One defining factor of a demand charge is whether peak demand is being measured at the time of system-wide peak (all customers combined reach peak consumption), within a designated "peak" time period, or at the individual customer's maximum demand. Another defining factor is whether demand charges are recovering distribution capacity costs, transmission capacity costs, generation capacity costs, or some combination thereof. Finally, the time period over which peak demand is measured is another variable. It could be a span of 15 minutes, 30 minutes, or an hour.

This three-part tariff structure—composed of fixed charges, demand charges, and time-based energy charges—better reflects the actual cost structure of power supply. A three-part tariff structure can encourage better use of grid capacity, minimize cross-subsidies between customers, and foster adoption of advanced technologies.

Historical barriers to developing and implementing three-part tariffs have been mostly driven by lack of data and technology for utilities to observe and understand individual customer usage patterns. Over the course of several decades, the industry developed and improved methodologies for understanding customer behavior and preferences through pilot programs. Regardless of customer reactions, an improved three-part tariff structure has

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helped utilities address some cross-subsidization issues. Additionally, the industry has found that E-TOU charges give customers the power to avoid high-cost electricity consumption and lower monthly bills, which may also be an essential ingredient to avoiding escalating emergency situations like the 2000–2001 California energy crisis. (See "Special Report: The California Crisis," Fall 2001.) These societal benefits can more than offset the cost of investing in new pricing tools and technologies if only the advanced rate design can incentivize customers to respond to price signals efficiently. Over the last few decades the industry has amassed considerable experience in testing, designing, and implementing E-TOU charges that maximize customer responsiveness.

First wave / As part of the first wave of tariff reforms, E-TOU tariffs were tested in the late 1970s in 12 pilots funded by the Federal Energy Administration (FEA), an organization that later became part of the U.S. Department of Energy. FEA's experimental designs were the first of their kind and they were of uneven quality.

The short-run effects of E-TOU on customer electricity usage were encouraging but not consistent. In most cases customers materially reduced peak consumption in response to the E-TOU rates, with very little (if any) demand-shifting to shoulder or off-peak periods. But some of the experiments resulted in statistically insignificant reductions in peak consumption. The FEA found that higher peak-to-off-peak price ratios and shorter on-peak periods generally led to stronger customer response.

However, these experiments did not test customer responses in the long run, response to multi-part tariffs (e.g., including a demand-based charge and a fixed charge), and customer welfare effects. Most state commissions chose to continue with a flat ¢/kWh tariff, but under the Public Utility Regulatory Policies Act of 1978 (PURPA) they were required to periodically consider time-of-use rates. The industry mostly put the idea of E-TOU implementation on hold until benefits and customer behavior could be better understood.

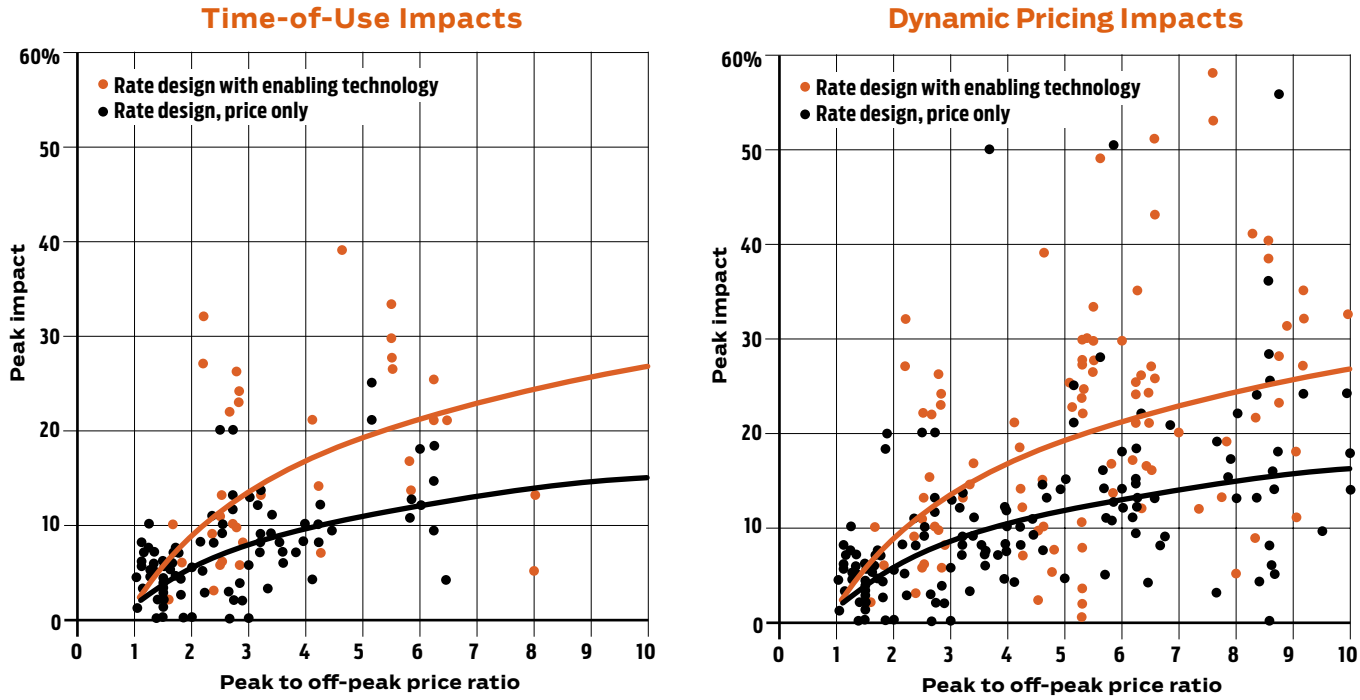
Second wave / The second wave began in the mid-1980s, when the Electric Power Research Institute examined the results from five pilots and found consistent evidence of consumer behavior. Unfortunately, not much came of this discovery because of the lack of smart metering infrastructure and because of the industry's focus on retail restructuring and the expansion of wholesale electricity markets.

However, a few utilities did move ahead with mandatory E-TOU rates for large residential customers. Virtually all utilities moved ahead with opt-in E-TOU rates, but only a few customers were actually on those rates.

Third wave / The 2000–2001 California energy crisis gave impetus to the next wave of pilots featuring dynamic pricing. Compared to E-TOU pricing, dynamic pricing is more of a general term for time-varying energy charges. Unlike time-of-use rates, where the

FIGURE 1

CUSTOMER PEAK REDUCTIONS IN RESPONSE TO TIME-OF-USE AND DYNAMIC PRICING



SOURCE: "Arcturus 2.0: International Evidence on the Impact of Dynamic Pricing," by Ahmad Faruqui et al., forthcoming.

time periods and the prices for each period are known in advance, dynamic prices may or may not be known in advance and the time period over which the prices are invoked may or may not be fixed in advance.

In the third wave, dynamic pricing pilots included studies of E-TOU pricing as well as other types of dynamic pricing. Some of these pilots featured enabling technologies such as in-home displays and smart thermostats. By 2013, more than 30 pilots featuring more than 160 energy-only pricing treatments were carried out around the globe.

Through these pilots, utilities and regulators learned more about the efficiency benefits time-varying rates could offer, and about factors that improve customer responsiveness during peak demand periods. We learned that load-shifting increases as the strength of the price signal increases, but at a decreasing rate. In California specifically, a major statewide pricing pilot conducted in 2003–2004 provided a conclusive demonstration that customers reduce peak-period energy use in response to time-varying prices.

Momentum from the third wave's scientific experimentation to understand customer behavior continues today. Since 2013, many more pilots have been conducted around the globe, bringing the total worldwide experience to 60 pilots featuring more than 300 energy-only pricing treatments. That number continues to grow. Figure 1 summarizes peak reduction effects from these pilots conducted through 2017, with each data point representing one pricing treatment.

As customers' peak to off-peak price ratio increases, customers reduce their peak consumption more, although at a declining rate. The black markers in Figure 1 show effects in response to prices only and without enabling technologies. Enabling technologies, such as smart thermostats, were shown to enhance customer responsiveness, as demonstrated by the orange markers. These results reinforce previous findings that customers do respond to price signals and that enabling technologies significantly enhance that responsiveness.

In the third wave pilots, observers also discovered that low-income customers can be price-responsive, although not to the same degree as the average residential customer. We further learned more about the effects of other factors such as weather and end-use saturation.

There was some experience with full-scale deployment of time-varying rates, such as in California, France, China, and Vietnam. A 2012 study summarized these experiences and lessons learned on actual customer behavior. Among the discoveries:

- In 2010, Pacific Gas & Electric called 13 events under its critical peak pricing program. Although there were no observable conservation effects, average peak reduction was 14% (with load shifting to subsequent hours) and customers saved an average of 8.2% on their bills. Low-income customers provided about the same percentage of peak demand reduction as other customers.
- In France, Électricité de France's critical peak pricing program had been in place in some form since 1996. In 2012 the program demonstrated a high level of price responsiveness compared to other parts of the world. Customers reportedly saved 10% on average compared to other rate options.
- China transitioned from government-mandated load shedding to some time-of-use pricing and inclining block rates. In several provinces customers responded with several hundred megawatts in peak reductions, the equivalent of one or two large central generating stations.
- In Vietnam, rapid growth in electricity use in the 1990s was an impetus for introducing time-of-use pricing in 1998. The national utility initially experienced major hurdles with customer marketing and information campaigns.

We also learned valuable lessons on how to design effective pilots, subject to available budget, time, resources, and other practical considerations. We learned how to better choose the appropriate type of pilot (demonstration, quasi-experiment, or controlled experiment), as well as how to define exactly the pilot motivation, what will be tested, and how it will be measured. We learned how to better establish control groups, recruit customers, and collect and analyze the pilot data.

Overall, the third wave of tariff reform brought the industry rich information on customer responsiveness to time-varying pricing. Pilots in the third wave provided the impetus and scientific evidence for widespread U.S. investments in advanced metering infrastructure. But our understanding of some aspects of customer behavior—like customer responsiveness in certain areas, customer preferences for different rate types, and risks and challenges with full-scale deployment of mandatory time-varying rates—is still incomplete. These remaining information gaps contribute to the barriers that prevent us from realizing the full potential of three-part tariffs today.

Fourth wave / Growth in energy efficiency, distributed solar, and other demand-side resources has raised the specter of a longer-term trend of declining electricity sales for utilities. Traditional two-part retail tariffs that charge residential customers on a mostly volumetric basis will not sustainably provide the revenues needed for utilities to cover their fixed and capital costs. This has led to a growing interest in demand charges and adjustments to fixed portions of retail rates in order to better reflect the true investment costs of maintaining a reliable system and meeting peak demand.

Demand charges can better align prices and costs, encourage smarter load management, improve utility cost recovery, and reduce intra-class cross-subsidies. These charges are already well-established for commercial and industrial customers. A survey of existing residential demand charges in 2014 found nine utilities offering demand charges with a range of 1.5–18.1¢/kW-month. Our own research suggests that this figure has grown to at least 32 utilities offering demand charges today—sometimes with energy-based dynamic pricing rates—to mitigate cross-subsidies

caused by prosumers and by the slowdown in sales growth.

However, there is very limited empirical evidence on customer response to demand charges. Table 1 shows the results of three older pilots on residential demand charges. These pilots were carried out in Norway, North Carolina, and Wisconsin. Estimated average peak reductions in these pilots ranged from 5% to 29%, brought on by demand charges that ranged from $10.13 to $10.80 per kW.

In the fourth wave, implementation of time-varying rates in most of the United States has not kept pace with the installation of advanced metering infrastructure. The Federal Energy Regulatory Commission estimates that 41% of all customer meters were advanced meters, but only 5% were enrolled in any kind of time-varying rate program in 2014.

Barriers to deployment of smart rates are mostly driven by some remaining uncertainties in how customers will react to a new paradigm in retail tariff structure, and hence what degree of societal benefits can be expected. Significant concerns remain that customers will somehow be harmed or fail to integrate into the new paradigm. Some common barriers to mandatory time-varying rate implementation include:

- **Insufficient evidence of benefits:** Stakeholders may have a perception that pilot programs and other evidence to date are not indicative of benefits that could be realized through full-scale deployment. This could be due to insufficient testing or to lack of awareness of existing evidence. Unless evidence of benefits is compelling, regulators, utilities, and customers will fear that a broader group of customers will not respond to the new rates and that the rates will fail to promote economic efficiency or equity.
- **Customer dissatisfaction and backlash:** The move from flat rates to time-varying rates will more efficiently and fairly allocate costs among individual customers. Bills will rise for some customers who were previously cross-subsidized by other customers. It may take time for those customers experiencing bill increases to understand how to manage their electricity consumption relative to the new rate structure. Additional investment in customer education and outreach will be needed to help customers fully understand the new rates, how to choose among their rate options, and how to adjust their usage patterns to lower their bills.
- **Effects on sensitive or disadvantaged customers:** There may still be uncertainties on how the new rates will affect low-income customers, small users, and customers with physical or technological challenges that prevent them from either fully understanding or reacting to the new rates.

There is no one-size-fits-all solution to addressing these concerns. The best approach can vary greatly because of service territory–specific factors; it also greatly depends on the degree to which customer behavior has already been studied in an area, and which parties (regulator, utility, customers) are hesitant to change the status quo and why. Arizona, for example, already has extensive experience with time-of-use rates, and many utility customers are enrolled in these programs. In contrast, many other U.S. service areas have little or no experience with the actual E-TOU implementation, and these service areas would benefit from pilot programs or other types of testing for customer effects and responsiveness. The highly politicized nature of energy and energy costs to customers has a significant effect on how and when these concerns are raised, and to what degree the public is willing to address and overcome perceived barriers to tariff reform.

But before considering solutions to overcoming barriers to time-varying rates, it helps to take a step back and consider where we are trying to go. In the next section we offer one vision

Table 1

THREE PILOT PROGRAMS ON RESIDENTIAL DEMAND CHARGES

Location	Utility	Years	Number of participants	Monthly demand charge ($/kW)	Energy charge (¢/kWh)	Fixed charge ($/month)	Timing of demand measurement	Interval of demand measurement (minutes)	Peak period	Estimated average reduction in peak period consumption
Norway	Istad Nett AS	2006	443	10.28	3.4	12.1	Peak coincident	60	7 a.m.–4 p.m.	5%
North Carolina	Duke Power	1978–1983	178	10.80	6.4	35.49	Peak coincident	30	1 p.m.–7p.m.	17%
Wisconsin	Wisconsin Public Service	1977–1978	40	10.13	5.8	0	Peak coincident	15	8 a.m.–5p.m.	29%

NOTES: All prices are in 2014 dollars.In the Norwegian pilot, demand was determined in winter months (the utility was winter peaking) and then applied on a monthly basis throughout the year. The Norwegian demand rate has been offered since 2000 and roughly 5% of customers have chosen to enroll in the rate. In the Duke pilot, roughly 10% of those invited to participate in the pilot agreed to enroll in the demand rate. The Duke rate was not revenue neutral; it included an additional cost for demand metering. The Wisconsin demand charge was seasonal. The summer charge is presented here because the utility was summer peaking.

SOURCE: "Rediscovering Residential Demand Charges," by Ryan Hledik. *Electricity Journal* 27(7): 82–96 (August/September 2014).

that relies on technology and efficient tariff design to empower customers to control their bills, respond to electricity market and system conditions, and contribute to efficient electricity use in a nimble and dynamic fashion.

