

IN REVIEW

The Cartel of States

◆ REVIEW BY PIERRE LEMIEUX

What are “invisible” countries and why is it so hard to create new, “visible” ones? Joshua Keating tries to answer those questions in his new book, aptly titled *Invisible Countries*. Keating is a journalist, currently an editor at *Slate* and previously at *Foreign Policy*. He defines a country as “a piece of land that has been

separated from the rest of the earth’s landmass by political boundaries agreed upon by the world countries as a whole.” A country is also a land dominated by a recognized state—that is, a recognized monopoly of force. Some of these states correspond to nations, a nation being a “community of sentiment.” As for nationalism, he quotes philosopher Ernest Gellner, who says it is the “political principle which holds that the political and the national unit should be congruent,” “political” meaning organized as a state.

From Abkhazia to Liberland / Keating observes that some “countries” are not formally recognized, while others that are recognized do not have “real” states. Some of the former have all or most of the attributes of recognized countries: Abkhazia and Somaliland are two examples.

Abkhazia is a Russian-backed enclave that fought the government of Georgia in a bloody civil war in the 1990s. It is now, for all practical purposes, an independent country run by its own government. But it is only recognized by a handful of states.

The fact that both Georgia and Russia maintain claims on Abkhazia illustrates that there is no room in the (political) world for a new country. All the land is now occupied or claimed by some state, except for “one remote slice of Antarctica” and a small number of minor exceptions. Such has been the accepted world order for a century.

Somaliland, which broke away from Somalia a quarter-century ago, “has all the

trappings of countryhood,” writes Keating. It is a “stable and mostly functional country” and “pretty freewheeling.” “There’s no pirate activity along Somaliland’s shores,” he notes, only along the Somalian coast.

A USAID news report last February said Somaliland’s last presidential election, for which the agency provided assistance, was a success. Somaliland was even an independent country for one week in 1960 before its legislature voted to unite with Somalia, a decision that most Somalilanders seem to regret.

Somaliland cannot become a real country today simply because it is not internationally recognized as such by other official states, including the United States. Perhaps instead of providing “voter education, ID cards, and polling equipment,” as the USAID bulletin boasted it had done, the U.S. State Department should now push for the country’s recognition.

Keating, who admits to not being a libertarian (though he seems to have potential), likes to tease them: “Libertarians curious about what a basically functional society would look like with a bare minimum of both services and regulations from a barely functional government should check [Somaliland] out.” The country is very poor. Why doesn’t it take off like Hong Kong did when it was a poor British territory? It may just be a question of time, but the reader, under the influence of Keating,

gets the impression that Somaliland’s poverty is in large part because its non-state status creates uncertainty for any party wanting to do business there. Its passports are accepted by only a few countries, making it very difficult for Somalilanders to travel. In our statist world, a territory and its residents are nothing if they are not subject to a recognized state—an important lesson from *Invisible Countries*.

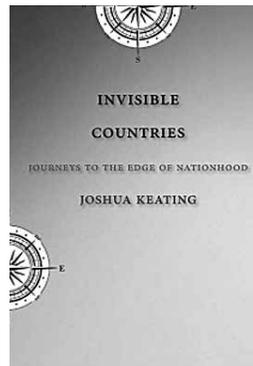
Kurdistan is also invisible but it, too, comes close to being a real country. It has a population of 25–40 million Kurds, and the land they occupy stretches across several recognized countries. Iraqi Kurds do have a semi-autonomous region, Iraqi Kurdistan, but the rest of the Kurds have no such sta-

tus. The Kurds were promised a country of their own in the 1920 Treaty of Sèvres, but it never happened. They are U.S. allies but, as one of them said, they are victims of genocide every 10 years or so.

Iraqi Kurdistan is a “pro-Western, free-market democracy.” Recognizing the frontiers of Kurdistan would follow the policy proclaimed by President Woodrow Wilson in 1918 that the borders of countries, and thus states, should be drawn “along clearly recognizable lines of nationality.” In general, though, the “realistic stance” of U.S. foreign policy “has

traditionally been more attached to the preservation of the map.” There are other complications, sometimes related to Kurdish clans. Not all Kurds, notably in Syria, want an independent state.

Akwesasne is another example of an invisible country, this time in North America. The small Mohawk territory that straddles the U.S.–Canada border meets the ethnic criterion but does not have real political autonomy. According to Keating, it is semi-sovereign on the U.S. side, but not as much on the Canadian side. Following an 1832 Supreme Court decision, Indian tribes are “distinct independent



**Invisible Countries:
Journeys to the Edge
of Nationhood**

By Joshua Keating

296 pp.; Yale University
Press, 2018

communities retaining their original natural rights as the undisputed possessors of the soil from time immemorial.” But the Mohawks of Akwesasne have to show an American or Canadian passport when they cross the “border” inside their own territory. The political arrangements of American Indians represent a sort of “nested sovereignty” or “overlapping sovereignty.”

The Free Republic of Liberland is especially interesting; Keating calls it his most extreme case. The republic was proclaimed on April 13, 2015 by Czech libertarian Vit Jedlicka on a 2.7 square-mile patch of *terra nullius* (land belonging to no one) between Croatia and Serbia. Jedlicka “is optimistic that [the Liberland government] can build ties to Donald Trump’s administration,” Keating reports. It would certainly be a coup if the United States agreed to recognize Liberland. To be fair, Jedlicka also said that he “was not sure about [Trump’s] protectionism.” “That’s probably where we differ,” he added.

Invisible Countries is full of such little but significant facts and adventures. The book also mentions Patri Friedman’s Seasteading Institute, a proposed floating libertarian nation. Such a country would make sense as it would give libertarians one place in the world where their political preferences would be respected.

More broadly, the respect of individual preferences is the fundamental reason why the existence of different countries can be beneficial. One could imagine an ideal world where every individual could choose to live in the country closest to his own preferences. This world is no doubt utopian but, from an individualist perspective, it should serve as the ultimate goal to guide political choices.

Virtual countries and statelessness / And then, writes Keating, there are outliers that “[refuse] to be confined by the world map as currently constructed” and, without any territory, claim some sovereignty. The millennium-old Order of St. John of Jerusalem of Rhodes and of Malta, also known as the Knights of Malta, is perhaps the best example. The Catholic lay religious

order is recognized as sovereign by many United Nations member states, but it has only an observer status at the organization. The Order enters into international treaties and issues its own passports (in very small number) and postage stamps. After a recent conflict with the Knights, Pope Francis reaffirmed their sovereignty.

Many hoped the internet would be an outlier capable of escaping the sovereignty—that is, the control—of existing states. Instead, states have imposed their own control under the idea of “internet sovereignty,” reaffirming the theory that only the state can be sovereign. The Chinese state is providing an extreme example. In a somewhat similar fashion, President Trump has talked about regulating “our internet.”

Perhaps the most extreme outliers are stateless people. They are individuals who have no citizenship and no passport, often because their one-time countries have dis-

Respect of individual preferences is the fundamental reason for different countries. People can live in the countries closest to their preferences.

appeared (in the case of Yugoslavia, for example) or because the government of the country they live in doesn’t recognize them as citizens. Among the latter, Keating mentions the Bidun of Kuwait. He could have also mentioned the Tibetans who have taken refuge in India.

Keating does not clearly explain why statelessness is such a handicap. The reason is that states are now so powerful, so sovereign, that stateless persons with no regular passports experience many problems when they want to travel or outright move to other countries. No government wants these people because, once they enter a country, there is no country where to deport them.

On the opposite side of the fence, there is a tiny minority of people who have more than one citizenship and more than one passport. Keating only mentions this fact. It would be interesting to know why a number of contemporary states allow this possibil-

ity, as it deprives them of captive clients.

Rise (and fall?) of Woodrow Wilson / The full range of individual preferences is much wider than mere ethnic ones, and many people prefer to live with others who share social and political values rather than ethnic heritage. The Wilsonian ideal of ethnic nationalism generated chauvinism and conflict. Keating notes ironically that, until the 1990s, the map of the world was coming

to resemble Wilson’s vision of self-determination: a country for every people and a people for every country. It took only a century of genocide, total war, and stifling totalitarianism to make it happen.

As he also observes, “There’s not a huge ideological leap from ‘Our people deserve a state’ to ‘Our state is only for our people.’” Much of the correspond-

ence between states and nations has been—if only imperfectly—achieved by ethnic cleansing. Keating cleverly notes that, in reality, “there are almost no ‘natural’ borders—people don’t divide themselves

neatly, and whenever you try to draw lines between groups of people, someone is going to end up on the wrong side.”

Redrawing borders is thus not necessarily a solution to ethnic violence or to the oppression of minorities. In some cases, though, it can help achieve the ideal of individuals living in countries that are closer to their own preferences. Required in both cases, it seems, is a minimum dose of the universal values of tolerance and individual liberty.

Why it is so difficult to create a new country? From around 1920 until the mid-1990s, many were created in the wake of decolonization and following the collapse of the Soviet bloc. But, writes Keating, “if you hadn’t created your country by the early 1990s, you were out of luck”; no further nation states were forthcoming. The member states of the U.N. form a cartel against potential competitors for their own citizens’

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clientele. U.N. Secretary-General U Thant said in 1970 that he did not believe the organization “will ever accept the principle of secession of a part of its member states.”

Since the mid-1990s, only three new countries have been recognized by the United Nations: South Sudan, Montenegro, and East Timor. But Keating suggests that Wilson’s idea may be making a comeback through the superpowers’ foreign interventions and the rise of ethnic nationalism. The Russian invasion of Crimea is an example.

Keating notes that it is unclear whether this is a good thing. He could perhaps express his ambivalence better by admitting that the satisfaction of individual preferences is the only philosophically acceptable criterion for evaluating breakups and the status quo.

Good and not-so-good ideas / *Invisible Countries* often challenges conventional wisdom, but there is one point where the author seems to incorrectly buy that wisdom wholesale. He gets bogged down in the climate change issue when he wonders what will happen when Kiwibati, a small but real island country in the Pacific, is flooded by rising sea levels. I am not claiming that this will not happen—I am rather agnostic toward “climate change”—but there is certainly a danger in further increasing state power because of this threat. I think that Keating weakens his book by lamenting “the attitude of the world” toward “the places where the effluvium of global capitalism and militarism finally washes up.” Nice sentence but vacuous thought.

He should take a lesson from an exaggeration he reveals himself: “The 2005 Intergovernmental Panel on Climate Change report estimated that the world would have to cope with 50 million refugees [from climate change] by 2010, a claim that was obviously premature and was dropped from subsequent drafts.” Keating suggests that the model of overlapping sovereignty practiced in American-Indian nations—different domains of jurisdiction granted to different governments—could help “nations,” by which he means states, take “a less rigid view of sovereignty.” This is a promising

idea, close to the argument for federalism. Leviathan lives by sovereignty—that is, uncontested power—and the less such power there is, the better. To go a bit further, the ultimate goal should be to replace state sovereignty with individual sovereignty.

It is dangerous to dream of an angelic international authority (“the international community”) that would solve all problems. This dream ignores the dangers of the state that Keating illustrates throughout his book. The existence of many countries, even if they tie themselves by international agreements, and the capacity to

create new ones are the best way to defend universal values. A world Leviathan, by preventing decentralized experimentation and the creation or maintenance of islands of liberty, would crush the universal values that are central to the Western tradition. (See “A Bridge to Collectivism,” Fall 2018.)

With its many virtues and notwithstanding its few weaknesses, Keating’s book leads us to the classical-liberal and libertarian idea of limiting state power. To the extent that this is achieved, nation-states and the adjustment of borders become less dangerous. R

A Flawed Theory but Some Interesting Observations

REVIEW BY DWIGHT R. LEE

Yascha Mounk, a Harvard University lecturer on government and a senior fellow in the political reform program at the center-left think tank New America, believes liberal democracy is in crisis as “authoritarian populists are on the rise around the world, from America to Europe, and from Asia to Australia.” The result, he argues in *The People vs. Democracy*, is that “liberal democracy is coming apart,” separating into “two new regime forms.” One of those forms he refers to as *illiberal democracy*, or democracy without rights, and the other as *undemocratic liberalism*, or rights without democracy” (Mounk’s emphasis).

He provides the following definitions:

- *A liberal democracy* is a political system that is both liberal and democratic.
- *Liberal institutions* effectively protect the rule of law and guarantee individual rights such as freedom of speech, worship, press, and association to all citizens (including ethnic and religious minorities).
- *Democracy* is a set of binding electoral institutions that effectively translate

popular views into public policy.

Mounk develops his theoretical basis for his pessimism in the book’s first two chapters. Though I share in this pessimism, I think his arguments in those chapters are unconvincing. Despite that, I think he makes some important observations throughout the balance of his book.

Democracy without rights / He begins his first chapter, “Democracy without Rights,” by recalling the 1989 protests in his native East Germany. Protesters chanted, “We—not the secret police, not the party elites—are the people.” Beginning in 2015, there has been a new chant in these same cities: “We—not those foreigners who are flooding Germany, nor the politicians who are in cahoots with them—are the people.” Protesters’ anger is now directed at immigrants and ethnic minorities and mistrust is directed at the press and “fake news,”

DWIGHT R. LEE is the Emeritus Ramsey Chair of Private Enterprise at the University of Georgia. He is a coauthor of *Common Sense Economics: What Everyone Should Know about Wealth and Prosperity*, 3rd ed. (St. Martin’s Press, 2016), with James Gwartney, Richard Stroup, Tawni Ferrarini and Joseph Calhoun.

and “perhaps more than anything else, the hankering is for someone who would speak in the name of the people.” Italy, Greece, Spain, France, Sweden, Austria, the Netherlands, Finland, Germany, and more recently the United States, have seen populists (both right and left) achieve unexpected electoral success by claiming to support the people.

Mounk summarizes his explanation of how this populism can lead to democracy without rights as follows:

To understand the *nature* of populism, we must understand that it is both democratic and illiberal—that it both seeks to express the frustrations of the people and to undermine liberal institutions. And to understand its likely *effect*, we must bear in mind that these liberal institutions are, in the long run, needed for democracy to survive: once populist leaders have done away with all the liberal road-blocks that impede the expression of the popular will, it becomes very easy for them to disregard the people when its preferences start to come in conflict with their own. (Mounk’s emphasis.)

There are clear historical examples of populists being elected and doing away with institutions that protected the rights of the people, and then being rewarded with reelection. This is a seldom-stable situation, however, because such populists almost always morph into dictators who quickly eliminate the right to free and honest elections, eliminating both democracy and rights. Mounk recognizes this problem at the end of the chapter when he states, “Unless the defenders of liberal democracy manage to stand up to populists, illiberal democracy will always be in danger of descending into outright dictatorship.” This raises the question: if the broader electorate stands up to populists,

why can’t they also keep their rights as well as democracy?

There is another problem. Mounk’s description of the path to democracy without rights is followed by an example that doesn’t provide convincing support for his argument.

He begins with some reasons for growing income inequality in the United States and other affluent Western countries and points out that policies to reduce this inequality are not simple. He then vents his frustration over Donald Trump’s 2016 election as president. He acknowledges that Hillary Clinton lacked a compelling political vision but informs us “that she has a long history of sincere public service and ran on an intricate package of policy proposals that would have made a significant difference on issues as varied as preschool education and the

battle against Alzheimer’s.” By contrast, Trump “has a long history of conning people, ... [and most] of the policies he championed were never going to work.”

Despite warnings by experts,

millions of voters saw the simplicity of Trump’s proposals as a mark of his authenticity and determination and the complexity of Clinton’s proposals as a mark of her insincerity and indifference.... [That] is precisely why glib, facile solutions stand at the heart of the populist appeal. Voters don’t like to think that the world is complicated.

This supposedly explains why the willingness of populists like Trump “to offer solutions that are so simple that they can never work is very dangerous.”

One doesn’t have to be a supporter of Trump or deny that he is a populist to see that this is a bizarre example of populism leading to democracy without rights. First, a history of conning people, championing policies that don’t work as promised, and

getting the support of millions of rationally ignorant voters hardly distinguishes Trump from most presidential candidates. A populist politician is commonly defined as one who champions the common person rather than the elite; one wonders how many presidential candidates Mounk believes got elected by promising to favor the elite over the common person. Second, it is difficult to claim that the United States has experienced the destruction of rights and threat of dictatorship that Mounk describes, despite our history that includes such populists as Andrew Jackson and Teddy Roosevelt.

This isn’t to deny that our rights have eroded as constitutional limits on government expansion have weakened from the public’s acceptance of less freedom for (purportedly) greater economic security. At times Mounk does a commendable job explaining the importance of the U.S. Constitution in protecting our freedoms and rights, but he ignores that those freedoms and rights have been eroding since at least the Progressive Era. The 2016 presidential election doesn’t seem like the best example of democracy leading to the loss of rights unless Mounk is more interested in exaggerating Trump’s flaws and Clinton’s virtues than in supporting his arguments with a more reasonable example.

Rights without democracy / He writes in Chapter 2, “Rights without Democracy,” that the histories of liberal democracies such as Great Britain and the United States show they “were founded not to manifest but to oppose democracy.” James Madison argued that the purpose of elections is to “refine and enlarge the public views, by passing them through the medium of a chosen body of citizens, whose wisdom may best discern the true interest of their country.” Mounk refers to this view as “the founding myth of liberal democratic ideology—the improbable fiction that representative government would facilitate the rule of the people.” He is forced to admit, however, that it “was under the watch [of this myth] ... that democracy conquered half the globe.” But he devotes

YASCHA MOUNK
THE PEOPLE VS.
DEMOCRACY
WHY OUR FREEDOM
IS IN DANGER
& HOW TO SAVE IT

The People vs. Democracy: Why Our Freedom Is in Danger and How to Save It

By Yascha Mounk
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much of this chapter to discussing the limits on electoral institutions that have drastically curtailed “the people’s ability to influence politics.”

The first limit he discusses is the expansion of bureaucracies and independent agencies that “are now responsible for the vast majority of laws, rules and regulations.” He next turns to central banks, which since the collapse of Bretton Woods

are now the key institutions deciding, for example, whether it is more important for a country to minimize inflation or unemployment. As a result, some of the most important economic decisions facing countries around the world are now taken by technocrats.