FIFTH WAVE: TRANSACTIVE ENERGY AND SMART HOMES

Understanding and enabling residential customer responsiveness under advanced tariffs will likely be an ongoing effort and challenge, even into the looming fifth wave. Once cost-reflective tariffs are in place, there will still be some technological barriers to full customer engagement. These include limited data *to the customer* from a complex wholesale marketplace, and limited tools for customers to respond to and participate in those markets. We expect the fifth wave of technology innovation to bring these data and tools to customers in the so-called future transactive energy market.

New technology is already beginning to reveal to customers the extent to which electricity cost can vary depending on usage patterns over time. Public policies and initiatives are opening the door for households to have more control over the source of their electricity—beyond retail choice—through distributed generation. Smart appliances, thermostats, and apps are giving residential customers more tools to control and customize usage patterns. Customers will still have the right to access reliable power supply, but these changes will continue to give households more power to optimize their individual electricity use, their cost of electricity, and their environmental footprint. Continued technology improvements and innovations will give rise to smart houses that better coordinate energy usage with customer preferences, and with electricity system and market conditions.

We also expect continued improvements in data exchanges from and to smart houses to give residential customers opportunities to capture value directly from wholesale electricity markets. This means that customers will not only react to wholesale market and system conditions, but they will actively participate in wholesale markets through agents or technologies that allow customers to communicate and coordinate directly with market administrators and system operators. Not all customers will have the appetite for engaging in power supply decisions to this degree, but the newer generations of customers who are used to social media, fast-paced and complex communications, and a suite of apps to manage their lives will not find this so strange. Some customers will provide distributed generation and load reduction services to the grid and compete directly with more traditional forms of electricity supply to help reduce electricity production costs, contribute to the reliability of the system, and possibly reduce longer-term capital investment costs.

In one vision of how this could evolve, customers would subscribe to a "baseline" load shape based on their typical usage patterns. They could buy or sell deviations from the baseline on the wholesale market through sophisticated energy management systems or agents. This was originally called "demand subscription," but the idea has morphed into "transactive energy." This vision has gained some traction with millennials through Wi-Fi thermostats, digital appliances, and first-generation home energy management systems. Regardless of the specific method, we believe that in the future the gaps among customers, retail markets, and wholesale markets will be significantly reduced.

But this future cannot be realized if customers do not have even the basic information on how their usage patterns relate to the real cost structure of electricity. Customers cannot react to the high production and investment costs of electricity during peak demand periods if they are shielded from observing these costs at the point of consumption. Customers who are charged the traditional and mostly flat volumetric rate for electricity will be immobilized in the transactive energy future. They will not have the incentives or information necessary to lower their bills in an efficient manner, participate in valuable demand-side services in wholesale markets, or actively contribute to more efficient electricity production and investments in the future.

TRANSITIONING TO ADVANCED TARIFFS

The challenge facing the utility industry is how to take the final steps in implementing mandatory (or, if that's politically impractical, default) three-part tariffs that more accurately reflect the cost structure of providing reliable electricity to individual residential customers. Some in the industry are prepared to take this step; others are not. Even though advanced tariffs are already widely used for medium and large commercial and industrial customers across the country, there is debate over whether they are well suited for residential customers. That is the case even though almost half of all customer meters have been replaced with advanced meters, which provide the necessary technology for offering advanced residential tariffs.

As already discussed, the industry has acquired significant knowledge about customer response to smart tariffs, including E-TOU tariffs and to some extent three-part rates featuring demand charges. Some questions and uncertainties remain about how customers will react with full-scale deployment, but the industry's studies and experiences to date have shown that advanced tariffs do yield real and quantifiable efficiency benefits to customers. Despite this evidence, progress has been stymied because of persistent fears about a customer backlash or a failure to realize expected benefits.

There are ways to overcome these fears, including:

- **Customer bill effect studies:** Utilities and regulators can conduct studies to understand how customer bills will change if the new rates are implemented and there is no change in customer behavior, i.e., the load profiles stay unchanged. These studies can help to identify how much bills will rise for small users. Then, utilities and regulators can find ways to mitigate these bill effects. Some of these are discussed below.

- **Customer behavior studies:** There are models available today for carrying out simulations to determine the likely customer response. These models draw from findings in prior pilot studies.
- **Customer outreach and education:** Utilities can engage in customer outreach programs to explain why tariffs are being changed and how the new tariffs will work. It will be important to ensure the new rates use clear and understandable language. Utilities can enlist neutral parties to endorse the change and they can use modern social media to spread the word. Tapping into the newer generations of technology-savvy customers will be crucial. Utilities can develop new and more efficient ways to communicate with their customers, help to develop apps and smart energy tools, and otherwise explore methods to enhance the customer experience with technology.

Here are some options for easing the transition:

- **Transition rates:** Utilities and regulators can design transition schemes that change the rates gradually over three to five years.
- **Bill protection:** Alternatively, bill protections can be provided to customers, with those protections being phased out gradually over time.
- **Add protections for sensitive customers:** For the first five years, rates could be optional for sensitive or disadvantaged customers, such as low-income customers, small users, and disabled customers. Or these customers could be provided financial assistance for a limited period of time.
- **Provide additional information and options to customers:** There may be ways to provide additional options for customer participation. For example, consider a subscription concept in which customers "buy" their historical usage at the historical price, and buy or sell deviations from that usage at the new tariffs. This option would also help to transition into the fifth wave of tariff reform involving transactive energy.
- **Empirical tests for customer response:** Utilities can conduct additional pilots to test customer acceptance and load response to the new rates. The pilots should follow some basic precepts the industry has developed in the years prior. They should be carried out as scientific experiments, expected to yield valid inferences about energy conservation and demand response. The pilots should be designed to yield price elasticity estimates that would allow the results to be extrapolated to other prices than the ones being tested in the pilot. Customer samples should be of sufficient size to yield valid inferences about the population. Ideally, pilots should be designed to yield granular information by customer segment. Also, they should test the effectiveness of different marketing, education, and communication technologies.

Household electricity historically has been mostly a uniform commodity for consumers, indistinguishable by source or time of use. For the most part, utilities could price electricity as if it were a uniform commodity without harming their bottom line. But in recent years a number of industry shocks and changes have made it clear that this pricing scheme is not always best for customers or utilities. The status quo is not sustainable going into the future.

The first four waves of tariff reform have gauged consumer response and enabled utilities to price electricity more efficiently as the diverse product it is. At the same time, customers are awakening to the diversity of electricity supply depending on location, time of day, and environmental attributes. Yet there is still much work to be done to implement three-part rates for residential customers more broadly and get the best use out of the smart grid investments that have been made across the country.

The next wave of tariff reform is soon to come. It will empower customers with better tools and more information, enabling them to contribute to efficiency improvements in power supply and giving them more control over the type and cost of power they consume. To address concerns over how customers might behave in this world, we can draw from significant experience in customer pilot programs. *R*

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IN REVIEW

How Governments Enforced Segregation

REVIEW BY DAVID R. HENDERSON

"We have created a caste system in this country, with African Americans kept exploited and geographically separate by racially explicit government policies." So writes Richard Rothstein in *The Color of Law: A Forgotten History of How Our Government Segregated America*. That's a strong statement. But Rothstein, a research associate of the Economic Policy Institute (EPI) and a fellow at the Thurgood Marshall Institute of the NAACP Legal Defense Fund, provides much support for his claim. He shows how racist Federal Housing Administration (FHA) policies on mortgages, exclusionary zoning laws, state real estate regulations, geographic placement of government schools, urban renewal, and even federal and state highway policies all combined to relegate black Americans to segregated communities. He also blames restrictive covenants in house titles, making an argument so effective that he brought me, a strong believer in property rights, closer to his viewpoint than I would have expected.

Most of the book is a careful historical look at the policies noted above. He could have made an even stronger case by looking at government regulation of labor markets. Disappointingly, Rothstein does not challenge, but instead embraces, the minimum wage, a law that disproportionately hurts black Americans and *was intended to do so*. He seems not to be aware of this.

Toward the book's end, he proposes a series of policies, ranging from extreme to moderate, to remedy the damage done by over half a century of destructive government policies. On the more extreme policies, such as large subsidies to black Americans, I find him unpersuasive. One of his more moderate policy proposals, on zoning, is attractive.

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Insuring "black" mortgages / One policy that Rothstein faults is the FHA's historical unwillingness to insure mortgages for black homebuyers and its opposition to racial mixing in neighborhoods.

In 1941, for example, a real estate agency representing a new development 20 miles west of Newark, NJ tried to sell 12 properties to middle-class black people. They had good credit ratings and banks were willing to lend to them if the FHA would approve. But the agency refused, declaring, "No loans will be given to colored developments."

Another example: In 1958, a white San Franciscan named Gerald Cohn bought a house in Berkeley and, not ready to move in, rented it to a black man named Alfred Simmons. The FHA then blacklisted Cohn, telling him that he would be "denied the benefits of participation in the FHA insurance program." The director of the agency's office in San Francisco wrote Cohn to tell him that any application for mortgage insurance that he made in the future "will be rejected on the basis of an Unsatisfactory Risk Determination." Naturally, the FHA had no way of knowing whether Cohn would be a bad risk in the future. Instead, the agency was, rather blatantly, communicating its displeasure with Cohn's renting to a black man.

These were not isolated cases. The FHA's 1935 underwriting manual for real estate agents states, "If a neighborhood is to retain stability it is necessary that properties shall continue to be occupied by the same social and racial classes." The manual also states that natural and artificially established barriers would protect a neighborhood from such "adverse influences" as "inharmonious racial groups." Although those last three words were excised from the 1947 edition of the manual, it still recommends valuations based on "compatibility among the neighborhood occupants."

Exclusionary zoning / Another segregating measure Rothstein documents is exclusionary zoning.

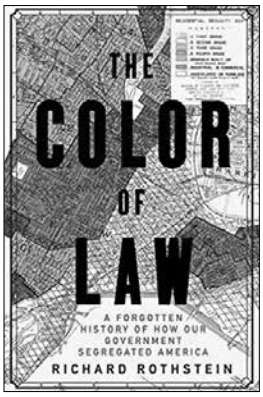
He notes that in its 1917 *Buchanan v. Warley* decision, the U.S. Supreme Court overturned an explicitly racial zoning ordinance in Louisville, KY. The Court "ruled that racial zoning ordinances interfered with the right of a property owner to sell to whomever he pleased." In response, those who wanted segregation employed a number of tactics. One was, believe it or not, to ignore the Supreme Court ruling, as the West Palm Beach, FL government did from 1929 to 1960.

A more common tactic was to use zoning to forbid all but single-family houses. Most black people could not afford them. In St. Louis, writes Rothstein, Harland Bartholomew, a full-time planning engineer, proposed rules "to prevent future multifamily, commercial, or industrial structures from impinging on single-family neighborhoods." So if single-family houses in a neighborhood "had deeds that prohibited African American occupancy," this "made it almost certain that the neighborhood would be zoned 'first-residential,' prohibiting construction of anything but single-family units and helping to preserve its all-white character."

Another measure by the St. Louis zoners was to permit polluting companies, nightclubs, liquor stores, and prostitution houses in black neighborhoods but not in white ones. Rothstein doesn't explain clearly why this would reinforce segregation. Presumably, what he has in mind is that allowing these other uses would reduce the value of houses, making them more attractive

to black people who, presumably, could afford less. One can certainly see his point with polluting companies and, most likely, prostitution houses. But with respect to liquor stores and nightclubs, it's not clear to me *which* group was unfairly harmed: blacks or whites. I live in a mainly white city that didn't allow liquor stores until the late 1960s and still doesn't allow nightclubs. That makes my life worse, not better.

Realtors and schools / One way that state governments enforced housing segregation was with regulations on the conduct of realtors. Real estate boards, writes Rothstein, "expelled brokers who sold to African Americans in stable white neighborhoods." Without the power that state governments had given to real estate boards, those brokers could not have been expelled. This happened not just early in the 20th century, but much later also. Rothstein tells of a case in Sarasota, FL in 1963 in which a real estate board expelled a member for selling to a black doctor in a white neighborhood.



The Color of Law: A Forgotten History of How Our Government Segregated America

By Richard Rothstein

345 pp.; Liveright Publishing, 2017

Local governments also segregated with their decisions on where to locate government-owned schools. Just after World War I, for example, local governments in Atlanta closed schools for whites "if they were in zones designated for future African American residence, and schools for African Americans were closed if they were in zones reserved for whites." This school location policy hurt whites as well as blacks. The Atlanta School Board, dealing with an overcrowded situation in a mixed-race area, built a new junior high school for whites in the far northern suburbs, prompting white families to move to that area and, therefore, causing more segregation.

Subsidizing whites / Local governments sometimes used government subsidies combined with eminent domain to displace people and then build housing for whites only.

One such major project in 1942 was the 9,000-unit Stuyvesant Town complex in east Manhattan. New York City's government "condemned and cleared eighteen square city blocks" and then transferred the property to Metropolitan Life Insurance Company, even though the company explicitly intended the housing for "white people only."

The apparent good news is that in 1950, New York's state legislature passed a law "prohibiting racial discrimination in any housing that received state aid in the form of a tax exemption, sale of land below cost, or land obtained through condemnation." So Met Life agreed to lease some apartments to black people. Here's the problem: During World War II, New York City's government had imposed rent control as what was then described as a temporary measure. But the policy ended up not being temporary. Rent controls keep rents below market levels, causing shortages and discouraging mobility. So there were few apartments available for black people.

Governments also used highway placement policies to run interstate highways through urban black communities. While it is not completely clear why this would cause more segregation, what is clear is that losing their homes to eminent domain would reduce black households' wealth and make it even more difficult for them to buy homes in middle-class areas. One haunting photo in the book is of poor black children in Miami looking on as the first wrecking balls destroyed a black neighborhood to make way for I-95.

Restrictive covenants / One way that developers assured home buyers that they would be able to live in neighborhoods without races or ethnic groups they wanted to avoid was the use of restrictive covenants. I had always thought that such covenants, although personally offensive, should be legally allowed. I think people should be able to decide, by voluntary contract, whom they live next to. Anyone who buys a property and signs the deed is agreeing to whatever conditions are in the deed.

But Rothstein, who opposes restrictive covenants, has moved me a little closer to his position. How? He points out that local governments often "aggressively promoted such covenants." In 1943, for example, the city attorney of Culver City, CA instructed air raid wardens that when they went door to door to make sure families turned off their lights in the evening, they "should also circulate documents in which homeowners promised not to sell or rent to African Americans." That was wrong for two reasons: the government was taking advantage of people while they were most fearful, and, more important, it was none of the government's business.

Minimum wage / My major disappointment with the book is that Rothstein could have made his case even stronger by discussing how minimum wage laws hamper the economic development of relatively unskilled black people.

Rothstein references a section of *An American Dilemma*, the 1944 classic on race in America by the late Swedish economist and Nobel laureate Gunnar Myrdal. In it, Myrdal tells how the U.S. Employment Service, a federal agency, refused to enroll black people for skilled work. But that agency was tiny and the harm it did does not come close to the harm the federal government has done with its minimum wage. The person who laid this out eloquently was none other than Myrdal, just 21 pages earlier in his book. He wrote:

> But it has been mainly [black workers'] willingness to accept low labor standards which has been their protection. When government steps in to regulate labor conditions and to enforce minimum standards, it takes away nearly all that is left of the old labor monopoly in the "Negro jobs."