Judicial review, which entrusts “nine unelected judges with the power to overrule the will of the people whenever it [comes] in conflict with the preservation of individual rights,” is discussed next. Even when legislatures retain real legislative power, Mounk recognizes that “legislators have become increasingly insulated from the popular will.” He laments the private donations to political campaigns and the money paid to lobbyists by large corporations. Both have grown significantly over the past 50 years, but then so has the effect of government decisions on business interests.

He offers relatively little about how our rights are affected by government activities that are removed from democratic approval. When he does, he sees our rights as *protected* by those changes. For example, he writes that judicial review is “justified by the fact that it protects individual rights and the rule of law.” Thus, we are left with “rights without democracy.” He makes no mention, however, of the work on the administrative state by Columbia law professor Philip Hamburger, who argues “that administrative power is denying Americans basic constitutional freedoms and procedural rights, such as due process, jury rights, as well as others.”

It is clear that central banks have reduced the ability of legislators to control monetary decisions in an era of fiat currency, with that control being shifted

to unelected technocrats. There is no mention, however, of the freedoms lost from regulations that are imposed on all of us, either directly or indirectly, to protect the currency monopolies of central banks. As far as minimizing a country’s inflation or unemployment, it is not clear that central banks have done much better than the gold standard did or Milton Friedman’s monetary rule would.

Regarding the amounts businesses spend on lobbyists, Mounk mentions that this benefits businesses by getting policies passed that improve their ability to compete. What isn’t mentioned is that those policies reduce economic freedoms

Recognizing the popular will and protecting individual rights are hardly parts of liberalism and democracy that can be separated from each other.

by benefiting some firms by limiting the ability of other firms to compete.

He concludes this chapter by stating that

liberalism and democracy do not go together nearly as naturally as most citizens—and many scholars—have assumed. As the popular will increasingly clashes with individual rights, liberal democracy is splitting into its component parts.

As opposed to Mounk’s analysis, however, realizing the popular will (best thought of as our general well-being) and protecting our individual rights are hardly component parts of liberalism and democracy that can be separated from each other. They are achieved, or fail to be achieved, together.

Every liberal democracy reflects a balance between, in Madison’s words, “enabl[ing] the government to control the governed; and in the next place oblig[ing] it to control itself.” Get this balance roughly right and we can protect our individual rights and increase our general well-being. Get it badly wrong and we lose our rights and diminish our well-being. While no one would claim

that the Constitutional Convention got the balance exactly right, they came up with a Constitution that achieved a far better balance between individual rights and general well-being for far longer than anyone could have reasonably expected in 1787. This does not mean we can safely ignore Thomas Jefferson’s warning that the tendency is for “liberty to yield and government to gain ground.” This tendency remains every bit the threat to our well-being that it was in Jefferson’s day.

Favorable comments / Mounk’s pessimism regarding liberal democracy can be appropriate even if his prediction that it will break up, at least initially, into either “democracy without rights” or “rights without democracy” is incorrect.

His third chapter, “Democracy Is Deconsolidating,” discusses several

reasons for pessimism about the future of liberal democracy. He cites evidence that citizens, particularly young people, give “less importance to living in a democracy” and are “increasingly open to authoritarian alternatives.” He also cites evidence that democratic norms are eroding.

While these and other concerns expressed in this chapter are truly troublesome, they have little, if any, connection with Mounk’s argument in Chapters 1 and 2 that liberal democracies are subject to splitting up into either “democracy without rights” or “rights without democracy.” I see this disconnect as a flaw in the book, though one that I find sufficiently interesting to devote most of my review to it. Yet, the remaining chapters contain several interesting observations that should be considered seriously.

Mounk nicely discusses how the early optimism about the political effects of social media has shifted to a more pessimistic view. It was initially thought to be a force to “deepen and spread democracy” by allowing “many-to-many” communication to provide an alternative to the “one-to-many” communication” of

a few large networks. Now the concern is that instead of “connecting erstwhile enemies and overcoming ancient hatreds ... the inverse would come closer to the truth.” Yet he concludes with hope that “once populists capture the government and break many of their promises, they may be rudely reminded of social media’s potential to empower the new outsiders against their rule.”

He makes it clear where he stands on free speech when responding to assertions that if “free speech is invoked as a reason to defend a public discourse that is full of overt forms of racism and microaggressions, then this hallowed principle needs to be sacrificed to the cause of racial justice.” He sees such recommendations as reflecting “an understandable impatience with the conservative defense of the status quo,” but then states that

they ultimately throw the baby out with the bathwater.... [Such comments go] too far.... They embrace principles that would ultimately destroy the very possibility of a truly open and multiethnic democracy.

Mounk follows this with a sensible discussion regarding the opposition to “cultural appropriation,” or the adoption by members of the majority group of “the cultural practices of ethnic and religious minorities.” Except in cases of cultural appropriation to ridicule or denigrate minority symbols or traditions, he argues that “a wholesale rejection of cultural appropriation ultimately stand[s] in stark conflict with the ideas of a truly liberal and diverse democracy.”

He concludes the book with two short chapters containing suggestions—some reasonable and some not-so-reasonable (e.g., tax increases, “restoring basic elements of the welfare state”)—for improving what most of us would recognize as problems with our political process. Despite what appears to me to be a puzzling disconnect between the early and later parts of Mounk’s book, it contains much that people interested in political economy will agree and disagree with. R

A Playbook for Lobbying Government

REVIEW BY SAM BATKINS

Should new businesses ask for permission from regulators to employ their business practices, or beg for forgiveness after employing those practices? For countless startups, the product or service they provide may not have clear regulatory guidelines. For others, nascent businesses can often fly under the radar of

government until they get big enough and profitable enough to draw regulators’ attention.

In a hypothetical world of limited government, small businesses wouldn’t need to devote nearly the resources to regulatory compliance that they do in reality. Yet, here we are; there is incredible demand for startups to not only innovate in their market, but also ensure they can do so with the blessing of regulators.

In *Regulatory Hacking*, Evan Burfield, CEO of a startup incubator called 1776, and J.D. Harrison, an executive with the U.S. Chamber of Commerce, describe the government obstacles that innovative firms face and offer strategies for how small businesses can handle the media, regulators, other bureaucrats, and politicians. To partly answer the question on permission or forgiveness, the authors cite the ridesharing service Uber and argue that, at least in some cities, it may have gone about things the wrong way by entering first and asking permission later.

The authors also argue that Elon Musk is the ultimate regulatory “hacker”—the guy who figures out how to break through the regulatory obstacles. (The book was

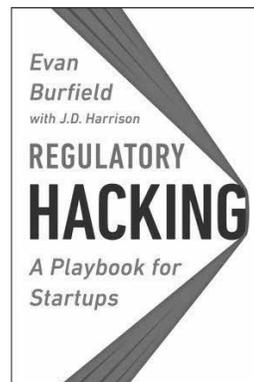
released before Musk’s recent run-in with the Securities and Exchange Commission.) That might make many libertarians reflexively gag, and understandably so, but Burfield and Harrison have a point about

Musk’s success as an innovator. He has built an empire in a variety of green industries that politicians crawl over themselves to support: electric cars, solar homes, and space exploration (just in case the green industry doesn’t work out on this planet).

Musk built his empire largely on the back of an adoring press and politicians willing to hand out subsidies to entrepreneurs in his business sectors, but also because—the authors argue—he successfully followed the “playbook” for influencing government. This is the crux of their book.

Regulatory Hacking is largely a “how-to” guide for startups to manage policymakers at the state and federal level, employing the grassroots, “grasstops” (i.e., opinion-leaders), and common lobbying to apply political pressure. In the words of Burfield and Harrison, “Regulatory hacking is the application of hacker culture to complex markets that are deeply intertwined with government because they meaningfully impact the public interest.”

Government and business / When they talk of “hacker culture,” the authors



**Regulatory Hacking:
A Playbook for Startups**

By Evan Burfield with
J.D. Harrison

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SAM BATKINS is director of strategy and research at Mastercard. The views expressed in this review are his own.

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don't mean the North Korean or Russian "hacker farm" variety. For many in the business community, "hacking" is defined as a tool that allows progress within a complex market faster or cheaper than the status quo. What the authors don't directly state is that virtually every market is intertwined with government at the federal and local level. The book highlights key industries like transportation, energy, and health care, but pick any other industry and government probably has a role.

Uber gets top billing for its ability to disrupt local transportation options—namely the taxi cab cartel—but even the motorized scooter industry is under mounting regulatory pressure in cities. Other than pedestrians, who don't exactly have a strong lobby, there are few incumbent interests yearning to regulate scooters. Nevertheless, cities have been banning scooter leasing companies from operating because they didn't first ask for government permission. Even startup-friendly San Francisco has targeted the scooter business for increased scrutiny recently, while Washington, DC has taken a comparatively laissez-faire approach.

For libertarians, the book is somewhat fatalistic about ever-expanding government. With many startups, not paying heed to local and federal regulators is tantamount to small business malpractice. As a function of size, most small businesses are more focused on innovation than regulatory compliance. Meanwhile, incumbent businesses that have spent years greasing palms can often employ the regulatory state to make life far more difficult for startup rivals.

Europe's recent data privacy regulations known as GDPR are one example of a framework intended to protect consumers. Yet, it has disadvantaged small businesses in the information technology sector, as evidenced by initial reports of Google and Facebook's increasing market share since GDPR went into effect. Many predict similar results from California's attempt to mimic Europe on privacy.