It was well understood from the time of the federal minimum wage in 1938 until the late 1950s that one major goal of minimum wage proponents—many of whom were union officials representing white unions—was to wipe out competition from black people. For instance, in 1957 during a hearing on the federal minimum wage, here's what a U.S. senator from a New England state said in defense of the minimum wage:

> Of course, having on the market a rather large source of cheap labor depresses wages outside of that group, too—the wages of the white worker who has to compete. And when an employer can substitute a colored worker at a lower wage—and there are, as you pointed out, these hundreds of thousands looking for decent work—it affects the whole wage structure of an area, doesn't it?

That senator was John F. Kennedy, who understood one of the main purposes of the minimum wage. It's possible Rothstein is not aware of this history. As noted, he's a research associate of EPI, which strongly advocates for higher minimum wages. I've never seen EPI address the sordid history of support for the minimum wage.

What to do? / Rothstein's absence of a critical view of the minimum wage carries over to his proposals to remedy the large amount of segregation that remains in America. He advocates returning minimum wages to their historic level. He clearly means that the minimum wage should be raised substantially, not realizing the damage this would visit upon black youths trying to get into, and make their way up in, the labor market.

Rothstein also advocates other policies that he admits are extreme. One is to have the federal government buy up, at market values, "the next 15 percent of houses that come up for sale in Levittown" and then "resell the properties to qualified African Americans for $75,000, the price (in today's dollars) that their grandparents would have paid if permitted to do so." Put aside the unintended consequences, one of which would be huge discord in the black community when only a lucky few would get the properties; this proposal is unjust. To pay for these subsidies, Rothstein advocates taxing regular taxpayers, almost none of whom are responsible for these policies.

To the charge that his proposal is a form of social engineering, he replies that desegregation "would attempt to reverse a century of social engineering on the part of federal, state, and local governments that enacted policies to keep African Americans separate and subordinate." Good point. But that doesn't mean that his proposals are not social engineering.

His main rebuttal is that "too few whites were terribly concerned with that kind of social engineering, and it's a bit unseemly to make that objection now." Really? Because our grandfathers didn't object to one form of social engineering, we can't object to another? That's weak.

To his credit, Rothstein does propose one policy that I can totally support: "a ban on zoning ordinances that prohibit multifamily housing or that require all single-family homes in a neighborhood to be built on large lots with high minimum requirements for square footage." He understands that such supply restrictions drive up the price of housing, a situation that has reached crisis proportions for blacks and whites alike on both coasts.

What federal, state, and local governments did to segregate black Americans in the last century was horrible. It's important to help the descendants of those victims. But it's also important to not victimize other innocent people. *R*

The Sordid History of Veterans' Benefits

REVIEW BY GEORGE LEEF

America's first and arguably still greatest welfare pressure group was not the poor or the unemployed. Rather, it was military veterans, who figured out when the nation was still a fledgling how to extract wealth from the state. After all, what plea works on more people than, "We fought and bled for you, so now you owe us"?

In *Paid Patriotism*, George Mason University economics professor James Bennett takes a long, highly critical look at the history of veterans' benefits: cash payments, medical care, hiring preferences, and more. It's an overwhelmingly sordid tale, but one that the author tells with enthusiasm (and often laced with sarcasm).

Bennett doesn't dispute that soldiers who have been wounded in U.S. wars (of which he obviously thinks we have too many) deserve to be treated and, as far as possible, made whole by the government. But he insists that we should draw a distinction between those unfortunates and the great majority in our military, who have never even heard a shot fired in anger, much less sustained a battlefield injury. Today, any kind of military service qualifies one for a smorgasbord of lifetime benefits whose costs spill red ink the way Gettysburg spilled blood.

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Pensions on the United States / One of the first acts of our new Congress was a 1792 law declaring that "any person called out into the service of the United States who was wounded or disabled while in actual service ... shall be taken care of and provided for at the public expense." That was perfectly reasonable, but as Bennett notes, "that phrase *while in actual service* will be a barrier that once breached is damnably hard to restore." In that respect, the dike

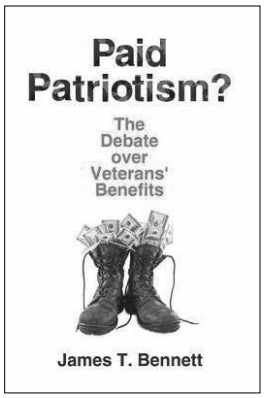
began to crack in 1805 when Congress amended the pension act so that benefits were extended to veterans who, later in life, became unable to earn a living, even though they had been hale and healthy at the time of their discharge.

Then in 1818 a great fissure opened when, Bennett writes, "a mixture of gratitude, patriotism and shrewd lobbying" led to enactment of the Revolutionary War Pensions Act. The romantic image of the suffering old soldier caused Congress to legislate that men claiming to have served in the war and attesting before a federal judge to their inability to provide for themselves qualified for a pension. The bill was pushed by President James Monroe, and his congressional allies said the costs would be minimal. Besides, the Treasury held a surplus and what better way to spend it than to assist the nation's heroes?

That piece of generosity did not turn out as expected. There was a flood of applications, many of them transparently fraudulent. Even after weeding out some of the latter, the cost of veterans' pensions went from 1.5% of the federal budget in 1818 to 16% by 1820.

Rather than learning a lesson from that experience, in 1832 Congress again extended benefits—full pay for life for Revolutionary War vets—leading to a new cascade of claims, many of them dubious. A daring opponent of this bill, Rep. Thomas Bouldin (Va.), stated that the expansion of military pensions led "a large portion of the people of the United States to look to the Treasury as the unfailing spring from which they were to receive every good. The poor, instead of being relieved in their own neighborhoods, were pensions on the United States." His words would prove to be extremely prescient.

Not only did the government's pension generosity drain the Treasury, but it also opened up sectional antagonism between the North and South. A large majority of the pensioners lived in the northern states, but the federal government's revenues came chiefly from tariffs, which were borne disproportionately by the South. Thus, the government's generosity toward the soldiers (and claimed soldiers) of the Revolution helped to fuel the country's next great war.



Paid Patriotism: The Debate Over Veterans' Benefits

By James T. Bennett

282 pp.; Transaction Publishers, 2017

Benefit of politicians (and others) / Whereas the government waited decades after the Revolutionary War to start paying military pensions (as well as for veterans of the War of 1812 and the Mexican War), the Civil War prompted almost immediate action: an 1862 law granting benefits to disabled Union soldiers (or their widows if killed). The cost of those payments rose steadily as the war progressed, but Pension Commissioner James Baker stated that they would peak in 1872, then begin to decline. What Baker failed to consider was that politics would keep ratcheting up the number of soldiers eligible and the generosity of the payments.

The crucial year was 1879, when the Arrears of Pensions Act was passed, in effect backdating pensions for thousands of Union army veterans. Its cost was estimated by its Republican proponents at around $20 million. Opponents, however, saw it as a far more expensive vote-buying scheme. The *Cincinnati Commercial*, for example, wrote, "This great pension fraud amounts to a scheme to confiscate and parcel out the money in the Treasury for the benefit of local politicians." That view proved correct, as claims (including a great many for widows, minors, and dependent relatives) poured into the Pension Office at an unprecedented rate.

Bennett quotes a contemporary observer, a minister, who noted the effect of the gusher of federal money on veterans: "Their organizations for mutual aid and fellowship were turned into political machines not for the promotion of public ends, but for the one purpose of political plunder for the personal profit of the members."

From that time until the present day, veterans groups lobbying for benefits would take center stage. In the 1880s, the heavyweight was the Grand Army of the Republic (GAR), which allied itself with the Republicans and would work ceaselessly to increase payments to veterans and their family members. In 1870, only 5% of Union veterans were receiving a pension, but thanks mainly to the GAR, that figure was 93% by 1910. Crucially, the need for a war injury to be eligible to collect was eliminated. "In its pursuit of loot," Bennett writes, "the GAR played the patriotism card often and without shame."

One result of the GAR/Republican alliance was pressure to keep tariffs high. Tariffs were still the main source of federal revenue and the GAR wanted vast amounts of money to flow into the Treasury to pay the ranks of Union pensioners. The nation's protectionism was therefore not just a matter of bad economic theory; it was also driven by the GAR's success in pushing the idea that America was eternally and infinitely indebted to the "boys in blue." Spending finally peaked at over 41% of federal outlays in 1893.

Beyond pensions / World War I yielded its share of military preferences and pension follies. One innovation was in giving veterans a huge boost on civil service exams. Vets had to be hired even if their scores were substantially below those of non-vets. As a result, by 1923 34% of all new civil service employees were veterans. Also, the government made the fateful decision to establish Veterans Administration hospitals across the nation. Their construction was rife with corruption and the problems with long waits and bad care remain to this day.

At the end of the war, Congress, feeling the inevitable pressure to help the millions of soldiers and sailors being mustered out, enacted a "bonus" for them. It wouldn't be payable, however, until 1944. When the Depression hit, demands for immediate payment of the bonus became insistent. In the summer of 1932, thousands of "Bonus

Army" marchers descended on Washington, DC to press their case. Just as the soldiers were starting to drift away in political defeat, the government overreacted, first with local police and then, after bloodshed, federal troops under Gen. Douglas MacArthur. Newsreel footage of troops rousting impoverished vets out of their pitiable encampments caused an uproar. Knowing that President Herbert Hoover would take the blame, his opponent in that year's campaign, Franklin D. Roosevelt, gleefully exclaimed to an aide, "This elects me."

World War II, of course, brought a fresh round of demands for benefits for the men and women in uniform. Beginning in 1943, the two big veterans' organizations, the Veterans of Foreign Wars and the American Legion, vied to push a new bill through Congress. The VFW wanted the traditional sort of postwar cash payment, but the Legion won this contest of political entrepreneurs by proposing a set of new, immediate benefits in what came to be called the G.I. Bill of Rights, a name that Bennett calls "a stroke of public relations genius." Who would dare oppose it? (Oddly enough, FDR was not enthusiastic, preferring to treat vets not as a special class but merely as recipients of the state's general welfare system.)

Under the bill, the government would help veterans by giving them up to 52 weeks of unemployment benefits, making them eligible for home, farm, and business loans through the Veterans Administration, and providing subsidies for vocational training or college.

The educational aspect of the bill has been hyped enormously, Bennett writes, with "nostalgia-crusted encomia." Supposedly, the G.I. Bill deserves credit for boosting the U.S. post-war economy because it opened up opportunities for talented people who would otherwise have remained undereducated. Bennett's attack on this sacred cow, alone, is worth the price of the book. Of the minority of vets who made use of the educational subsidies, the majority did so for vocational training, which had been around before the war, but not with free government money. Many vets, he writes "received training allowances to teach them to do things they'd been doing ably since they were ten years old." Moreover, there was a huge amount of fraud in these training programs.

As for those vets who used their benefits for four-year colleges and universities, most would have attended anyway, continuing a trend toward increasing higher education attendance that had been in progress since the 1920s. The great effect of the G.I. Bill, Bennett argues, was not that it made the American workforce more skilled and capable, but that it enriched colleges as never before. Administrators quickly realized that they could raise tuition, and did so. All that the G.I. Bill actually accomplished was to start the unwholesome trend of Americans needing to acquire a college degree for work that had previously been done mainly through on-the-job training. The economy didn't get a boost—just the higher education sector.

Since the initial G.I. Bill, we have had many amendments that always ratchet up the level of "generosity" toward the men and women who enter the military. Now the prospect of heavily subsidized college, a lifetime of low-cost medical care, hiring preferences, and other benefits are the major recruiting tool for the armed forces. The costs are prodigious and rising, but there is no reason to believe they will decline because, Bennett notes, "no one ever lost a congressional race by being too solicitous of veterans' demands."

And that's why the book doesn't close with an upbeat solution to this gigantic problem. There isn't one. R

Public Interest or Powerful Interests?

REVIEW BY BRUCE YANDLE

Do you ever wonder why the Federal Communications Commission persists in making political allocations of radio and TV broadcast licenses instead of auctioning off those rights? And why the FCC has the power to regulate broadcast content? If you think you have those explanations, then why during the Carter administration did the FCC move to award cellular licenses by auction? Or why did the 1996 Telecommunications Act usher in a requirement that V-chips be implanted in all post-2000 TV sets so that parents could limit or control their children's viewing of "violent" programs? And why did Ted Turner seem so delighted by this, yet the V-chip solution never seemed to work? And what about satellite broadcaster SiriusXM; why is it required to broadcast nationwide and not allowed to offer regional or local services?

Are you curious about how and why Lady Bird Johnson gained the rights to radio and television broadcasts in Austin, TX and what was the quid pro quo? What about "wireless" data, the communications system that many early experts thought would at best become a valuable niche market, but instead has formed a new bedrock for millennial culture and global communication? Would you like to know how and why the FCC opened the regulatory barn gate for wireless, so to speak, and let the horses run? What happened to the regulators' previous heavy hand? Is it gone or was this just a temporary lapse of regulatory judgment?

Here, I offer a sample of teasers for the material presented in this delightfully written and heavily documented history and analysis of U.S. telecommunications policy,

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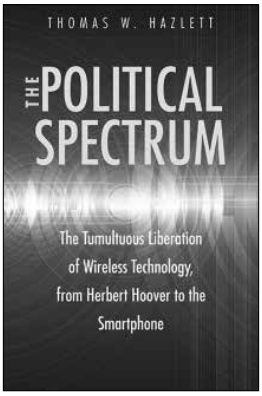
written by Clemson economist Thomas Hazlett. (Full disclosure: I formerly was dean of Clemson's School of Business and Behavior Sciences and I hold an emeritus title at the school.) *The Political Spectrum*, which reflects Hazlett's career-long study of and participation in communications policymaking, is packed with fascinating stories buttressed with more than just casual references to industrial organization and public choice economics. He brightens his story with discussions of common law contracting, property rights, and potential market solutions that could be used to allocate communications access. Interestingly, the rent-seekers' preference for command-and-control regulation that emerged for spectrum management parallels almost exactly what emerged with environmental regulation. Cartel-forming technical standards quickly replaced common law–accommodated market forces based on property rights.

The electronic spectrum has not, in and of itself, physically constrained the growth of telecommunications, though that is the justification for its regulation.

Property rights and public interest / The story Hazlett tells begins with late 19th century communications technology breakthroughs and ends with the 21st century wireless revolution. Throughout, there is one common theme: The electronic spectrum through which communications are transmitted has not, in and of itself, physically constrained growth and expansion of telecommunications, although that is a popular justification for federal regulation. As Hazlett explains, it is politics not physics that limits human communications capabilities.

Nonetheless, no less than the U.S. Supreme Court chose to assert the opposite. Hazlett writes:

> The idea that radio services did not conform to legal or economic norms was formalized in law under Justice Felix Frankfurter's key 1943 Supreme Court opinion in *NBC v. United States*. The case resolved a legal challenge to the FCC's Chain Broadcasting Rules brought by the largest such network, the National Broadcasting Company (NBC). Regulators had imposed various limits on the agreements made between radio stations and networks that sold them programs. NBC argued that this exceeded the authority of the Commission, which was to police airwave interference while leaving broadcasters free to create (or buy) their content.... NBC lost.... Observing "certain basic facts" about radio stations, the Court wrote that "the radio spectrum is simply not large enough to accommodate everybody who would like to transmit."



The Political Spectrum: The Tumultuous Liberation of Wireless Technology, from Herbert Hoover to the Smartphone

By Thomas W. Hazlett

329 pp.; Yale University Press, 2017

As Hazlett explains, the Court confused excess demand that results when markets are not allowed to function (as when rights are not auctioned) with technical relationships. He argues that the problem contemplated by the Court would have been resolved if markets had been allowed to allocate broadcast rights.

Earlier in the book, after giving a brief synopsis of radio and television regulation, he describes the regulatory process this way:

> Here lurks a template for the creation of communications policy. Government identifies a problem and takes measures to address it. The [asserted] market failure is misdiagnosed, and the regulatory "fix" reflects political bargains with powerful industry incumbents. Barriers to entry are created. The "public interest" is asserted. When the purported solutions is finally abandoned, more robust market forces assert themselves. Government proudly claims that its policy is a success. The cycle repeats.

As one who always enjoys a good "Bootleggers-and-Baptists" story of regulation (in part because I coined that term in the pages of *Regulation* in 1983), I appreciate the notion that regulators would find ways to feather special interest nests while at the same time claiming to serve the public interest. I note that Hazlett likes this sort of analysis, too: Chapter 9 is titled, "Baptists, Bootleggers, and the LPFM [Low-Power Frequency Modulated]."

The book is organized chronologically, moving from early to the most recent major regulatory episodes. Yet for those who cannot enjoy the luxury of embarking on a sustained read, the book offers an advantage: each chapter can stand on its own. To top it off, Hazlett is a talented storyteller, a trait each chapter demonstrates.

While there are several strong contenders for the book's best chapter, I found myself rereading, "Spectrum Policy as If the Future Mattered." It is here that the reader receives a summary of key thoughts, an explanation of how markets and property rights may continue to improve spectrum allocation, and how the economic way of thinking can offer valuable guidance along the way.

Who might gain from reading Hazlett's book? Obviously, those engaged in the world of policy formation and analysis will value its contents, as will teachers and students of politics and government regulation. But then, there are countless individuals who enjoy reading a good account of how the world works. They should welcome this book, too. Highly accessible, delightfully written, and strongly organized, it should be read and discussed widely. *R*

IN REVIEW

Reining in the Deep State

REVIEW BY THOMAS A. HEMPHILL

Philip Hamburger, the Maurice and Hilda Friedman Professor of Law at Columbia University Law School, has written a pamphlet for general consumption that distills the essence of his Hayek Prize–winning scholarly book, *Is Administrative Law Unlawful?* (Manhattan Institute, 2014). In the tradition of American pamphleteer Thomas Paine, Hamburger believes that he needs to inspire everyday Americans to declare independence from what he considers "the civil liberties issue of our time." He argues that, just like the American colonists who revolted against the tyranny of the British Crown, 21st century Americans must overthrow the administrative excesses of the "deep state"—the rule of government bureaucrats—and the subsequent restrictions of their constitutional rights to liberty and due process.

Constitutional problems / When it comes to the threat from the administrative state, Hamburger is unmoved by the "economic critique" of administrative power, which is the argument that such control of the economy is undesirable because it is inefficient. It's more than that, he writes:

> The economic critique does not address the breadth of this danger. Indeed, it tends to protest merely the degree of administrative regulation, and it thereby usually accepts the legitimacy of administrative power—as long as it is not too heavy-handed on business.

Given this observation, he is not surprised that "economic criticism has not stopped the growth of administrative power."

To explain the "administrative threat," he turns to the legal critique:

> The legal critique more fully addresses the problem than does the economic protest, for although much administrative power is economically inefficient, all of it is unconstitutional. And this legal objection is central, because it confronts administrative power on its own terms—on its pretension to bind Americans in the matter of law.

Hamburger argues that administrative power is not built on the use of coercion, but on legal obligation. Moreover, the U.S. Constitution is clear on where authority lies in the three branches, with such power to make laws located in the Congress and judicial power in the federal courts. Administrative power evades many of the Constitution's legislative and judicial processes, and hence procedural rights of Americans.

For the reader to better understand this danger, he discusses the English absolutism of the 17th century, specifically that of King James I. His "administrative power," exercised through bureaucratic "prerogative" tribunals and commissions (that era's versions of administrative agencies), most famously including the Star Chamber and the High Commission. The former was partially founded on statute and the latter was entirely founded on statute, both exercising absolute power "in ways that have come back to life in America." This absolute or "extralegal" power, says Hamburger, "can be understood as an evasion of law," while this administrative power "has flowed around the Constitution's pathways of power and even around formal administrative pathways, thus creating a cascade of evasions."

He deftly provides examples of modern American "soft absolute power" by citing various actions of the Obama administration. For instance, the Affordable Care Act (ACA) has agencies issuing binding rules, i.e., "exercising legislative power," on the nation's health care system. Such rules are justified by what Hamburger refers to as the fiction of the "intelligible principle" whereby agencies are "merely specifying what Congress has enacted."

He also cites the Clean Power Plan, an Environmental Protection Agency rule designed to reduce greenhouse gas emissions by establishing emissions standards for existing power plants. Hamburger contends that the EPA, through its issuance of the Clean Power Plan, has simply interpreted an ambiguous section of the Clean Air Act.

Another example of this soft power: federal agencies have the legal authority to interpret statutes, and even their own rules, in the form of "guidance"—again, making law. They also can suspend laws using letter waivers, such as the "mini-med" waivers issued under the ACA. These agency waivers to affected parties were not authorized under the ACA, but unilaterally excused the affected parties from complying with some statute or regulation, thus placing the parties above the law.

Hamburger takes the reader on a concise intellectual journey through how the U.S. Constitution bars administrative (extralegal and absolute) power (Articles I and III), delegation, and waivers, and also discusses the Necessary and Proper Clause and federalism. He also addresses the U.S. Constitution's guarantees of procedural rights, including due process, the reduction of constitutional guarantees to mere options, and substantive rights, arguing that administrative power "ignores all of this."

He further addresses procedural deprivations in the courts when judges hear appeals from administrative adjudications, including judicial bias in deference to agency interpretation, deference to agency fact-finding (and the concomitant loss of jury rights and judicial bias), and judicial bias even after holding agency acts unlawful. All of this results in what he refers to as "the double violation of such

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rights, both administrative and judicial." Lastly, he touches upon the jurisdictional boundaries, noting that the "preeminent qualification concerns the states," but other, lesser qualifications include local governments, the nation's borders, and military law, all confined "to edicts that bind or unbind."

Hamburger argues:

> These jurisdictional qualifications are not merely exceptions but valuable boundaries to the Constitution's principles. By leaving room for administrative power in the states, localities, at the borders, and so forth, these limits allow Americans to establish strong principles against extralegal power in the U.S. Constitution.

He further argues that the most effective way to understand how administrative power threatens civil liberties is by evaluating it through the prism of equal voting rights. He suggests that there is a strong corollary between the expansion of voting rights for African-Americans and women, and the "shift of legislative power out of Congress and into administrative agencies." Progressives, such as Woodrow Wilson, were concerned that such newly enfranchised groups would reject their "reforms," thus the Progressives embraced administrative governance. Administrative governance would transfer legislative power from an elected body representing the "enfranchised masses" (including accountability to local, regional, religious, and other distinctive communities) to a "knowledge class," resulting in a "further step away from the people and into the hands of a relatively homogenized class."

The Administrative Threat

By Philip Hamburger

64 pp.: Encounter Books, 2017

Reclaiming constitutional authority / Is it practicable to abandon administrative power? Addressing the issue of complexity (a justification for the executive branch issuing administrative rules), Hamburger concludes that Congress has the ability to write statutes that are as "complex" as any agency rule. Echoing legal scholar Richard Epstein, he also questions whether a complex society truly needs complex rules. As to the question of how the courts would handle the vast amount of adjudication that is currently handled by agencies, he argues that the overwhelming volume of such adjudication is "merely the ordinary and lawful exercise of executive power."

Concerning the value of impartial administrative expertise, he is not convinced that the "knowledge class" in these agencies has greater expertise than the industries they are entrusted to regulate. Most importantly, "although experts can be valuable for their specialized knowledge, they usually cannot be relied upon for decisions that take a balanced view of the consequences."

What is to be done about "administrative power [that] crushes the life and livelihood out of entire classes of Americans?" Hamburger's policy recommendations include, first, that Congress should reclaim its administrative power and bar judicial deference to agencies on questions of law, abolish administrative law judges and replace them with real judges, and remove immunity from agency administrators. Second, he would require that the executive branch agencies send their rules to Congress for their adoption. Third, Americans must persuade judges to do their duty, uphold the law, and especially the Constitution.

His policy recommendations are spot-on as a "wish list" that ostensibly is part of the current Republican agenda. Yet I am not convinced that the Republican-controlled Congress is on board with "fully reclaiming" such administrative power. Consider, for example, the Regulations from the Executive in Need of Scrutiny (REINS) legislation, which would require Congress to approve every new major regulation (meaning a regulation with compliance costs of $100 million or more) before the rule can take effect. REINS passed the House in January but it is still awaiting Senate approval. Congress has gradually ceded many of its "legislative" responsibilities to the executive branch, and many lawmakers seem happy to avoid that difficult work.

A positive indicator, however, is the current Congress and the Trump administration have successfully employed the 20-year-old Congressional Review Act to withdraw 14 rules adopted in the final months of the Obama administration. Moreover, in the first six months of the Trump administration, the White House's Office of Information and Regulatory Affairs has approved significantly fewer major rules and dramatically fewer minor rules than the previous three administrations during their respective first six months in office. (See "Deregulation through No Regulation?" p. 4.) So elected officials are making some progress in overseeing the regulatory state.

Concerning the judiciary, the most effective way to "persuade" judges to uphold the Constitution is to appoint judges who already reflect this judicial philosophy in their opinions. As Hamburger adroitly explains, the federal judiciary clearly shows deference (bias) to agency interpretations and fact-finding—even after holding agency acts unlawful! This is where the Trump administration and the Senate can play a critical role in gradually changing the federal judiciary's philosophy on the limits of administrative power.

A remarkably easy read for the nonlawyer, Hamburger's book makes a convincing case that American constitutional liberty and procedural justice have been in slow, troubling decline as a direct result of the expansion of the deep state's regulatory power. *The Administrative Threat* is a clarion call for Americans to recognize the ever-increasing power of the federal administrative leviathan—and do something about it. *R*

IN REVIEW

Hard Cases and Economics

REVIEW BY PHIL R. MURRAY

Law is fertile ground for economic thinking. Harold Winter, the author of *Issues in Law & Economics* and an economics professor at Ohio University, explains that the main goal of his new textbook "is to provide my students with a thorough economic analysis of the issue, with emphasis on what current researchers have to say about the theoretical, empirical, and policy aspects of it."

Although the intended readers are students, the book is challenging. The issues relate to "the big four" areas of law and economics: "property, contracts, torts, and crime." There is also a bonus chapter on behavioral economics and the law.

Poletown and property rights / To begin, Winter shares his methodology:

1. Identify the theoretical tradeoffs of the issue in question.
2. If possible, empirically measure the tradeoffs found in step 1.
3. Advise social policy based on steps 1 and 2.

He introduces issues with a question and an actual court case. Take this question on property law: "Should eminent domain power be available to private companies?" To answer it, he cites the 1981 case *Poletown Neighborhood Council v. City of Detroit,* in which the Supreme Court of Michigan ruled the city could take residents' property and give it to General Motors for industrial development. (See "Before *Kelo*" Winter 2005–2006.) "The power of eminent domain is to be used in this instance," Winter quotes from the majority opinion, "primarily to accomplish the essential public purposes of alleviating unemployment and revitalizing the economic base of the community." Given the influence of General Motors, the author of a minority opinion observed, "One is left to wonder who the sovereign is."

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Various reasons support the use of eminent domain. The first is that transactions costs may preclude a wealth-enhancing transfer of property from private citizens to government officials. "When this occurs," writes Winter, "a nonmarket solution, such as eminent domain, may be necessary to facilitate the transfer." He expresses caution: "Eminent domain power is not magically invoked—its use requires potentially substantial administrative costs." Imagine, for example, the costs that would occur if private citizens resist eminent domain proceedings.

Government might also wield eminent domain in order to acquire property at lower cost. This justification is objectionable because if a court sets just compensation below what property owners are willing to accept, that's a good deal for government officials (and taxpayers) but a bad deal for property owners. The author does not expect a private corporation to refrain from goading government officials into using eminent domain on its behalf in order to acquire property at lower cost. If a government abuses its power of eminent domain on behalf of a private corporation, "this may very well lead to moving a resource to a lower-valued use." That's wealth destruction and bad policy.

Breaching contracts / To introduce contract law, Winter asks, "Should the courts encourage contractual breach?" To answer it he cites the 1911 case *Acme Mills and Elevator Co. v. J.C. Johnson*. Acme Mills agreed to buy wheat from Johnson for $1.03 per bushel, and also provided him bags for transporting the crop. After receiving the bags, Johnson breached and sold the wheat to another buyer for $1.16 per bushel. Acme took Johnson to court, seeking compensation.

The court declared, "The measure of damages is the difference between the contract price and the market price." Given that the market price was no more than $1 per bushel, there were no damages, aside from the $80 the court ordered Johnson to reimburse Acme for the bags.

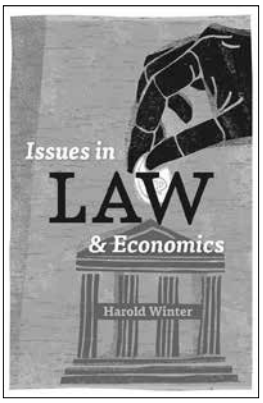
Why, if the market price was no more than $1 per bushel, was Acme paying $1.03 and supplying bags? Why did the other buyer pay $1.16? Winter doesn't address those questions; instead, he posits a "simple example" to think about damage remedies. He supposes that you want to buy a collector's edition of a book, and you are willing to pay $500 for it. You put $50 down and plan to return with the balance. Between now and then, you pay $75 for a bookstand to display the book. But when you return to the bookstore, "the seller informs you he no longer has the book" and repays your $50.

Given that the seller breached, does he owe you anything? Winter considers three remedies:

> *Expectations remedy*—compensates the breached-against party so that he is in the same position that he would have been in had the contract been performed.
>
> *Reliance remedy*—compensates the breached-against party so that he is in the same position that he would have been in had he never entered into the contract in the first place.
>
> *Restitution remedy*—returns to the breached-against party any benefits he conferred on the breaching party.

In order to calculate damages according to the *expectations* remedy, Winter assumes that you value the book and the stand at $800. By buying the book and stand, you would have increased your wealth by $225 on net. The author states, "The expectations remedy sets a monetary damages amount of $300," which would cover the

cost of the stand and the $225 increase in wealth that you didn't achieve. If a court uses the *reliance* remedy, damages would be just $75, covering the cost of the stand (ignoring the $50 the book seller already returned). According to the *restitution* remedy, there would be no damages because the seller returned the $50 deposit. Winter adds that in the *Acme Mills* case, the court used the restitution remedy.



Issues in Law & Economics

By Harold Winter

233 pp.; University of Chicago Press, 2017

Initially, one senses that breaching is wrong and the law should curb breaching by penalizing those who do so. But it's straightforward to conceive of situations in which breach is acceptable. Is there any way the seller of the book you wanted could sell it to the second buyer with your approval? Yes. Had you bought the book, your net gain would have been $225. Plus, you'd want $75 for the stand. So if the seller gives you more than $300, you'd allow him to sell to the second buyer. Breaching in this situation is both efficient and moral because the seller procured your consent.