One could argue crony capitalism and regulatory hacking are synonymous, so long as they are done in the public interest. But that term, "public interest," has many

different definitions to different people. A subsidy to the right firm providing public goods or services may be deemed to be in the public interest, even if the firm is a fossil fuel energy company or a publicly funded stadium.

To some extent, there is a division among Americans over government supporting companies. On one hand, many begrudge the special tax breaks or subsidies that large companies receive, while the average taxpayer receives little. On the other, politicians have been falling over

Incumbent businesses that have spent years greasing palms can often employ the regulatory state to make life far more difficult for startup rivals.

themselves to lure Amazon's proposed second headquarters, dubbed HQ2, to their city, and plenty of voters will reward those politicians who ultimately succeeded. If the company were worth \$100 billion instead of \$1 trillion, would the HQ2 fervor be the same? Would politicians ever do the math on tax subsidies appropriated versus the economic benefit of each new job? Probably not, but Amazon might be another "ultimate hacker" for its ability to defeat harmful taxes and receive an endless stream of tax breaks for HQ2.

Tools of the trade / Broadly, the book weaves together anecdotes about successful startups with strategies and tactics on how to influence government and ensure the media is on your side. From innovative child care solutions (Uber for Kids) to identification solutions for government and the private sector, Burfield and Harrison weave plenty of examples of small businesses working with government to survive and, in some cases, thrive.

These stories reinforce the hazy dividing line between "regulatory hacking" and crony capitalism. If a business is able to change a regulation to allow its model to innovate, is that political manipulation or a form of deregulation? Should objec-

tive observers draw the line at government subsidies or refundable tax credits? For every business, dealing with regulators is simply a reality. However, scoring a multi-billion-dollar tax benefit is the province of true experts like Musk.

As evinced by its subtitle, "A Playbook for Startups," the book functions much like a how-to guide for lobbying government at every level and creating a positive media narrative for one's business. For folks inside the Beltway, these tools will sound familiar, but there are countless startups that will find the book's advice helpful.

Getting media on your side is one of the quickest ways to influence policymakers and the broader debate. Develop a popular product that gains reporters'

sympathy and chances are they'll carry your message to voters. And when voters take notice, policymakers typically follow. Burfield and Harrison heap praise on Musk for his ability to charm the media. As they write, "His most meaningful invention is that unique image that we have of Elon Musk, the narrative thread weaving through his entire career and stitching together each of his business ventures, because it's the foundation that has made all of the others possible." Since there is only one Elon Musk, new businesses that want to follow his strategy will likely need to hire a good public relations firm and tell a compelling story.

Lobbying / The naughty portion of the book concerns what is often regarded as the dirtiest part of politics: lobbying. It's somewhat of a testament to the role of government and business that lobbying is as much a necessity to business as innovation and proper accounting. As every business grows and meets the scrutiny of policymakers, it discovers that it must spend millions of dollars to influence government. As the authors note, for the largest companies—e.g., Google—annual lobbying spending approaches \$20 million. In an ideal world, the company would likely find

better uses for that money.

The average citizen shouldn't necessarily begrudge this figure. In some cases, lobbying is necessary to ensure a business's very existence. The authors point to the case of the DNA decoding firm 23andMe, which the U.S. Food and Drug Administration shut down for a time, until intensive regulatory outreach allowed the firm to resume its business. However, for the makers of caffeinated beer and liquor (e.g., the brewer Moonshot), their political outreach couldn't stop government from ending their businesses.

What should concern taxpayers is the clout of lobbying heavyweights to push policymakers to erect regulatory barriers that give lobbyists' clients a comparative advantage. If these moves are pursuant to the "public interest," do they count as regulatory hacking? If a hack is for me but not for thee, is it benign? These are some important questions not directly answered by the book. Of course, it wasn't written as a treatise on regulatory capture or the proper role of government, but as a guide for small businesses to survive potentially onerous regulations. As the authors note, the innovation giants of Silicon Valley don't demand immediate engagement with D.C., but as companies grow, the intersection is inevitable.

Conclusion / Those inside the Beltway will find few surprises in this book, but they are probably not Harrison and Burfield's intended audience. There are plenty of startups outside the Beltway that will soon be encountering local and federal regulators for the first time. *Regulatory Hacking* is a step-by-step manual for businesses to navigate those encounters.

By incorporating relevant anecdotes about successful—and some not-so-successful—startups, the book tells its story through real-world examples, not just empty rhetoric or rehashed American Politics 101. Small businesses with a limited government persuasion may not like the reality the book paints, but they must operate in that reality. If they don't heed the book's advice, they may not be around for long. 

Challenging the Fed on Lehman

◆ REVIEW BY VERN MCKINLEY

A lot of ink has been spilled in the media, academic journals, and a number of prominent books about why Lehman Brothers was allowed to fail in September 2008, at the depths of the financial crisis. Last year, I reviewed one of the more recent of these books, Oonagh McDonald's *Lehman Brothers: A Crisis of Value*

("Is There Value in Revisiting the Lehman Collapse?" Spring 2017). This year, Johns Hopkins University economist Laurence Ball offers his analysis in *The Fed and Lehman Brothers*.

Ball brings considerable expertise to the task. Besides his tenure at Hopkins, he is a research associate at the National Bureau of Economic Research and a consultant for the International Monetary Fund. He has also been a visiting scholar at the Federal Reserve Board of Governors and the Reserve Banks of Boston, Kansas City, and Philadelphia, as well as the Bank of Japan, the Bank of England, and the Reserve Bank of New Zealand.

Ball admits that his book does not unearth much in the way of new, earth-shaking evidence about Lehman and the Fed. But he has spent years painstakingly compiling and assessing the already-existing evidence. He writes, "I soon discovered something that is not widely appreciated: there is a huge amount of hard evidence on these topics that is easily available to anyone." He draws heavily from the report of the Financial Crisis Inquiry Commission (FCIC) and the report drafted by Lehman's bankruptcy examiner, Anton Valukas. He also uses records from the Federal Reserve, Lehman's financial statements filed with the Securities and Exchange Commission, and research by journalists. Ball did make Freedom of Information Act requests for Federal Reserve Board documents on the

AIG rescue, but the Fed declined to release those documents and, when Ball appealed to the courts, they deferred to the Fed's opacity.

How the Fed's justifications are flawed / The book is straightforward. Ball relates the narrative offered by the Federal Reserve and Treasury Department regarding the Lehman Brothers collapse and federal officials' decision not to bail out the bank. He then aggressively argues that the individual components of that narrative are false.

The primary points that he dissects are:

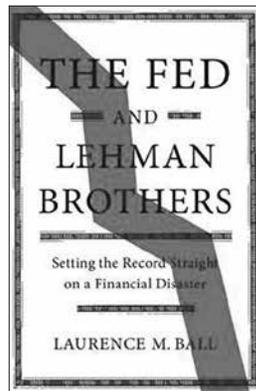
- The New York Fed claimed that it had no legal authority to fund Lehman because Lehman lacked supporting collateral. Ball argues that Lehman had sufficient collateral and thus the Fed had the legal authority.
- Fed officials claimed Lehman was deeply insolvent. Ball argues that Lehman was merely on the border of insolvency.
- Fed officials also said Lehman was too risky to bail out. Ball argues that other rescues, like the one of AIG, were riskier.
- Fed and Treasury officials claimed they reached their "Lehman must fail" decision based on an independent technocratic assessment. Ball argues that Treasury Secretary Henry Paulson made the decision based mostly on political grounds.
- Fed and Treasury officials said they knew that Lehman's unwinding would

VERN MCKINLEY is a visiting scholar at George Washington University Law School and coauthor, with James Freeman, of *Borrowed Time: Two Centuries of Booms, Busts and Bailouts at Citi* (HarperCollins, 2018).

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be a disaster. Ball argues that the authorities believed the fallout would be limited.

- The Fed claimed it did all it could within its power to lessen the effects of Lehman's failure. Ball argues that some of the Fed's actions worsened and accelerated the disorder from Lehman.



The Fed and Lehman Brothers: Setting the Record Straight on a Financial Disaster

By Laurence M. Ball
294 pp.; Cambridge University Press, 2018

An assessment of the many narratives Ball advances and refutes would exceed the limits of space for this review, so I will focus on just a few.

No legal basis / Ball dedicates a significant portion of the book to refuting what I would consider the most outrageous of the Fed's claims: that it lacked legal authority to fund Lehman. Section 13(3) of the Federal Reserve Act gives the Fed authority to undertake such support, provided that any funds advanced to a troubled institution like Lehman must be "secured to the satisfaction of the Reserve Bank."

The lack-of-authority argument was not made contemporaneously with the failure of Lehman in mid-September 2008, but was first advanced by Fed Chairman Ben Bernanke weeks later in a speech to the National Association for Business Economics. According to Bernanke:

Neither the Treasury nor the Federal Reserve had the authority to commit public money.... The Federal Reserve's loans must be sufficiently secured to provide reasonable assurance that the loan will be fully repaid. Such collateral was not available in this case.

He made similar public statements in October and December 2008, on CBS's *60 Minutes* in March 2009, at the Fed's Jackson Hole conference in August 2009, before the FCIC in November 2009 and again in September 2010, and in interviews with the team of the Lehman bank-

ruptcy examiner in December 2009.