A "fully specified contract" eliminates breaching. By anticipating "every possible contingency that can occur" and negotiating a mutually advantageous solution, a fully specified contract cannot be breached. Returning to the scenario with the book, you and the seller could agree to an amount you'd require in the event that a second buyer comes along and is willing to pay a higher price. But it is highly doubtful that the parties to a contract would foresee all circumstances and negotiate solutions to them, which is why, according to Winter, fully specified contracts "rarely exist in the real world." Contract specification provides benefits and costs; the marginal benefits of additional specification might be less than the marginal costs.

Torts / Much of the book reviews empirical studies. Consider this question from tort law: "Do doctors perform more C-sections when faced with increased medical malpractice liability pressure?" Winter cites six studies in order to answer that question. Four answer in the affirmative. One concludes the opposite: doctors faced with less risk of liability delivered more babies by C-section. The sixth shows that liability risk does not influence the decision to perform C-sections.

One reason these studies produce different results is that they measure medical malpractice risk in different ways: insurance premiums versus the presence of various tort reforms. Although contradictory empirical results can be frustrating, we should expect them. "It is not uncommon to find a substantial body of evidence that supports a particular hypothesis," Winter warns us, "only to discover an alternative substantial body of evidence that refutes the same hypothesis." The author appears to welcome divergent empirical findings for what we can learn from them.

Crimes and punishment / Turning to the last of the big four areas, criminal law, economists assume that potential criminals compare the expected benefits to the expected costs of a prospective crime and then decide whether to commit it. Winter articulates the economist's perspective:

> The idea behind rational crime analysis is not that the criminals sit with pen and paper and explicitly calculate the costs and benefits of their actions. There may even be a large number of criminals who barely pay any attention to the future ramifications of their current behavior. All that is needed to motivate rational crime analysis is that some criminals respond to changes in crime enforcement strategies.

Therefore, raising the cost of committing a crime should induce potential criminals to commit fewer crimes. This is the "deterrent effect." Researchers who investigate the deterrent effect encounter the stumbling block of "*reverse causation*." When a police force expands, the probability of arrest increases and crime declines. That is a deterrent effect. But a researcher might observe positive correlation between the number of police officers and crime because rampant crime causes the authorities to increase the ranks of a police force. Isolating the two effects requires a crafty researcher.

An early research strategy used to investigate this issue made use of the fact that politicians often expand police departments before elections. If crime subsequently decreases, that shows a deterrent effect. Although this technique uncovered a deterrent effect, Winter calls it "small" and considers it possibly dubious according to another study.

A subsequent research strategy observed changes surrounding an "extreme event." In the wake of a terrorist strike in Buenos Aires, government officials increased the police presence. The research shows that "car thefts fell by nearly 75 percent, a substantial impact." These researchers admit the possibility of a "displacement effect," whereby greater police protection around terrorist targets causes crime to increase elsewhere. A second study detected a weak displacement effect. Most of the studies Winter summarizes confirm that a greater police presence causes crime to decrease.

Property rights / Winter does not discuss the infamous 2004 case of *Kelo v. City of New London* in the chapter on eminent domain, but he does discuss it in the chapter on behavioral economics and the law. Both *Kelo* and *Poletown* involved a government seizing private property and conveying it to another private party. The difference is that *Kelo* provoked more public "outrage" than *Poletown*.

Winter summarizes a study that explains why eminent domain draws the public's ire. One source of resentment is

that government offers of "just compensation," as required by law, are usually below the lowest price that property owners are willing to accept because the latter amount reflects sentimental value. A second source of resentment relates to the reason why the government is taking property, to whom it is giving the property, and the type of property it is. For example, taking idle land to remove a dangerous curve on a highway might be popular, but taking an elderly couple's residence and giving it to a large, profit-seeking corporation would be unpopular. (Note that the latter example is similar to *Kelo* and *Poletown*, and does not explain why *Kelo* caused more anger than *Poletown*.)

The authors of Winter's cited study designed experiments to understand people's resistance to eminent domain. According to Winter, they found that the number of years someone has owned a property has more to do with the owner's propensity to sell than whatever the buyer intends to do with it. "Once it becomes known that the government will step in to aid the private developer through the use of eminent domain power," they also found, "subjects typically vehemently oppose the taking (but this effect is not found to affect willingness-to-sell values)." This surprised me because I expected property owners who "vehemently oppose the taking" to be less inclined to sell. Another problem is that it is unclear whether the "subjects" in these experiments actually owned property; if not, the decisions they made had nothing at stake. Actual property owners might make decisions differently.

Conclusion/ Faced with a tradeoff between covering more of the author's analyses in brief and fewer in depth, I chose the latter when writing this review. Cases related to the Coase theorem and empirical studies of racial discrimination in criminal law are among the other issues readers will encounter.

Readers of *Issues in Law and Economics* will learn that hard cases illuminate economics, and that Winter's analysis is good economics. R

IN REVIEW

Buchanan the Evil Genius

REVIEW BY ART CARDEN AND PHIL MAGNESS

Duke University professor Nancy MacLean's *Democracy in Chains* is a curious book. While it is published by a trade press, it is the work of a distinguished historian. Its provocative thesis is that the late economist (and Cato distinguished senior fellow) James McGill Buchanan was an "evil genius" who drew up blueprints for a new oligarchy. The book has received enthusiastic attention from National Public Radio and other media outlets, and it was listed as one of Oprah Winfrey's "must reads."

MacLean explains that her thesis is the product of her unique archival work with Buchanan's papers, and she spins from them an exciting (by the standards of intellectual history) and breathless tale of a hard-hearted son of the South aligning with segregationists and working to maintain white supremacy in response to the1954 *Brown v. Board of Education* decision. Buchanan's work eventually caught the attention of Charles Koch, and Buchanan became the intellectual architect of "the radical right's stealth plan for America." His legacy is a path of Koch-funded destruction extending from Pinochet's Chile to the North Carolina legislature.

Problem is, it's not true.

In a long review essay that will appear in the *Independent Review*, MacLean's Duke University colleague Michael Munger calls the book a work of "speculative fiction," and we agree. The author's credentials and the book's positive coverage might lead the unsuspecting reader to conclude that the story is true in substance if not in every minor detail. That reader would be badly misled.

The book is filled with errors and misinterpretations that would have been easy for MacLean to avoid. Duke's political science department is home to the current (Georg Vanberg) and two former presidents of the Public Choice Society, a group of academics devoted to the theory of government and political action that Buchanan pioneered. One of those past presidents is Geoffrey Brennan, who was Buchanan's coauthor on some of his most influential work, like *The Power to Tax* and *The Reason of Rules*. The other past president is Munger himself, and he reports that MacLean did not contact any of the three. Duke is also home to the Center for the History of Political Economy, and its director is Bruce Caldwell, an authority on F.A. Hayek, who influenced Buchanan and helped found the Mont Pelerin Society. MacLean made no attempt to contact Caldwell. There is no evidence in *Democracy in Chains* to suggest that she attempted to contact any of the small army of Buchanan students and coauthors who are still active. Given David Levy and Sandra Peart's recent book *Escape from Democracy* (see "The Discontented Animal," Summer 2017)—as well as their own work with the Buchanan papers—and Richard Wagner's new study of Buchanan, this is a surprising oversight by someone ostensibly committed to understanding Buchanan's ideas.

MacLean's substance and style suggest that she isn't *actually* interested in understanding those ideas. Her own sources seldom if ever support her harshest allegations about Buchanan and his fellow travelers.

She makes no mention of his support for high estate taxes, for example. This put him squarely at odds with most classical liberals; it is hardly the position a flunky of the plutocracy would take, and it's also hardly a position that plutocrats would sup-

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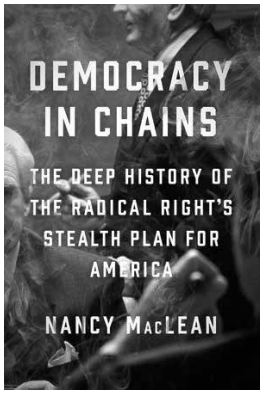
port if they want to maintain dynasties. The tax idea isn't central to Buchanan's written work—it was a policy idea he floated from time to time in discussion—but it's at odds with MacLean's thesis and the sort of thing that would have come up in conversation if she had walked across campus to visit her colleagues or just sent them an email. This omission contradicts her portrayal of Buchanan as an agent of the ruling elite and should, we think, make us more skeptical of how she handles her evidence.

Calhoun conspirator? / MacLean's unfamiliarity with Buchanan's work extends into her depiction of his philosophical roots. Specifically, she devotes substantial energies to portraying him as an intellectual heir to John C. Calhoun and, more directly, the Southern Agrarians. Calhoun was infamously the leading pro-slavery theorist of the 19th century and the Agrarians—a group of scholars who led a southern literary revival in the 1930s—counted numerous segregationists in their ranks. Both examples are highly convenient to MacLean's efforts to paint Buchanan's reputation with the broad brushes of racism and segregation. It is helpful to recount her telling of each case to see how she connects them to Buchanan.



Democracy in Chains: The Deep History of the Radical Right's Stealth Plan for America

By Nancy MacLean

368 pp.; Viking, 2017

Early in the book, she depicts Calhoun as the "intellectual lodestar" (p. xxxii) of public choice, and she does so by citing his somewhat similar interest in the function of constitutional voting rules as a constraint upon majoritarian impulses. This observation is neither a smoking gun nor original to MacLean. A simpler, non-devious explanation is that both Calhoun and Buchanan, though writing in different eras and using dramatically different analytical tools, were both expanding upon a common source: James Madison's theory of constitutional federalism—a theory that, it's worth noting, is especially timely amidst today's surge of populism and nationalism.

MacLean opts for a conspiratorial interpretation, though, in which Calhoun assumes the role of an unspoken ur-text to *The Calculus of Consent.* Her portrayal immediately encounters a substantial evidentiary obstacle: Buchanan does not appear to have ever cited, referenced, or commented upon Calhoun in his academic career of over half a century. He does, however, make frequent references to Madison.

Undeterred, MacLean enlists a six-degrees-of-separation game to shoehorn Calhoun into Buchanan's system of thought. She offers an incomplete reading of Tyler Cowen and Alex Tabarrok's 1992 paper, "The Public Choice Theory of John C. Calhoun," which notes Calhoun's and Buchanan's distinct but sometimes similar developments of Madisonian theory, as further evidence of the conspiracy.

Perhaps aware of the flimsiness of this argument when taken alone, she next notes that the libertarian economist Murray Rothbard discussed Calhoun's emphasis on the conflict between the taxers and the taxed in his own 1960s work. While Rothbard supposedly demonstrates a libertarian affinity for Calhoun at the time Buchanan was developing his theory, MacLean either neglects to note or—more likely—is unaware that Buchanan and Rothbard were each quite critical of the other. Rothbard in particular panned the very book that MacLean cites as an esoteric dialogue on Calhounism, writing in a commentary that "I am so out of sympathy with James M. Buchanan and Gordon Tullock's *The Calculus of Consent* that I don't think a particularly detailed critique to send to them would be worthwhile." In the end, the link that MacLean posits between Buchanan and Calhoun simply isn't there.

Her purported linking of Buchanan to the pro-segregation Southern Agrarians is even weaker. A casual reader of her book could easily be led to believe that the Agrarian poets played a direct and formative role in Buchanan's own intellectual journey through college and into academia. Although his lack of financial means led him to study at what was then a small public teachers college in his hometown (and today is Middle Tennessee State University), MacLean asserts that the Agrarians were "a cultural project that attracted James Buchanan" to want to attend Vanderbilt, where several of them taught. There is nothing, as far as we are aware, suggesting that Buchanan was ever "attracted" to the Agrarians' "cultural project," and she cites no evidence to support this contention.

Buchanan described himself as having socialistic leanings prior to encountering Frank Knight at the beginning of his graduate studies at the University of Chicago, which makes an earlier affinity for these deeply conservative literary critics unlikely. But MacLean's argument is not rooted in any actual evidence. She claims that the Agrarian poet Donald Davidson was "the Nashville writer who seemed most decisive in Jim Buchanan's emerging intellectual system" (p. 33). Davidson, she alleges, provided the source of Buchanan's oft-enlisted concept of the Leviathan state in his academic writings and a recurring interpretive framework for public choice skepticism of government. Again, though, she offers no evidence to establish Davidson's alleged influence on Buchanan.

Of course, the Leviathan metaphor derives from the English philosopher Thomas Hobbes. MacLean acknowledges that in passing, but then credits Davidson with introducing a "new and distinctive" use of the term to assail the growing federal government in the post–Civil War era, and particularly its intrusions upon "state's rights" and other coded language for segregation. However, Davidson is nowhere to be found in Buchanan's *Collected Works*; Hobbes, by contrast, is cited frequently. The evidence—actually, the lack

of it—does not support her narrative that places Buchanan amidst the resistance to *Brown v. Board*.

MacLean cites Buchanan's autobiographical collection *Economics from the Outside In: "Better Than Plowing" and Beyond* (originally *"Better than Plowing" and Other Personal Essays*) as one of her sources. Chapter 9 of the book is a collection of quotes Buchanan liked and had written down in notebooks. None of the quotes come from Calhoun, Davidson, or any of the Southern Agrarians. It isn't because Buchanan was particularly shy about his literary tastes; in several places he mentions the poet Thomas Hardy. Indeed, there is more evidence in Buchanan's written work and in the interviews of which we are aware to substantiate a claim that "the most decisive" writer in Buchanan's intellectual system was western novelist Zane Grey than to substantiate MacLean's claim about Davidson. The men who MacLean tells us are behind the curtain simply aren't there.

MacLean's majoritarianism / MacLean also charges that Buchanan was not an empiricist. In a narrow sense, she is correct. He employed a largely theoretical style that reasoned from starting principles, such as a constitutional rule or a stated assumption about voting behavior. From this position she leaps to the conclusion that public choice ideas are unsupported empirically. But an empirical study appears in the very first issue of the journal that became *Public Choice*, and Buchanan the theorist inspired legions of empiricists. In a 2012 appreciation of Buchanan that appeared in the *Journal of Economic Behavior and Organization*, Elinor Ostrom—a Nobel economics laureate and as fine an empiricist as there has ever been—wrote, "There is substantial empirical work now that strongly supports his ideas." On the basis of this empirical evidence, we reject MacLean's hypothesis that there is no empirical evidence to substantiate public choice theory.

MacLean's own majoritarianism places her argument well outside mainstream constitutional theory. This much is particularly apparent in a lengthy tangent where she assails checks and balances as "an all but insuperable barrier to those seeking to right even gross social injustice" (p. 224). There is a grain of truth to this observation. Historical wrongs such as slavery and segregation do reveal faults in our constitutional system, but this *affirms* the importance of public choice contributions to understanding and ameliorating these conditions.

MacLean misses this insight, offering instead an aggressive appeal to a peculiar populism that aligns with her own redistributive politics (p. 226). The implicit rejection of a basic Madisonian principle in MacLean's political ideal is odd given her frequent depictions of Buchanan's constitutionalism as a conspiracy to undermine "American democracy." Unfortunately, she offers no evidence that the populist alternative she prefers would produce better results. In fact, she glosses over the role that populist majorities played in some of the worst injustices of our history: segregation, discrimination against homosexuals, and the drug war, to name a few. These injustices speak to one of Madison's and Buchanan's larger points: without constitutional mechanisms to protect them from politically entrenched and powerful government actors, political minorities are vulnerable to abuse and exploitation under the cover of law.

In Buchanan's collection of favorite quotes, none come from Calhoun, Davidson, or the Southern Agrarians. MacLean's bogeymen aren't there.

MacLean also interprets the classical liberal tradition in light of a false tension between capital and labor. A more sophisticated analysis—like those done by many economists, including those inspired by Buchanan—shows that (for example) labor unions increase the incomes of some workers at the expense of others. Thomas Leonard's 2016 book *Illiberal Reformers* is in this sense a necessary corrective to *Democracy in Chains*. (See "Progressivism's Tainted Label," Summer 2016.) *Illiberal Reformers* shows the ways in which some of the very same labor market interventions that MacLean celebrates were historically motivated by explicit racists who sought to keep African-Americans, immigrants, and the poor out of the competitive workforce.

MacLean does not allow for the possibility that labor markets might have worked as competitive models predict, a possibility firmly supported by the evidence summarized by, for example, Price Fishback in a 1998 *Journal of Economic Literature* paper. In another example, she cites Charles Dickens (p. 97) as historical evidence for the apparent squalor of early industrial society. She should consult Deirdre McCloskey's work or virtually any serious quantitative work that has been done by economic historians in the last half-century or more, instead of citing a novelist's work of fiction.

***Buchanan and* Brown** / MacLean's enthusiasm for progressive economic policies leads her into problematic territory, given her thesis. It is no small irony that she appeals to the authority of such figures as Richard T. Ely, John R. Commons, and John Maynard Keynes for their rejections of laissez-faire in a book aimed at painting Buchanan as a closet segregationist and racist reactionary whose ideas gained currency because of backlash against *Brown*. Ely, Commons, and Keynes were all outspoken eugenicists who incorporated this position into their own respective assaults on laissez-faire in human reproduction.

For a decision that was supposedly decisive to Buchanan's intellectual program, *Brown* is conspicuously absent from his work. The ruling does not appear in the index to his *Collected Works*, nor is it discussed in *Economics from the Outside In*. One would expect evidence of at least *some* link in light of the *Democracy in Chains* promotional material that emphasizes the *Brown*

angle. Munger has obtained the relevant documents MacLean cites to support this charge and he argues in his *Independent Review* article that they are inconsistent with her interpretation.

Attacking scholarship / MacLean criticizes the Thomas Jefferson Center for Studies in Political Economy, the former academic center at the University of Virginia where Buchanan and many of his colleagues once worked. Indeed, it was an unorthodox place in an orthodox academy. But if we are talking about "stealth plans" to undermine ideas, she lets pass with little comment the fact that the Jefferson Center scholars were effectively pushed out as a result of a secret internal investigation finding fault not with their scholarship but with their politics. Buchanan and colleague Ronald Coase would go on to win Nobels in economics, and there is widespread agreement that another colleague, Gordon Tullock, should have won one. In a book about deep histories and conspiracies, she is remarkably uninterested in the politically oriented purge of a group that included two future Nobel laureates. Given her emphasis on funding as a litmus test for the veracity of one's ideas, she does not mention the support Buchanan and other public choice scholars have received from (for example) the National Science Foundation.

Speaking of Tullock, she quotes the verdict that his research record was "undistinguished" when he was denied promotion to full professor at the University of Virginia. While it is true that Tullock did not have a degree in economics (and, in his telling, he only took one real economics course), he had four books to his credit by the end of 1967: *The Calculus of Consent, The Politics of Bureaucracy, The Organization of Inquiry*, and *Toward a Mathematics of Politics*, as well as three papers in the *Journal of Political Economy*, two in the *American Economic Review*, one in the *Quarterly Journal of Economics*, and papers in *Oxford Economic Papers*, the *Western Economic Journal* (now *Economic Inquiry*), and other publications. "Undistinguished" is not the word we would use.

MacLean's readings of Buchanan's works are also fraught with trouble as scholars and commentators have recently pointed out in blog posts for *Bleeding Heart Libertarians*, the "Volokh Conspiracy" blog at the *Washington Post*, and elsewhere. Her misreading of Buchanan's paper, "The Samaritan's Dilemma," is an example. She treats it as a repudiation of compassionate ethics and indignantly scolds Buchanan for discussing "exploitation by predators of his own species." The paper is far more complex than this, and it isn't really about the biblical parable of the Good Samaritan at all. (Buchanan writes that he uses the term "Samaritan" because he couldn't think of anything better.) Rather, Buchanan analyses the structure of a general problem: no decent person likes to see other people suffer and most likely experiences a great deal of pain at another's misfortune, but the indiscriminately benevolent give others incentives and opportunities to take advantage of them. He goes on to discuss the importance of general rules as it is often easy in the short run to simply capitulate to the difficult child or grade-grubbing student.

That MacLean misses Buchanan's meaning—or is at least does not communicate it clearly—is evident from the way she treats a passage of his about a parent spanking a child. Here is MacLean: "Buchanan used as an analogy the spanking of children by parent: it might hurt, but it taught 'the fear of punishment that will inhibit future misbehavior'" (p. 143). Now here is Buchanan:

> A family example may be helpful. A mother may find it too painful to spank a misbehaving child ("This hurts me more than it does you"). Yet spanking may be necessary to instill in the child the fear of punishment that will inhibit future misbehavior. ... Even when she fully discounts the effect of her current action on future choice settings, the mother may still find it too painful to spank the misbehaving child. (*Collected Works of James Buchanan*, vol. 1, p. 335)

From the way she portrays Buchanan throughout, one might get the impression that the person experiencing the "hurt" she describes is the misbehaving child. From Buchanan's context, however—and what makes this such a powerful contribution—the pain is felt by the mother who does not want to experience the "short-term utility losses" that come from punishing her child even when it is to the child's long-run benefit.

Pinochet / No exposé on the alleged free-market conspiracy would be complete without a prominent appearance from Chilean strongman Augusto Pinochet, a thug who in 1973 overthrew the government of the democratically elected Salvador Allende, ruled the country with an iron fist, systematically abused human rights, and later implemented free-market reforms under the supposed direction of Milton Friedman and the "Chicago Boys." To hear MacLean tell it, Buchanan had a hand in writing Chile's 1980 constitution under the Pinochet regime and, in Buchanan's 1981 address to the Mont Pelerin Society, provided ideological cover for Pinochet's anti-democratic junta government. Again, if she had taken the time to walk across campus, she would have learned a different story.

Citing work by Andrew Farrant and Vlad Tarko, Munger points out that "Buchanan had essentially no role in the writing of the Chilean Constitution and in fact was critical of the regime and its actions." He goes on to write of that constitution:

> The people of Chile needed help escaping from the military regime. A constitution must foster a move to democracy, and free and fair elections, but also avoid a military coup. It would serve no one to have had a constitution that allowed an immediate transfer of power, and a Truth Tribunal had been convened, followed by arrests of top military officers. That is frustrating, because they clearly deserved it. But the only way to get from military regime to functioning democracy was the way they did it.

MacLean spins the opposite story. At one point she accuses Buchanan of providing "in-person guidance" to the Pinochet regime (p. 157), before immediately transitioning into a list of its arrests, political assassinations, and other acts of brutality. The juxtaposition is plainly intended to tar Buchanan with those crimes, even as she has no actual evidence linking the two. Her footnotes are illustrative of the scholarly deficiencies of this chapter. To document the Pinochet regime's brutalities she cites an assortment of easily accessible newspaper articles and secondary literature about Chile, not one of which mentions Buchanan. She then pivots to Buchanan's attendance at a weeklong academic conference in Chile where he committed the offense of speaking to other economists who worked for the Chilean government. The "archival" finds she enlists to demonstrate this nefarious collaboration include such items as a common thank you note for a lunch at the conference (p. 161) and the fact that some of Buchanan's books were translated into Spanish in the early 1980s (p. 157).

MacLean then pivots right back to Pinochet's authoritarian thuggery to implicate Buchanan, by association, in the same. What she does not do, though, is perform even a cursory review of the existing literature on the tensions between the Pinochet regime and classical liberalism. John Meadowcroft and William Ruger's 2014 article in the *Review of Political Economy* is an excellent starting point on this subject. In particular, it documents how Buchanan's eschewing of politics and his individualist notion of liberty chafe with both the Pinochet regime and other classical liberals—Hayek among them—who could be legitimately criticized for negligence or credulity in their own treatments of the Chilean dictatorship. As with other examples though, MacLean appears to be fundamentally uninterested in investigating Buchanan's ideas, let alone accurately portraying them.

Conclusion / MacLean extends no scholarly charity to Buchanan, Tullock, or the entire subfield of public choice economics. Instead, she treats them with contempt. *Democracy in Chains* was an opportunity for serious cross-disciplinary inquiry, but that opportunity was missed.

Instead, the book is the perfect symbol of these times, fumbling the facts and ignoring ideas in order to titillate one's tribe, provoke the paranoid, and exclaim that The End is Nigh. The book makes no serious contribution to our understanding of public choice theory or the evolution of classical liberal ideas in the late 20th century. We fear, though, that readers will come away from critical reviews like this one *even more convinced* that there is an insidious conspiracy. And indeed, maybe the truth is out there. But *Democracy in Chains* certainly isn't it. R

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The Handicapper General

REVIEW BY PIERRE LEMIEUX

Matters at the intersection of philosophy, politics, and economics are more complicated than what immediately meets the eye. This is illustrated well in *Philosophy, Politics, and Economics*, a 662-page anthology edited by Jonathan Anomaly, Geoffrey Brennan (both of Duke University and the University of North Carolina), Michael Munger (Duke), and Geoffrey Sayre-McCord (UNC). Anomaly and Sayre-McCord are philosophers and Brennan and Munger are both political scientists and economists.

The book is obviously geared to college PPE (Philosophy, Politics, and Economics) programs, which use the three disciplines to analyze social life and political power. In their introduction, the editors explain that, in their view, such programs must provide a learning experience that is both integrated and yet respects the different approaches of the three disciplines. The basic questions are: How can individuals live peacefully and productively in society? How should we organize political authority (if any is necessary)?

Philosophical adventures / It is not easy to review an anthology containing 66 articles and nearly as many different authors who often defend contradictory theories. The

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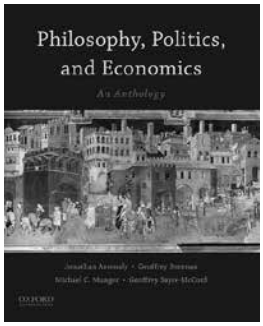
readings—typically academic articles or book excerpts—cover a wide range of theories, from Plato, through modern political thought (notably Thomas Hobbes and John Locke), up to Friedrich Hayek, Gary Becker, and James Buchanan. Libertarianism, which occupies a strategic place in the selections, is also challenged by intelligent thinkers. The anthology is not for the faint of heart who believe they have already found the eternal truth.

The oldest text in the book is Plato's *Crito*, written around 360 BCE. It is considered one of the first philosophical defenses of absolute political authority. In the dialogue, Socrates has been condemned to death and his friend Crito is trying to persuade him to flee Athens. Socrates refuses, explaining that "your country is to be honored more than your mother, your father, and all your ancestors. ... You must either persuade it or obey its orders, and endure in silence whatever it instructs you to endure."

Although not far from Socrates on this particular point, Hobbes (also part of the anthology) adhered to an individualist methodology, which was unknown to the Ancients and would soon support the modern conception of liberty.

Methodological individualism is the backbone of modern social, political, and economic analysis. In their 1982 article "An Economic Theory of Military Tactics: Methodological Individualism at War," Geoffrey Brennan and Gordon Tullock explained that the study of military tactics has to start with the fact that "the *ultimate* unit of analysis is always the individual" (emphasis in original)—as good a short definition of methodological individualism as one can find. "Armies," the two authors continue, "must be analyzed as collections of independent individuals who are, in some sense, as much at war with one another and their own leaders as they are with enemy forces." Looking at individual incentives is the only way to understand how, for example, decorations and rewards are crucial for motivating soldiers to risk their life and body integrity. This is why heroic soldiers are eventually removed from the direct line of battle and put into safer jobs.

Market failures / Several selections of the anthology deal with "market failures"—mainly externalities and public goods—using both standard economic analysis and game theory. Contributors such as Tyler Cowen, Jonathan Anomaly, David Friedman, John Hampton, Elinor Ostrom, and Samuel Bowles and Herbert Gentis show that many of these problems can be solved by voluntary cooperation, although some areas such as national defense remain problematic.



Philosophy, Politics, and Economics: An Anthology

Edited by Jonathan Anomaly, Geoffrey Brennan, Michael Munger, and Geoffrey Sayre-McCord

662 pp.; Oxford University Press, 2015

Philosopher David Gauthier explains how rational individuals are able to adopt strategies and dispositions (such as honesty and justice) that allow them to solve so-called "prisoner dilemmas" and thereby obtain the benefits of cooperation. But fellow philosopher Gregory Kavka then argues that one cannot will an intention, as opposed to willing the object of the intention, if the reasons for the intention don't match the reasons for its object. A person cannot form the honest intention to cooperate if he knows that he will want to defect when it becomes profitable to do so. Gauthier replies that rationality (in his sense) implies commitment; a person who respects his commitments *can* commit to drink a toxin (borrowing from an elaborate thought experiment proposed by Kavka) and he knows he will do it when time comes.

The anthology contains excerpts from John Rawls and Robert Nozick. Rawls argues that rational parties to a social contract would adopt principles of justice affirming equal individual rights and, subordinately, limitations of inequalities so that they will benefit the least advantaged. Nozick counters that a Lockean entitlement theory of justice is inconsistent with the distribution pattern that a Rawlsian state must continuously reestablish—because, for example, baseball or rock-music lovers voluntarily pay to enrich their idols. People, argues Nozick, are entitled to what they appropriate without coercion.

These are complex topics. For example, Nozick argues that the restitution principle (to correct past offenses against just entitlements) can justify redistribution. "One *cannot* use the analysis and theory presented here to condemn any particular scheme of transfer payments," he writes (emphasis in original); "past injustices might be so great as to make necessary in the short run a more extensive state in order to rectify them." Even in the sort of minimal state advocated by Nozick, some redistribution may be required, which of course opens a Pandora's box. Life is full of Pandora's boxes, which man cannot resist opening.

As soon as issues of morality and justice are raised, one cannot avoid the question of whether laws should always be obeyed as Socrates argues in the *Crito*. Many articles in the anthology have a bearing on this issue, but the only other one that directly addresses it is *Harrison Bergeron*, a delicious short story by Kurt Vonnegut. In it, a "U.S. Handicapper General" is tasked with imposing handicaps on anybody who could otherwise tilt the equal playing field. Bags of birdshot are attached to the bodies of the strong. Regular noises from a compulsory earpiece interrupt the thoughts of the too-intelligent. George Bergeron, the hero's father, rhetorically asks his wife as they watch TV, "The minute people start cheating on laws, what do you think happens to society?"

Government failures / Public choice theory, the great discovery of the mid-20th century, is well represented in the anthology. Markets are not perfect of course, but neither is the state—that is, political and

bureaucratic processes. In other words, government failures are at least as prevalent as market failures. Although this idea now looks obvious (at least to many people), it did not become so until public choice economists formulated it. It is based on the rather simple assumption that politicians and bureaucrats are, like the rest of us, guided mainly by their self-interests. As Buchanan said, it amounts to viewing "politics without romance."