According to Ball's research, Bernanke is simply telling tall tales. Ball argues that "Lehman would have needed about \$84 billion of liquidity assistance from the Fed to stay in business over the four weeks from September 15 to October 13," which could have been provided through the Federal Reserve's Primary Dealer Credit Facility (PDCF). He claims that this would have at least sustained Lehman into mid-October 2008, by which time Lehman should have been able to come up with a more permanent solution to its long-term

funding difficulties. He examines the funding side of Lehman's balance sheet and matches the firm's borrowing needs with sufficient collateral (about \$122 billion). His numbers and conclusion are well-supported: "[Lehman] could have avoided its bankruptcy filing if it had received a sufficient loan from the Fed, and the firm had plenty of collateral to secure such a loan."

How deep a hole? / If Lehman was indeed solvent, then lending to Lehman would

The fact that no acquirers stepped up to fund Lehman and take on the risk of deep insolvency indicates continued uncertainty regarding its insolvency.

have fulfilled the Federal Reserve's traditional role as lender of last resort to solvent but illiquid institutions. Ball cites Walter Bagehot on the importance of this role: "Bagehot's basic idea was that a central bank can lend to a bank when a run has disrupted its usual sources of cash, thereby enabling the bank to stay in business." Ball pores through the available financial statements of Lehman Brothers from May and early September of 2008

to conclude: "Lehman was solvent, or at least close to solvent, when it filed for bankruptcy on September 15. Its assets were approximately equal to its liabilities, which suggests it should have been able to pay its creditors."

Given the uncertainties that go along with valuation in the midst of a financial crisis, I find this conclusion less convincing than Ball's arguments concerning the Fed's legal authority. He admits as much: "We will never know for sure whether Lehman's equity based on ideal fair-value accounting was positive or negative." Yet he insists that "Lehman was near the border between solvency and insolvency." The fact that no acquirers stepped up to fund Lehman and take on the risk of deep insolvency indicates continued uncertainty regarding its solvency.

Should the Fed have funded Lehman? / Ball presents clear evidence that under law the New York Fed could have extended credit to Lehman. But simply because the Federal Reserve had the legal power to do so doesn't mean that it *should* have done so. Ball argues for intervention by describing the aftermath of Lehman's failure: "The U.S. financial crisis intensified dramatically after the Lehman bankruptcy." He also cites the justifications for the subsequent AIG bailout a few days after

Lehman was allowed to fail: "One reason was that policymakers had by that time observed the immediate results of the Lehman failure.... All hell broke loose."

Ball argues that this disorder could have been largely avoided if Lehman had been propped up like the Fed and the Treasury did for other institutions. But given all the turmoil in September 2008, it is not at all clear that Lehman's failure can be blamed for all or even most of the turmoil. There were imbalances and mal-investment in the financial sector that needed to be brought into balance and Lehman's failure—along with the failures or near failures during September 2008 of Fan-

nie Mae, Freddie Mac, AIG, Wachovia, Washington Mutual, and others—was merely a signal of how bad these distortions were.

Ball also concludes that a bailout was proper without thoroughly addressing the long-term moral hazard concerns that are at the core of economic arguments against bailouts. Lehman was a poorly managed and possibly corrupt firm that should have been allowed to fail. The U.S. government has been propping up failing individual financial institutions for at least a century and there is evidence that banks and other financial institutions that have benefited from that backstop have taken on greater risk. Ball seems unaware of the fact that

risk-taking will continue to expand because of his policy prescriptions that the Fed should have greater discretion to lend.

Rationalizing it all / I agree with one of Ball's conclusions: during the response to the collapse of Lehman Brothers, the Fed and Treasury were flying by the seat of their pants. The principal policymakers from 2008 have engaged in *post hoc* rationalizations for what they did, and that rationalizing has continued through this fall's 10th anniversary of Lehman's failure. Ball has done his homework and has provided his readers with the contradictions inherent in those rationalizations. R

fully make his case. To be sure, he makes a strong argument that cost-benefit analysis has the power to be good analysis. He also shows cases in which good analysis overcame political pressure. But for someone who was in his job when "four thousand regulations were under discussion," he relates surprisingly little about those discussions when, to make his case, he needed to provide more than just some details about a handful of regulations. He also goes too easy on heads of government agencies, not acknowledging their evident bias. He even makes a simple but telling error in one of his examples of cost-benefit analysis, using an annual figure where he should have used a present value.

Also, as noted above, he wants cost-benefit analysis to evolve into welfare analysis. But even though he discusses welfare often in the book, he never gives readers a clear idea what it is.

To his credit, he deals head-on with some of the major pitfalls in cost-benefit analysis. He devotes a whole chapter, for example, to Friedrich Hayek's "knowledge problem," concerning the difficulty governments have in gathering and employing important information that exists in decentralized form in millions of minds. Sunstein seems to think, though, that he has answered Hayek's objection. I think he hasn't. Also to his credit, even though I

think that his reasoning falls short, he employs cost-benefit analysis in ways that few other advocates dare, including in evaluating the tradeoff between national security policy and civil liberties such as privacy and freedom of speech.

Respecting people's will / The book has many strengths. The best chapter by far is Chapter 3, titled "Willingness to Pay and the Value of Life." In it, Sunstein defends the view that measuring people's willingness to pay (WTP) for something is a good measure

Sunstein Will Be Dancing, But Should He?

◆ REVIEW BY DAVID R. HENDERSON

In his preface to *The Cost-Benefit Revolution*, Harvard law professor Cass Sunstein writes something that readers may not expect:

To date, the cost-benefit revolution has had three defining moments. They stem from the work of presidents Ronald Reagan, Bill Clinton, and Barack Obama.

An approving nod to a Republican president may seem surprising for the Democrat-allied Sunstein, but he credits all three presidents for advancing the use of cost-benefit analysis in the executive branch of the federal government. He gives a nice history of that revolution, starting with Reagan.

From 2009 to 2012, Sunstein headed the Obama administration's Office of Information and Regulatory Affairs (OIRA), the part of the executive branch that enforces the requirement for cost-benefit analysis of major government regulations. Seeing

government up close often makes analytic people cynical, but that hasn't been the case with Sunstein. He emerged from his almost four-year stint in Washington as a strong believer in the power of cost-benefit analysis to lead not only to answers but also to good policy outcomes. In this book, he lays out why and concludes that the cost-benefit revolution "may well turn out to be a transition to something far better, focused more directly on the measurement of human welfare and enlisting unimaginably ambitious strategies to capture and improve the real-world effects of public-sector initiatives." When that happens, he closes, "There will be dancing at the revolution, and I'm coming."

Unfortunately, he doesn't



The Cost-Benefit Revolution

By Cass R. Sunstein

266 pp.; MIT Press, 2018

DAVID R. HENDERSON is a research fellow with the Hoover Institution and emeritus professor of economics at the Graduate School of Business and Public Policy at the Naval Postgraduate School in Monterey, CA. He was a senior economist with President Ronald Reagan's Council of Economic Advisers. He is the editor of *The Concise Encyclopedia of Economics* (Liberty Fund, 2008).

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of value. That won't surprise most economists, but he argues this case particularly well. Indeed, this chapter would make an excellent reading for a cost-benefit analysis course.

Consider, for example, the argument that using WTP biases the analysis in favor of those who are typically willing to pay a lot, namely, the rich. Sunstein shows that's not true. He points out that instead of paying, say, \$90 to eliminate a one-in-100,000 risk of dying, some people might want to use that money for more pressing wants such as food, medical care, or clothing. In that case, he concludes, WTP is a good foundation because "people are hardly helped by being forced to pay for regulatory benefits that they do not believe to be worth buying."

Sunstein also defends WTP on grounds that will appeal to those who favor freedom. He writes, "Government should allow people to make choices about how to allocate their resources, not necessarily because people know best, but because they should be treated as adults rather than as infants." It's particularly encouraging to see him write this because his well-known earlier view, expressed in his coauthored book *Nudge*, was that government should treat people as—well, maybe not infants, but not quite adults either. He has consistently thought that people make bad choices, but his defense of their right to make those choices is more full-throated than in his earlier work.

Knowledge problem / Probably the weakest chapter is Chapter 4, "The Knowledge Problem." In it, Sunstein addresses the issue that Hayek raised in his classic 1945 article, "The Use of Knowledge in Society." Hayek argued that the information required for an economy to work exists in the minds of the economy's players and is employed organically in a free marketplace, but cannot be aggregated in a way that would allow even brilliant central planners to run an economy well. This article drove the final intellectual nail into socialism's coffin, as socialist economist Robert Heilbroner admitted 44 years later.

Sunstein points out that the same problem could hamper government officials' attempts to get the information they need to make new regulations that pass a cost-benefit test. But, he believes, the American rule-making process mitigates this problem. If he were to argue that getting the information required to make an effective rule is less daunting than getting the information to plan a whole economy, I would agree. But he seems highly confident that the feedback that regulators receive

If feedback from the public helped inform regulators, Sunstein would have numerous examples to report. But the book reports none.

when they put out proposed regulations for public comment solves the knowledge problem. This process, he argues, helps them accumulate the knowledge that is distributed in many minds.