This analysis of politics with the tool of economics owes much to Anthony Downs's classic 1957 article (reproduced in the anthology) "An Economic Theory of Political Action in a Democracy," as well as his book on the same topic. Many of Downs's analytical results anticipate their further development by public choice theorists: "Some men are more important than others politically, because they can influence more votes than they themselves cast"; the ordinary citizen's "incentive to become well informed is practically nonexistent"; "it is rational for every individual to minimize his investment in political information." Therefore, the typical voter remains rationally ignorant of politics; he votes blind. "Ignorance of politics," Downs explains, "is not the result of unpatriotic apathy; rather, it is a highly rational response to the facts of political life in a large democracy."

The anthology presents fascinating discussions by Michael Huemer, Geoffrey Brennan, Loren Lomasky, Jason Brennan, and Sayre-McCord suggesting that there is no moral duty to vote, although there may be a duty for the ignorant not to vote.

Downs observed that

> men are much more likely to exert direct influence on government policy formation in their roles as producers than in their roles as consumers. In consequence, a democratic government is usually biased in favor of producer interests and against consumer interests.

He cites protectionist measures as an example—a very current problem, indeed.

A whole chapter of the anthology is devoted to the technique of cost-benefit analysis. Steve Kelman of Harvard University provides an "ethical critique" of cost-benefit analysis. It is, in my opinion, one of the few weak articles in the book: the author does not seem to really understand what he criticizes. A more credible critique comes from Elizabeth Anderson, a philosopher at the University of Michigan, who argues that the technique cannot be used for higher goods of intrinsic value, which can only be evaluated by democratic deliberation. The question that a student of public choice theory would ask is, who decides what are the higher goods with intrinsic value, Trump voters or a general assembly of politically correct snowflakes? David Schmidtz, a philosopher at the University of Arizona, provides a more enlightened and instructive critique.

The calculations of costs and benefits provide only fragile estimates that offer multiple opportunities for biases, especially for government bureaucracies.

Many problems remain, besides the well-acknowledged fact that the individuals who pay the costs are typically not the ones who reap the benefits. Environmental fetishes often intrude in discussions about cost-benefit analysis. The actual calculations of costs and benefits, based on a forest of assumptions, provide only fragile estimates that offer multiple opportunities for biases, especially for government bureaucracies with lots of resources. Have you ever heard a government announce that one of its pet projects will be abandoned because cost-benefit analysis has shown no net social benefit? On the contrary, its bureaucrats or outside consultants seem to always come up with an analysis justifying the projects. (See "The War on Consumer Surplus," Spring 2017.) It is true, though, that the theoretical precision of the method puts *some* constraints on governments.

Price gouging / The last chapter of the anthology deals with a host of practical applications: prostitution, sex and the family, drugs, organ rationing, sweatshops, and price gouging—again with a good balance of libertarian and nonlibertarian arguments. In general, and despite the level playing field, I believe libertarian arguments win the debates. The only selection I didn't find useful is an economically confused plea for sweatshop regulation by Mathew Coakley (Warwick University) and Michael Kates (Georgetown University).

The case of price gouging is neat and interesting. Munger reports on the disturbing case of a 1996 hurricane in North Carolina. Enterprising ice sellers were arrested as they sold at higher prices something that hurricane victims could not otherwise obtain and for which they were obviously happy to pay more. These same customers applauded when their suppliers were led away by police before their eyes! "They clapped," Munger writes in disbelief.

As Munger explains, after a disaster has hit, "the only way to ensure *low* prices, and large supply, to buyers is to allow sellers to charge *high* prices, the highest they can get" (emphasis in original). Otherwise, prices will stay up for longer. The only other option is for government to effectively control prices, which would result in real shortages and generate arbitrary waiting lines to allocate the scarce goods.

Philosopher Jeremy Snyder argues against this sort of price gouging in times of disaster. In his opinion, it shows a lack of respect for others, namely the poor. For that reason, price gouging is immoral and should be prohibited or, at least, merchants should voluntarily eschew it.

University of San Diego philosopher Matt Zwolinski provides a master counterargument. It cannot be immoral for entrepreneurs to sell at higher prices things that people could not otherwise obtain (at the same time and place); these price gougers do not in any way worsen the situation of

their customers compared to the latter's alternatives if the former were not there. If there is no attempt at price gouging, Zwolinski points out, the consequence will not be "equitable access"; supply will be even tighter and it is doubtful that the poor will get more.

Bottom line / Before I conclude, I hope the reader will forgive me an unspeakable grumble. Anyone should be at liberty to write as one wishes, with the benediction of his godly editor. And it is normal that language adapts to change and fads. I also believe that formal equality of individuals, whatever their color, sex, or forehead shape, is more than a fad. Yet English is now written in a way that may soon render barely readable any writer published more than 20 years ago. Talking about a given voter A ("Consider for example citizen A"), one of the anthology selections uses both pronouns "she" and "he," a disconcerting sex change that occurs within a single paragraph.

Regarding the contents of the anthology, the bottom line is the book is a well-conceived crash course in philosophy, politics, and economics. It is a must for PPE students. After reading it, they will be very street-wise about the world in which they live. *R*

When Economics Isn't On Your Side

REVIEW BY GEORGE LEEF

If you were to ask people who have taken an undergraduate economics course what they think of raising the minimum wage, you would expect them to express at least some reservations, saying the increase could hurt employment for low-skill workers. That concern, according to University of Connecticut law professor James Kwak, would exemplify the harmful phenomenon he calls "economism." When people make decisions on what he deems complex policy questions based on their having absorbed some of the "simple" concepts from Econ 101, that is a bad thing. In his view, the United States is being held back from addressing what he believes is our crucial issue—rising economic inequality—because economism has indoctrinated so much of the population.

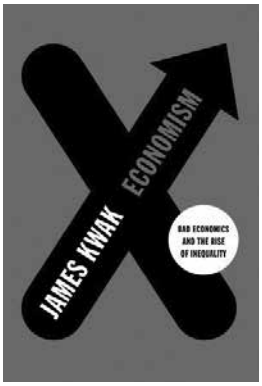
The "elegant model" of supply and demand, Kwak writes, "rests on a set of highly unrealistic assumptions. The definition of a competitive market requires that all suppliers offer the same product—there are no differences in features, quality, or anything else—and each competitor is so small that its behavior has no effect on overall supply."

Because the model of a perfectly competitive market is unrealistic, Kwak argues, it follows that the basic teachings derived from it are not reliable policy guides. Hence we really can't be sure about what the effect of a mandated wage increase would be, and so it's wrong to instruct impressionable students that there are any necessary implications from it or other interventionist policies.

In short, learning the basic principles taught in Econ 101 is an instance of the old adage that a little learning is a dangerous thing. If it weren't for these simplistic notions implanted in people's minds, government would have adopted a host of regulatory and tax policies to relieve suffering and make America a more equal nation. Interestingly, Kwak doesn't reach the parallel conclusion that assumptions about the benefit of such interventions are likewise simplistic and unreliable.

If his thesis seems like an attack on economic theory, that's because it is. He derides writers such as Henry Hazlitt for arguing that the world obeys economic laws. Theory, Kwak maintains, has been overthrown by data. We can only discover the effect of different policies by looking at studies after implementing them, and if any study finds an apparently beneficial result—even if that study conflicts with a larger body of empirical work—that's adequate justification for the policy. Naturally, he points to outlier academic studies finding little or no harm from minimum wage increases and little or no benefits from tax cuts to make his case that the world is too complicated for mere theory.

Undermining FDR / Where does economism have its roots? They're found in the ideas of economists who have argued that free markets lead to the most efficient use of resources to satisfy the desires of consumers and, equally important, that coercive interference with markets will have predictable and generally harmful consequences.



Economism: Bad Economics and the Rise of Inequality

By James Kwak

237 pp.; Pantheon Books, 201

Kwak displays a superficial familiarity with those economists. Throughout the book, he mentions Adam Smith, Ludwig von Mises, Friedrich Hayek, Milton Friedman, and others. All of them opposed the sorts of interventionist policies that he thinks are now necessary to restore fairness: trade restrictions, minimum wage laws, strong labor unions, high taxes on the wealthy, and so on.

But he never ventures a

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direct assault on their ideas. Rather, his contention is that their theoretical notions, while not necessarily wrong, have been pulled out of their books and impressed into the service of rich Americans who were unhappy that the New Deal had slightly reduced their share of national wealth and wanted some means of fighting back. If, for example, Charles Koch cites Milton Friedman on the benefits of deregulation in an op-ed, that's bad old economism at work: using simple, merely theoretical ideas to tear down our regulatory apparatus so Koch's companies can gain.

In Kwak's version of history, America had settled into a comfortable and relatively fair economic equilibrium under the enlightened policies of Franklin Delano Roosevelt, which sensible Republicans continued under Eisenhower. But then a few people on the far right decided that the New Deal's big administrative state was an obstacle to their wealth maximization. They created a movement to counter it, a movement centered around the anti-interventionist arguments of Smith, Mises, et al. Thus was economism born. It takes "simplistic" economic concepts and repackages them in op-eds, videos, and radio commentaries designed to get Americans to believe that free markets are always good and government interference with them is always bad.

In making his argument, Kwak is relentlessly uncharitable toward his opponents. They're mean-spirited people, all about money for themselves, never about principled economic and philosophical arguments against government coercion. Yale social scientist and noted libertarian intellectual William Graham Sumner is tarred with the false claim that he was indifferent to the poor, who just "deserved it." Leonard Read, founder of the Foundation for Economic Education, was just a business executive looking for ways to put business back on top, not a man with a deep philosophic commitment to liberty. Americans who oppose the minimum wage merely want to keep down labor costs for business. And those who argue for tax cuts do so only because their deep pockets could hold a few more dollars.

Kwak can't even resist a dig at two Nobel laureates who provide ammunition for the practitioners of economism. He writes of Hayek and Friedman, "Both were well versed in the complexities of various markets, even if their political sensibilities constantly colored their economic assessments." I don't think I have ever before seen the intellectual sincerity of Hayek or Friedman called into question, but Kwak feels the need to suggest that they were part of the right-wing cabal against the Golden Age of progressivism.

Against debate / Kwak claims that he isn't trying to say who is right and who is wrong in such policy debates; he only wants deeper and more enlightened discussion. But given his dismissiveness of first principles on the pro-market side of these debates, it's hard to take this claim seriously. He never indicts any of the equally simple arguments that come from progressives. For every instance of "economism"—let's say a *Wall Street Journal* editorial arguing that raising the minimum wage will increase unemployment—it's easy to find one of simple progressivism—say a *New York Times* op-ed declaring that taxes should be raised on the "wealthiest 1 percent" as a matter of basic fairness. Only the former appears to bother Kwak; simplistic appeals that help advance the policies he likes occasion no complaint.

Instead of promoting deeper discussion, the book encourages leftists to believe that free market arguments are just masks for greed.

Whatever effect the book has will be to encourage true-believing progressives to say "Well, that's just economism for you" any time they encounter an argument that's premised on supply and demand, incentives, efficiency, or other foundational concepts of economics. Instead of promoting deeper discussion, the book encourages leftists to believe that free market arguments are just a mask for greed.

Besides the book's tactic of impugning the motives of those who argue for freer markets and less interventionist government, Kwak's work is open to two obvious objections.

First, is it true, as he says, that basic supply and demand analysis is so drummed into American students that they reflexively oppose government interventionism? Demonstrating that would seem to be crucial to Kwak's case, but he never bothers to try. In point of fact, only a rather small percentage of Americans ever take an economics course (very few colleges require them) and as George Mason University economist Daniel Klein has shown, many economics professors are not free-market enthusiasts. So among the minority of students who do take Econ 101, many are taught in a way that gives more attention to alleged market failures and the need for intervention than to the adverse consequences of tampering with prices. And in the rest of the college curriculum, students are far more likely to be imbued with egalitarian and statist ideas than to hear anything that reinforces supply and demand theory from Econ 101. If "economism" affects American thinking, its effect is far, far smaller than Kwak would have us believe.

The second obvious problem is that despite the supposedly gigantic barrier of economism, the United States has kept right on increasing the power of the state to interfere in markets. Economism did not prevent the Affordable Care Act from passing; it didn't keep Congress from raising the minimum wage in 2007 or keep Seattle from raising it to $13 per hour last year; it didn't prevent ethanol subsidies or steel tariffs; it didn't keep states from enacting laws against price gouging. Nor has the government repealed any of the laws that people ostensibly infected with economism have long railed against. The Davis-Bacon Act? Still on the books. The Department of Education? Still there.

In short, Kwak vastly overstates the power of economism to dictate policy. He declares that it prevents Americans from even considering a single-payer national health policy, but many politicians and policy advocates have put forth that idea and it has been widely discussed. Most Americans seem to have concluded that single-payer would be a big mistake. That isn't because "economism" is so dominant; it's because the case for a federal health care monopsony is so poor.

Conclusion/ What this book boils down to is the author's complaint that the world of policy debate doesn't operate to his satisfaction. "With economism," he writes, "there are only implicit assumptions and asserted conclusions. When commentators and politicians say that a higher minimum wage will increase unemployment ... they often do not realize that they are making contested claims about how the economy should be organized and how its output should be distributed."

Yet, writers who rely on economism are just as apt to know they're making "contested claims" as progressive writers are to know that they're doing so when they advocate interventionist, redistributionist policies. People on any side who seek to shape public opinion couldn't possibly include and respond to every objection that has been lodged against the positions they advocate. The realm of policy debate is (thankfully) still an even field of battle and Kwak's lament that "economism" gives greedy right-wingers an unfair advantage is risible.

In the end, what does he want? He wants his philosophical allies to develop "a new, compelling narrative about how the world works." What would that entail? To break the grip of economism, he wants to fight the idea that "the overriding objective should be to have more and more stuff." He praises Amartya Sen for saying that we should care about "the richness of human life" and not just "the richness of the economy."

Fine. Let Kwak and anyone else make that case any way they can, even if those advocates don't bother to acknowledge when they're making "contested claims" and ignore the counterarguments about the tradeoffs their preferences would require.

In fact, writers have been trying to sell people around the world on a "less is more" philosophy for thousands of years. They haven't gotten far. Perhaps Kwak's next book will argue that Americans should change to a sharing ethic because we have enough stuff. *R*

Pride in Staying Out of Jail?

REVIEW BY DWIGHT R. LEE

The new book *Read My Lips: Why Americans Are Proud to Pay Taxes* is a report on how average Americans with rather modest knowledge of public finance feel about paying taxes. Written by Vanessa Williamson, a fellow in governance studies at the Brookings Institution, the book's objective is to convince readers that Americans are proud to pay taxes, and to explain why.

In the preface, Williamson states that she is regularly told that "Americans hate taxes ... [and] are angry ... and intrinsically anti-government." But this, she says

> has become a truism without the benefit of being true.... To be a taxpayer, Americans believe, is something to be proud of. It is evidence that one is a responsible, contributing, and upstanding member of society, a person worthy of respect.

She offers preliminary support for this belief by citing political scientists who have "reviewed decades of survey data to conclude that a majority of Americans, including a majority of Republicans and the affluent, not only favor 'concrete government programs targeted to jobs and wages, educational opportunity, and protections against illness and deprivation' but would be willing to pay higher taxes to fund these efforts."

The book's introduction continues with background on American attitudes toward taxation and the connection Americans feel between paying taxes and their place in the community. She also discusses how she acquired the primary support for her case from open-ended interviews with 49 Americans plus an independent survey of another 1,000, both from diverse samples.

In this review I will try to give a representative summary of the many comments by Williamson's interviewees and her discussion of those comments. Let me say upfront that I see little indication that the people she interviewed or who responded to the survey are proud to pay taxes. Indeed, she deserves credit for putting in plenty of evidence inconsistent with her thesis of taxpayer pride. But she seems resistant to seeing such evidence as undermining her argument.

For example, she dismisses anti-tax attitudes as reflecting personal flaws by saying they "are often tied to anger that minority groups might benefit from public spending." Also, after stating that "the paperwork [required to pay income taxes] is extremely arduous," she makes the bizarre argument that

> there are reasons to think that an arduous taxpaying process is a good thing. It might encourage taxpayers to think what government provides. To the extent that the income tax awakens Americans' sense of connection to their government, its inconvenience may be a price worth paying.

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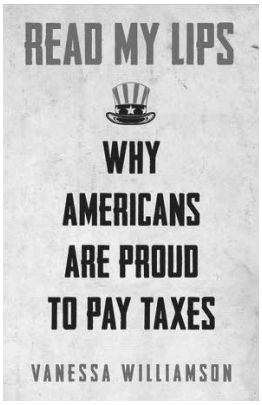
I accept the accuracy of the survey indicating that people say they are willing to pay higher taxes for government programs, and I accept that this could indicate pride in paying taxes. But I do so with a caveat: public choice economists have pointed out that many voters are motivated to vote for paying higher taxes because it allows them to feel proud of themselves at effectively zero cost. The reason for the miniscule cost is that the probability that an individual vote will determine an election's outcome is effectively zero, and voters know this. How one person votes almost never creates a financial obligation. The same, I submit, is true of answers to surveys. The pride may be real, but it is so cheaply acquired that it doesn't seem significant enough to justify Williamson's thesis.

Forgetting their pride? / In the first chapter, titled "Pride and Prejudice and Taxes," we hear mostly from the people Williamson interviewed, along with some comments from the author.

The chapter begins with three questions from Williamson, each answered by a different interviewee. In response to "When I say the word 'taxes' ... what do you think?" one respondent replied: "The cost of sort of running the country and maintaining a culture, infrastructure of our country. The cost of being an American." In response to, if you were writing a book on your views of taxes, "what would be the most important chapter?" another respondent answered: "I would think social responsibility, things we all owe each other as members of a functioning society.... The fact that I really think more people should take more responsibility for making sure that we're all okay as opposed to just ourselves." In response to "How do you feel when you're filling out your income taxes?" a third respondent said: "Like I am doing my part in supplying the needs and to help pay for the things in this country that are needed.... It's my civic duty and that I am responsible for paying taxes."

The chapter continues with Williamson informing us that "around four in five Americans see taxpaying as a moral responsibility" and that "over 90 percent of Americans agree" that "it is every American's civic duty to pay their fair share of taxes." Additional statements follow from interviewees on how they feel about taxpaying, such as "a responsibility to each other"; connects us to "basic considerations" for others such as "don't steal" and "don't kill your neighbors"; makes me think that "you can't expect some guy like me, who's an individual, to do everything on his own"; every individual is a "member of the group," so taxpaying is "a responsibility to everyone else, and also to yourself"; "people in authority are in place because God put them there," and so their laws should be followed; taxes pay for "the benefits of living in a society; and "it feels good to be able to contribute."



Read My Lips: Why Americans Are Proud to Pay Taxes

By Vanessa S. Williamson

304 pp.; Princeton University Press, 2017

Obviously, these comments are heavily influenced by a sense of identity with and connection to one's community. But Williamson correctly points out that "one's community extends only so far." She continues that "many Americans draw a distinction between the people ... to whom they feel a sense of shared obligation and those who fall outside their self-defined community," with the most likely outsiders being immigrants, minorities, and those seen as not paying taxes. Many are not happy about paying taxes to be spent on certain groups. As one of Williamson's interviewees delicately expressed it, "Our president [Barack Obama at the time] wants us to keep up the million (sic) of illegal aliens in our country or at least keep their kids here and feed them and keep them up with tax payers money that should be used to pay our country debts but is instead used to keep up Obama's cousins."

Williamson cannot be happy with many of these statements, and she creates credibility by including them. Yet she remains undeterred in believing that those who fulfill their obligation to pay taxes "take pride in their contribution to the public good." She concludes the chapter by saying: "My interviewees describe the taxpaying obligation as ... a belief in their fellowship with others in the community. To be a taxpayer is therefore a source of pride."

Statements like these began to puzzle me once I realized that nowhere in this chapter did any of Williamson's interviewees use the words "pride" or "proud." The only mention of "pride" is in the chapter title and by Williamson in the above two quotations. Maybe later, I thought, the interviewed taxpayers will mention for themselves their pride in paying taxes. As Williamson states in her introduction, an advantage of interviews is that "they allow respondents to easily express the strength of their opinions."

Ignorant on foreign aid? / In the second chapter, there is some mention of how taxpayers feel about themselves, but more about how they feel about people who are believed to not pay taxes. In the chapter's opening quotation, when asked how he feels about being a taxpayer, a respondent states, "I like the fact that I am contributing in that way (to economic growth) because there are so many who aren't." "Anger at these supposed nontaxpayers is rampant," Williamson writes, followed by more statements from her interviews similar to the ones in the first chapter. For example, a South Carolina independent's first response about taxes was about "stupid people who don't pay any." Another interviewee says that "one must earn not only an income but an income of a certain level before one really qualifies as a taxpayer."

These and other interviewee statements set the stage for Williamson to highlight a key theme in this chapter. She emphasizes accurately that almost all American adults pay taxes. Yet people typically think of only

income taxes when taxes are mentioned, which (because of the high percentage of Americans who don't pay income taxes) helps explain why the public (particularly Republicans, according to her data) overestimate the number of nontaxpayers. Even many of the relatively poor seem to think of themselves as taxpayers only reluctantly, despite being aware of their financial burden from sales taxes.

The third chapter examines how people want their tax dollars to be spent. There are no real surprises in this chapter, but there is an interesting insight indicating taxpayers are not as uninformed as commonly thought. People like spending on local projects that are visible (such as roads, schools, and public safety), with transfer programs receiving more mixed support—except for Social Security and health care—provided that the recipients "'earned' their benefits." There are clear partisan differences between Democrats and Republicans on spending for such things as science, health care, and national defense. But the level of support from those in both parties is more favorable when tax money is going to "people with whom they feel a strong sense of shared interest" and "those who are chipping in for government's costs."

A common example of the rational ignorance of voters is that they greatly overestimate federal expenditures on foreign aid. Based on her interviews, however, Williamson argues such foreign aid estimates are not unreasonable because they are based on "the tendency of Americans to think of foreign aid in military terms," a plausible tendency since "American military interventions are often described in terms that sound a lot like foreign aid."

Williamson led astray? / In the fourth chapter, which considers attitudes about progressivity, Williamson has another opportunity to compliment her interviewees. She points out that most of them approve of the progressive tax code. However, she believes "the complexity of the tax code [has led] Americans (and some of those she interviewed) astray" by convincing them that a flat tax with few loopholes would increase the share of taxes paid by the rich. She clearly believes the rich are not paying enough taxes and that they would pay a smaller share under a flatter, simplified tax code.

Yet, both evidence and theory suggest that Williamson is the one being led astray on this, not her interviewees. The 1986 Reagan tax reforms lowered tax rates dramatically and eliminated a lot, though hardly all, tax loopholes. As a result, the wealthy began paying a larger percentage of federal income tax. The excess burdens of taxation and rent seeking (two concepts never mentioned) that would be reduced by reestablishing the Reagan reforms are currently creating economic distortions and waste that are harming the poor, the wealthy, and those in between.

Reestablishing the Reagan reforms would reduce the excess burdens of taxation and rent seeking that are now creating harmful economic distortions.

The last chapter of Williamson's book that I consider in detail concerns wasteful government spending. She "asked only one question about waste, but interviewees [spontaneously] talked about this subject a great deal." They blamed government waste on politicians' perks, pork (special interests), inefficiency, and overpayments, with the most cited examples being money being spent on disliked programs. She once again believes her interviewees have been led astray on this topic, arguing that scholars "have expressed astonishment at Americans' estimate[s] of government waste, ... [which] often approach 50 percent [of the federal budget]." She adds that "a 2013 Congressional hearing put waste, fraud, and abuse at 7 percent of the federal budget." Williamson continues to express skepticism of public opinion on government waste by informing us that "most people simply do not think of 'government waste' the way that experts do." Yet the reader is never informed of what experts think about government waste. She never refers to any work by public choice economists, who would be more sympathetic to the interviewees' view of the size of government waste.

There is another mention of "pride" in this chapter, again by Williamson. She states that "the interviewers' sense of pride as taxpayers is often tainted by the thought that the money is wasted." That's not powerful support for her thesis about taxpayer pride.

Staying out of jail / Williamson's concluding chapter solidified my initial suspicion that her research really doesn't make the case that Americans are proud to pay taxes. No doubt many will say they are when asked by earnest pollsters, and some of them probably do feel that way. But I doubt that such pride is intense enough for many to move it very far from the bottom of the list of things they are proud of. If pride was mentioned explicitly by any of the 49 Americans who Williamson interviewed, she failed to include it in her book.

She seems remarkably immune to the thought that people pay their taxes because governments are fully prepared to make their lives miserable if they don't. This is reflected in her closing statement that

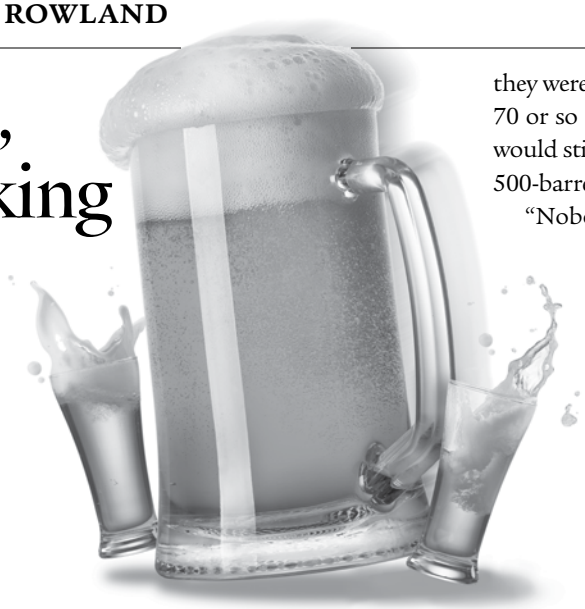
> taxpaying allows us to demonstrate our commitment to the community and to the country. It is the investment of a people in the shared task of self-governance. By these lights, it is no wonder that so many Americans see it as a badge of pride.

Given the penalties that befall nonfilers, it seems odd to describe taxpayers as being "allowed" to pay their taxes.

Let me admit that any pride I feel about paying taxes is overwhelmed by my pride in staying out of jail. I cannot speak for others, but as for me, if the government *allowed* me to reduce my taxes as much as my taxpaying pride permitted, my first question would be, Are negative taxes allowed, or do I have to accept the corner solution? *R*

FINAL WORD BY TIM ROWLAND

My Goodness, My Rent-Seeking



Artifacts of the old American temperance movement—a good idea for 10% of the population but a burdensome buzzkill for the rest—remain with us to this day, as anyone who has tried to buy a bottle of Pinot Grigio in a supermarket at 11 a.m. on a Sunday morning can attest.

The singular economic effect of Prohibition was to take money away from American workers and public treasuries and invest it in criminals who were canny and daring enough to give the people what they wanted. This lesson seems to have been lost on today's lawmakers as we blunder from one illicit drug crisis to the next.

Dating back to the days of the Whiskey Rebellion, America was quite literally built on hooch. Liquor taxes up through Prohibition comprised an outsized portion of government budgets. The federal government alone lost $11 billion in revenues to Prohibition, while spending $300 million to enforce the unenforceable.

Prohibition also threw thousands of employees out of work in the decade leading up to the Great Depression. A little-known part of the New Deal work programs was the legalization of beer, albeit with a lower alcohol content, prior to Prohibition's formal demise. So an accelerated dependence on the income tax and bad beer are two of Prohibition's more dismal unintended consequences.

Even today the government's relationship with alcohol remains awkward. We have not entirely shaken off our Puritan instincts, and through the bulk of the 20th century, state legislators (where whiskey in House and Senate cloakrooms was often dispensed by the keg) have tried to soften alcohol laws without making it look as if they were softening alcohol laws. In this way, they hoped to win the votes of reprobates and church ladies alike.

As readers of this magazine know well, those who cheered on the barrel-busting axes sometimes are the private alcohol interests themselves. Earlier this year, an entertaining three-way battle among big brewers, little brewers, and taverns broke out in the Maryland legislature over an existing law that prohibited breweries from selling more than 500 barrels of beer a year at their plants' taprooms.

The kerfuffle began when the international alcohol concern Diageo, whose holdings include the legendary Guinness beer brand, announced it would fashion an old rum plant near Baltimore into a brewery. The plan is for a "world class beer tourism destination" that would test new brews on the public in a trendy, upscale taproom while the plant would become home to the manufacture of Guinness's Blonde American Lager. (Something about Guinness coming out with a blonde beer seems wrong; like Martha Stewart coming out with a diet croquembouche.)

And while 500 barrels, or 125,000 pints, sounds like a lot, it's a drop in the stein compared to what Guinness eventually hopes to sell at the tap room. So it asked Maryland lawmakers for an exclusive and less restrictive liquor license, which they were all too happy to provide. Or at least they were until they heard a roar from the 70 or so craft brewers in the state, which would still have been burdened by the old 500-barrel limit.

"Nobody who is a Maryland brewer who is part of our association doesn't want to see Diageo come here and be successful," Hugh Sisson, founder of the Heavy Seas label, told the *Baltimore Sun*. "But we don't want to pass another carve-out bill and have a large, international conglomerate have privileges that homegrown businesses don't have."

Then came the retailers, taverns, and restaurants, which complained that brewery taprooms would amount to unfair competition. Well, they didn't put it that way, exactly; they said raising the limit would violate the spirit of Maryland's sacred "three tier" alcohol system, under which only brewers can brew, only wholesalers can distribute, and only retailers can sell to the public. This system was designed, of course, to (*wink*) "protect consumers," which once upon a time maybe it did. But today, like many alcohol laws, it has been commandeered to protect commercial fiefdoms from competition.

So while there are sensible laws against drinking and driving, in all other regards it might be time to start treating alcohol as we would any other commodity. As such, we might substitute "tomato" for "alcoholic beverage" to see if a regulation makes sense: Should we not sell tomatoes before noon on Sunday? Should a tomato purchased in a restaurant not be allowed to be taken off premises? Should it be required that tomatoes be wrapped in an opaque bag before they are taken from the store?

In the end, all Maryland could manage was a stopgap measure that made no one happy. Lawmakers raised the taproom limit to 2,000 barrels—half of what Guinness wanted, but enough for it to proceed with its plans. But lawmakers also required taprooms to close at 10 p.m., just as the night's getting started.

So if you're making a salad, better get those tomatoes early. R

TIM ROWLAND is a columnist and humorist for the (Hagerstown, Md.) *Herald-Mail* newspaper.

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