But it's hard for me to share his faith in the rulemaking process. During the Clinton administration, I wrote a comment on some restrictions on cigarette advertising proposed by the Food and Drug Administration. Apparently—and I'm going from memory here—the comments against the regulation outnumbered the comments in favor. So what did the regulators do? Extended the time limit and got word to thousands of teachers to have their students write comment letters as an assignment. It's easy to imagine what side of the issue K-12 students, "encouraged" by their teachers, would take. Voilà! The number of comments favoring the regulation ended up exceeding the number against. I'm pretty sure, though, that the regulators didn't give much attention to the children's comments—or to mine.

Perhaps Sunstein could have better persuaded me and could persuade other skeptical readers by providing some examples where the comment process uncovered information that led regulators to change their proposals. Recall that he was involved in approximately 4,000 regulations during

his time at OIRA. Surely, if feedback from the public helped inform regulators, he would have numerous examples of that. Yet, how many such examples does he provide in the book? Zero.

He does, though, provide a good example of regulators—including himself—tripping up on the knowledge problem. On the second-to-last page of the book, he describes how the Affordable Care Act's incentives for doctors to use electronic medical records have "caused them to spend significantly less time with their patients—and significantly more time entering information into a computer." He doesn't tell us whether that provision was open

for public comment, but he does write, "I was involved in many discussions of the issue in government, and no one raised the problem." In other words, there were a number of smart people involved in that discussion—Sunstein clearly is smart—and no one raised what I, an onlooker, thought at the time was an obvious problem. That's breathtaking.

In the same chapter, he says that governments can adjust regulations on the fly, writing:

With respect to security lines at airports, for example, they can make rapid adjustments as the number of travelers varies over time. With respect to traffic fatalities, they can test interventions to test what works and what does not. The sky is the limit here.

Much more likely is that the deadening incentives within the bureaucracy are the limit.

Sunstein seems to lack skepticism about the motives and ability of government officials. In one paragraph, he refers to an OIRA study during the George W. Bush administration that found that federal government agencies overestimated the benefit-cost ratio 47% of the time and underestimated it 30% of the time. In the very next paragraph, he concludes that

“there does not appear to be a large systematic bias in any one direction.” But 47% overestimation versus 30% underestimation suggests a fairly large bias in favor of regulation.

Myopia / As I mentioned, there are some very good sections of the book. One is Sunstein’s demonstration that the “Precautionary Principle” is inherently contradictory, a case he made in *Regulation* back in 2002. (See “The Paralyzing Principle,” Winter 2002–2003.) There are various versions of this principle. One he quotes is:

If an action or policy has a suspected risk of causing severe harm to the public domain (affecting general health or the environment globally), the action should not be taken in the absence of scientific near-certainty about its safety. Under those conditions, the burden of proof about absence of harm falls on those proposing an action, not those opposing it.

Sunstein points out the obvious problem. Efforts to limit or reduce risk can create risk. For that reason, “the very steps mandated by the Precautionary Principle violate the Precautionary Principle.”

But there are also other bad sections. One of the worst is an illustration of Sunstein’s that contains not one, but two serious errors. He gives an example of a fuel-efficient car that saves its owner \$2,000 annually versus a less fuel-efficient car that costs \$500 more upfront. He claims the difference in cost is \$1,500. See the problem?

In a telephone conversation, he quickly admitted to me that for his example to work, he should have said that the *more* fuel-efficient car costs \$500 more upfront. But I pointed out a much bigger problem: his assumption implies that the car dies after one year—he considers only one year’s worth of fuel savings. The fuel-economy savings in his example, using a reasonable interest rate and a car life of 10 years, should be over \$15,000 over the life of the car.

That mistake didn’t bother him, he said, because he was looking for a num-

ber that the car buyer could compare to the \$500 in added cost. Although I left the conversation satisfied by that explanation, I am now rather stunned by it. Sunstein, as noted earlier, coauthored the book *Nudge*. In it, he and economist Richard Thaler argued that consumers are often myopic, tending to look at the numbers right in front of them and not thinking about implications for the more-distant future. Shouldn’t Sunstein, of all people, have admitted that he himself was guilty of the myopia that he ascribed to the car buyer? By the way, evidence from the used car market shows that consumers do take account of gasoline costs over much more than a year. (See “Working Papers: CAFE Standards,” Winter 2015–2016.)

What of liberty? / As mentioned earlier, Sunstein subjects the issue of national security versus privacy, and even freedom of speech, to a cost-benefit analysis. Concerning privacy, he argues against what he calls “Snowdenism,” a term he coined from whistle-blower Edward Snowden, who exposed the massive and arguably illegal gathering of Americans’ telecommunications data during the Obama admin-

Shouldn’t Sunstein, of all people, have admitted that he himself was guilty of the myopia that he ascribes to the car buyer?

istration. Snowdenism, writes Sunstein, reflects enthusiasm for “aggressive precautions against risks” of oppressive government and is an instance of detrimental use of the Precautionary Principle. He argues that the government might simply want to engage in surveillance that saves lives, not to malevolently snoop through Americans’ communications. But did Snowden argue against surveillance? I don’t recall his doing so. Instead, he blew the whistle on federal government surveillance *without warrants*. Sunstein doesn’t mention that important fact at all.

Nor does he mention, although he

surely knows, that in 2013, national intelligence director James Clapper perjured himself before the Senate Intelligence Committee when he said that the National Security Agency did not “wittingly” collect data on millions of Americans. Clapper later admitted that his categorical denial was the “least untruthful” statement he could make. He was never held to account for uttering something that was nonetheless untruthful. In a chapter that deals seriously with surveillance, and in a book by someone who seems to have enormous confidence in federal bureaucrats, I would have expected Sunstein to at least confront the issue of lying government officials.

In his second-to-last chapter, he applies cost-benefit analysis to the issue of free speech. He points out that the whole idea of limiting speech only when there is a “clear and present danger,” to use the words of Supreme Court Justice Oliver Wendell Holmes Jr., isn’t really consistent with a cost-benefit test. Even though Holmes used the language to justify the conviction of someone speaking out against U.S. involvement in World War I—hardly a case of a speaker presenting a clear and present danger to the nation—Sunstein notes that

the court in *Brandenburg v. Ohio*, which has now become the standard way courts look at this issue, read “clear” to mean “likely.” What if the danger is not in the present but in the future with a

high probability? That’s a good question, and I was pleased to see Sunstein wrestling honestly with a tough problem.

One of the arguments against relying on cost-benefit analysis to decide whether to allow free speech is what Sunstein calls “institutional bias.” When government officials invoke a risk of harm, he notes, “they are often trying to insulate themselves from criticism.” He thinks that the “clear and present danger” test protects speech too much but “is incalculably preferable to what would emerge from open-ended balancing by unreliable balancers.” His bottom line is that the clear and pres-

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ent danger test hasn't caused much mischief in the last 50 years but it might do so in the next 50.

I should point out one especially disturbing sentence in the book. In reading it, remind yourself that Sunstein has taught constitutional law at some of the top law schools in the country and, thus, has surely read the U.S. Constitution many times. In discussing the idea of having a cost-benefit agency that is independent of the president, he writes, "True, no president is likely to love that idea; it takes control away from the commander-in-chief." The U.S. president is commander-in-chief of the U.S. *military*, not of the executive branch. Sunstein offers no discussion of the military. So is this simply

a slip-up, or are we getting a little insight into the amount of power he thinks the president should have? I hope the former, but I don't know.

Conclusion / Throughout the book, Sunstein argues that cost-benefit analysis is simply a step toward what is really desirable: namely, welfare analysis. The term "welfare" comes up again and again, but not once does he explain what he means by it. He seems to have a feel for it, but he doesn't share it.

So, when the revolution comes, maybe only Cass Sunstein will know it has arrived. He will be dancing, but will he be dancing alone? Should he dance at all? R

decreased both relatively *and* absolutely—an incredible feat, given massive increases in population." The book's appendix documents the many ways in which life has been improving over the long run.

The Miracle / Goldberg borrows the term "the Miracle" to refer to the Industrial Revolution and ongoing human progress. He primarily aims to convince the reader that the Miracle is happening. *Why* it is happening is a lower priority, though he offers two possible answers.

The first is English author and politician Daniel Hannan's view that, as Goldberg puts it, "England did it." That is, the English people's "weirdness" or "exceptionalism" produced democratic capitalism. According to Goldberg, Hannan sees five English characteristics that set the stage for political and economic progress. Of those five, "common law" is paramount. Goldberg quotes Hannan to define "common law: a unique legal system that made the state subject to the people rather than the reverse." Goldberg shares what Hannan writes about common law and adds that "English common law recognized the rights of all Englishmen, which made all the difference."

The second view is offered by University of Illinois at Chicago professor Deirdre McCloskey. Prior to the 19th century, people spurned technological progress. But that suddenly changed; people began to appreciate and employ innovations and respect innovators, unleashing capitalism on the production of goods.

Goldberg acknowledges that various influences combined to cause capitalism. His greater concern, however, is

whether the good times will continue to roll. He is pessimistic.

While the capitalist economy is dynamic, "human nature" is static. Human nature comprises the "basal instincts" that we all share. There are seemingly positive aspects such as "cooperation," "compassion," and a desire for

Corrupting the Miracle

◆ REVIEW BY PHIL R. MURRAY

In *Suicide of the West*, *National Review* senior editor and American Enterprise Institute scholar Jonah Goldberg diagnoses America's current political, economic, and cultural condition. He aims to persuade the reader of four points:

- The citizens of the world are experiencing booming economic success.
- This success is fragile.
- "Human nature" is real and stubborn.
- Even though the dark side of human nature cannot be excised, it can be controlled. Failing to do so will doom us to cultural, economic, and political failure.

Goldberg likens democratic capitalism to a goose that lays golden eggs. He presents a graph of the world's gross domestic product from the year 0 to 2000. Viewing the graph, one cannot distinguish the world's output of goods and services from zero for the first 18 centuries. Thereafter, production grows exponentially. In numerical terms, "Global GDP has soared, from an estimated \$150 billion in A.D. 1 to more than \$50 trillion

as of 2008" (measured in "1990 International Dollars").

Humanity's success is not just material. It also appears in human life's quality and quantity. Infant mortality is plummeting and life expectancy is rising. Although our numbers are greater, we do not live at a sub-

Goldberg aims to convince the reader that the Miracle of human progress is real. Why it is happening is a lower priority, though he offers two answers.

sistence level. Rising productivity increases our standard of living. Goldberg relays Brad DeLong's estimate that, from the dawn of the Industrial Revolution to today, average income in the world rose "from \$180 per person to \$6,600 per person." Concerning global poverty, Goldberg reports, "The number of people considered poor has

“admiration.” Consider human history as far back as you know. Throughout it, people cooperated because they could see that more could be accomplished by coordinated effort. Out of that grew such virtues as compassion and such sentiments as the desire to be admirable. Compassion seems to be timeless and universal; people at different times and in different cultures tend to feel sorry for the less fortunate. Seeking “admiration” means wanting to be liked. Goldberg quotes Adam Smith, “Man naturally desires, not only to be loved, but to be lovely; or to be that thing which is the natural and proper object of love.”

The negative aspects of human nature include “greed,” “violence,” and “romanticism.” Some people think greed is an aspect of capitalism. They are wrong, at least to the degree that greed predates capitalism. Some also think violence is a modern phenomenon. They too, are wrong; Goldberg cites several scholars on this matter. Here’s McCloskey again: “Conquest, enslavement, robbery, murder—briefly, force—has characterized the sad annals of humankind since

Cain and Abel.” To recap, human nature, whether an inclination to cooperate or be greedy, is natural. The good must be encouraged and the bad must be discouraged. Human nature must be “channeled” toward good ends. Goldberg maintains that we are now failing at that task.

Corruption and the state / He writes of “corruption,” by which he means something other than the standard public official taking a bribe. “I argue,” Goldberg elaborates, “that political ideas and movements based upon the romantic idea of following our feelings and instincts can best be understood as *corruption*.”

To him, romanticism is not a movement in any subject of the humanities. Rather, it

is “a school of rebellion against the unnatural nature of the Enlightenment and all of the Enlightenment’s offspring: capitalism, democracy, natural rights, and science.” He invokes one of America’s founders to help us understand:

As Jefferson warned, “The natural progress of things is for liberty to yield, and government to gain ground.” My only quibble with Jefferson here is that he chose the wrong word. The dynamic he was describing was not progress but decay, or corruption.

A good example of contemporary corruption is the administrative state. The roots of the administrative state in America go back a hundred years to the Progressive Era. Progressives aimed to use government to make society better. Goldberg quotes Princeton economic historian Thomas C. Leonard’s description of the progressive mindset: “First, modern government should be guided by science and not politics; and second, an industrialized economy should be supervised, investigated, and regulated by the visible hand of a modern administrative state.”

Progressives trust “experts.” Goldberg knows how progressives think. “If you have the ‘scientific’ facts on your side, why would you put the question before the voters?” He is no fan of President Woodrow Wilson. Among his reasons: “Wilson believed that the science of administration could elevate man above his nature and the people he serves. The old dream of the perfectibility of man would be achieved in, of all types, the bureaucrat!” Thus, we have the administrative state.

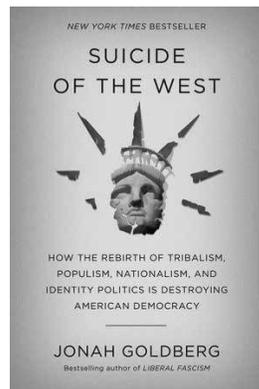
The core of the administrative state is big government. He defines it as “a vast complex of bureaucrats and regulators—and the rules they work by—outside the constitutional order.” For example, the

2010 Affordable Care Act granted overwhelming authority to the secretary of health and human services. Some government agencies tax at their discretion, without authorization from legislatures. Citizens find themselves afoul of regulations issued by the Environmental Protection Agency, the Equal Employment Opportunity Commission, the Internal Revenue Service, and so forth, and their cases are adjudicated by an administrative law judge, not a jury of their peers.

This form of government is unconstitutional, Goldberg protests. He quotes Columbia University law professor Philip Hamburger to explain why: “The administrative regime consolidates in one branch of government the powers that the Constitution allocates to different branches.” That is, the administrative state violates the separation of powers, combining legislative, enforcement, and judicial powers in the federal executive branch. One danger of this type of governance is that it will not reflect the will of the people, but of government bureaucrats.

Unlimited government is another danger. Goldberg frames it this way: “There is no limiting principle inherent to the idea that a caste of experts should be empowered to do whatever they think is right.” Although agents of the administrative state may have good intentions, they will err. Goldberg recalls the case of the EPA attempting to remove polluted water from mines in Colorado and unintentionally releasing it into the Animas River. Evidently no EPA personnel were fired for that, though the agency was guilty of perpetrating the very harm it was supposed to prevent. Without a check on incompetence, expect more of it.

Administrative law is not just unconstitutional; it produces bad economic outcomes. Goldberg introduces the idea of “regulatory capture,” or “guild economics” as he calls it. In general, established practitioners dominate bodies that grant occupational licenses and they block upstarts from entering those occupations. Local governments in particular act to preserve the status quo for taxi cab companies at



Suicide of the West: How the Rebirth of Tribalism, Populism, Nationalism, and Identity Politics Is Destroying American Democracy

By Jonah Goldberg
453 pp.; Crown Forum,
2018

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the expense of Uber and its drivers. Regulatory barriers that thwart new businesses also harm consumers.

Guilds have existed for hundreds of years and occupational licensing has been covering an increasing number of occupations for decades. The standard of living has nevertheless increased. One might thus reason that technological progress will trump regulatory barriers in the future, but Goldberg is skeptical of that idea. “For every ‘disruptor’ [like Uber] that puts a crack in the façade of the regulatory state, allowing us to see what might lie on the other side, there are a dozen examples of how that façade is getting thicker and more impenetrable.” In other words, he doubts that entrepreneurs and their innovations will continue to save us.

Besides government and the market, other institutions are weakening. Take marriage and the family. “Approximately half of the children born to married parents in the 1970s saw their parents part, compared to only about 11 percent of those born in the 1950s,” Goldberg observes. He concedes that “the transformation of ideas about marriage had some benefits”; no one would deny the abused wife’s right to exit, for example. Yet he emphasizes research indicating the negative effects of parental separation upon children. For instance, he relates, “The Brookings Institution’s Isabel Sawhill—no Bible-thumping right-winger—found that 20 percent of the increase in child poverty since 1970 can be attributed to family breakdown.” Goldberg exalts the family. “By any measure,” he claims, “the most important mediating institution in any society is the family.” He infers that if we lose families, we will lose capitalism and civilization itself.

Conclusion / Society is at a critical juncture. The left argues for a larger role of government in the economy and in cultural affairs. The right is turning to tribalism, populism, nationalism, and identity politics. Goldberg generally disapproves of these trends.

Obamacare was an awkward interven-

tion into health care markets. The Trump administration’s tariffs are likewise a bungling attempt to benefit some American producers at the expense of American consumers and other American producers. Populism, nationalism, and identity politics may be born of group solidarity, but if taken to their limits they become toxic. If the left goes too far with socialism, we’ll get statism. If the right goes too far with nationalism, we’ll also get statism.

He borrows from his *National Review* colleague Yuval Levin to state the problem. Statism, which is essentially too much bad government, weakens the institutions between individual autonomy and coercive authority. Without “mediating institutions” such as the family, the church, volunteer organizations, etc., we cannot effectively deal with the destructive side-

effects of capitalism such as unemployment in the wake of technological progress.

Goldberg does not close with a list of policy recommendations. Instead, he recommends putting God back into our lives. Without God, he contends, we seek “fulfillment, belonging, and meaning in tribes and crowds.” He overlooks that religiosity can also descend into tribalism.

“The only solution to our woes,” he concludes, “is for the West to re-embrace the core ideas that made the Miracle possible, not just a set of policies, but as a tribal attachment, a dogmatic commitment.” Going tribal can apparently be a good thing. Goldberg speculates that “under the right circumstances, our tribal nature can be grafted to a commitment to liberty, individualism, property rights, innovation, etc.” Is that the libertarian movement? R

You Didn’t See It Coming

◆ REVIEW BY PIERRE LEMIEUX

“Can it happen here?” ask 19 different contributors, most of them law professors, in this interesting book edited by Cass Sunstein. “It” is tyranny or, as they say more discretely, “dictatorship” or “autocracy,” which is further laundered as “authoritarianism.” This is a crucial question that must be answered squarely. The

book gives many good but incomplete—and sometimes question-begging—answers.

Sunstein is a well-known law professor, now at Harvard University, who headed the White House Office of Information and Regulatory Affairs during Barack Obama’s first term as president. A prolific author, he has also written in the field of behavioral economics, sometimes trying—and failing, according to some—to reconcile regulation with the idea of consumer sovereignty and economic efficiency. (See “Paternalism and Psychology,” Summer 2006.) With economist Richard Thaler, he helped to originate the idea of government “nudging” individuals toward the presumed best

choices without actually forcing them to choose. (See “A Less Oppressive Paternalism,” Summer 2008.)

Prudent optimism / Some of the book’s contributors are optimistic that the United States can avoid authoritarianism. University of Chicago law professor Eric Posner as well as Sunstein himself argue that fascism and dictatorship are very unlikely to happen here because of the United States’ diversity, decentralized power, and legal and constitutional protections. But Sunstein includes a caveat: “If the American project is to be seriously jeopardized, it will almost certainly be because of a very serious security threat.”

What quickly becomes apparent as one reads the book is that the authors

PIERRE LEMIEUX is an economist affiliated with the Department of Management Sciences of the Université du Québec en Outaouais. His latest book is *What’s Wrong with Protectionism* (Rowman & Littlefield, 2018).

are specifically concerned about right-wing fascism. None of the contributors defines fascism, but we understand that it is something like Mussolini's Italy. The danger of Donald Trump is frequently mentioned, but left-wing authoritarianism is not discussed.

Psychologist Karen Stenner and New York University business professor Jonathan Haidt argue that authoritarianism "is no momentary madness. It is a perpetual feature of human societies." In their estimate, one-third of individuals have an authoritarian personality. (Many will question the measure they use to determine this, related to a survey question about preferred child education.) They develop a model in which both "authoritarian personality" and "threats to social oneness" explain populism (of the right) and provide some empirical verification for this model in Trump's America, Marine LePen's France, and the United Kingdom's Brexit vote. They venture that some adjustments may be required to liberal democracy in order to avoid authoritarianism, such as avoiding too much diversity from immigration.

Their model doesn't consider whether a policy of "live and let live" would be better than more regulation. Perhaps authoritarians would be tamer if they were left alone?

"No, it can't happen here," writes George Mason University economist Tyler Cohen. "Not anytime soon." This would make him an optimist if it were not for the reason he gives. A takeover of the American government by fascists or any other radical group is impossible, he argues, because government "is so large and unwieldy": "*Big government is useful precisely for (among other reasons) helping to keep government relatively small*" (Cowen's emphasis). Fascists were able to take over Germany and South American countries, for example, because their governments

were small by today's standards.

This is an interesting theory, but it suggests that we can't fall under fascism because we already have it. In light of the Trump experiment, we may concede that, up to a certain point, the administrative state, however close we may think it is to soft fascism, is still better than the whims of a strongman. But other contributions in the book cast doubt on the theory that a heavily interventionist, apparently too-big-to-manage state cannot be co-opted by an authoritarian.



**Can It Happen Here?
Authoritarianism
in America**

**Edited by
Cass Sunstein**

**496 pp.; Dey Street
Books, 2018**

It could happen stealthily

Most of the book's contributors are pessimistic or cautious about the country's prospects of avoiding authoritarianism. If it happens here, it would probably happen slowly. University of Chicago law professor David Strauss writes: "There will have been no single, cataclysmic point at which democratic institutions were

demolished. For the same reason, the steps towards authoritarianism will not always, or even usually, be obviously illegal." Like other contributors to the book, Strauss gives the impression that the state should do everything he thinks is good (like the New Deal) and nothing he believes is bad. Still, his article provides an interesting introduction to constitutional law.

Timur Kuran, an economist and political scientist at Duke University, develops an interesting model of cascading intolerance that builds a road to serfdom different from the one that Friedrich Hayek foresaw. Trump, he says, is more a symptom than a cause. The problem is the clash between two "intolerant communities": "identitarians," who define individuals in terms of politically correct minority groups; and "nativists," who define individuals as part of the majority. Without a moderate middle and "a return to policies based on mutual respect and willingness

to seek common ground," the system may reach a hatred-filled equilibrium or else produce a demagogue offering to one of the intolerant communities the means of crushing the other. The difficulty of collective action undermines the organization of a moderate middle.

One big step toward authoritarianism would be the proclamation of a state of emergency in the face of a real or fabricated security crisis. As noted by Yale law and political science professor Bruce Ackerman and by University of Chicago law professors Tom Ginsberg and Aziz Huk, the U.S. president's power to make war and declare a state of emergency, possibly followed by the mass arrest of individuals on government watchlists, is less constrained than in many Western countries.

Under the title of "How We Lost Constitutional Democracy," Ginsberg and Huk's chapter describes how the United States is vulnerable to "the most prevalent form of democratic backsliding: the slow and tortuous descent in partial autocracy." Except for the difficulty of amending it, the U.S. Constitution is not exceptional from the point of view of preventing democratic backsliding: it can be sidestepped, in some cases more easily than in other countries. Current or recent examples in other countries—Hungary, Poland, Turkey, Venezuela—show that each power grab may be legal in itself up to a certain point, but eventually no resistance to the strongman is feasible. They write, "We would, in short, do well to reject feel-good talk about American exceptionalism and embrace some of the founders' bracing and necessary trepidation about the future."

Many contributors to *Can It Happen Here?* use the term "democracy" to mean free elections and individual freedom. But we must realize that democracy itself can lead to authoritarianism. Ginsberg and Huk point out how populist leaders claim to embody "the authentic voice of the people." They quote Trump who, in a May 2016 campaign rally, expressed his fuzzy organicist conception of the *volk*: "The only thing that matters is the unification of the people—because other people don't mean

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anything.” As “other people” are often (but not necessarily) foreigners, a national security crisis is an ideal opportunity to fuse the leader and his people.

One of the most important messages of the book: most people will realize that they are living under a dictatorship once it is already well entrenched.

It happened before / Columbia University political scientist Jon Elster provides a historical example of how, in a sophisticated country, an autocrat can grab power in a few steps, each of which is not decisive except for the last one. Within just one year in 1848, Louis Napoléon Bonaparte rose to dictatorship despite three distinct branching points where he could have been stopped legally. His political opponents, including Alexis de Tocqueville and the poet Alphonse Lamartine, failed to do so because of wishful thinking, lack of organization, and political ambition.

One strong point of the book is its discussion of how, as University of Chicago law professor Geoffrey Stone puts it, “It would be a grave mistake to think that ‘it can’t happen here.’” In some ways, it has already happened in America. These precedents cast a long shadow. Stone reviews the following events:

- Against the backdrop of an undeclared war with France, John Adams’s Federalists adopted the Alien Act and the Sedition Act of 1798. Matthew Lyon, a congressman from Vermont, criticized Adams’s “ridiculous pomp, foolish adulation, and selfish avarice,” a charge deemed to bring the president into “disrepute.” For that, Lyon was prosecuted and sentenced to prison.
- During the Civil War, Abraham Lincoln suspended habeas corpus and imposed martial law. Between 13,000 and 38,000 civilians were imprisoned, some for simply criticizing the war.
- During World War I, “aggressive federal prosecutors and compliant federal judges soon transformed the [Espionage] Act [of 1917] into a full-scale prohibition of seditious

utterance.” The Justice Department prosecuted more than 2,000 individuals under the act.

- The Sedition Act of 1918 was even more restrictive of free speech. During the Red Scare of 1919–1920, “more than five thousand people were arrested on suspicion of radicalism,” including “Eugene V. Debs, who had received almost a million votes as the Socialist Party candidate for president in 1916.”
- During World War II, against the advice of the Justice Department, Franklin D. Roosevelt ordered the internment of 120,000 men, women, and children of Japanese descent, of which 70,000 were American citizens.
- During the McCarthyism period, the leaders of the American Communist Party were prosecuted. The Supreme Court approved, with only one justice dissenting.

Throughout American history, Stone writes, the government has often been busy stifling dissent. During the Vietnam

It would be a grave mistake to think that authoritarianism can't happen in America, because at various times in history it already happened.

War, however, individual rights were better protected. At last, the Supreme Court stood firm in defense of the First Amendment. But that did not prevent National Guardsmen from firing into a crowd of student protestors at Kent State University one month after California governor Ronald Reagan was reported saying about campus militants, “If it takes a bloodbath, let’s get it over with.” Nobody is perfect, but politics has a way of making most people worse.

Fascism came to America under other forms. Slavery was fascism, but it could also be seen as socialism. Is there a real difference between the two systems? Slavery defender Hugh Fitzhugh argued that “slavery is a form, and the very best form,

of socialism.” (See “A Coherent Authoritarian,” Winter 2015–2016.) Strangely enough, *Can It Happen Here?* nowhere mentions the eugenic tyranny that gripped America in the Progressive Era and eventually led to the involuntary sterilization of 30,000 persons. (See “Progressivism’s Tainted Label,” Summer 2016.)

Hope and weak links / One of the contributors, Harvard law professor Martha Minow, analyzed the Japanese internment episode in more detail, asking whether mass detentions without process could happen again in the United States. A Japanese-American, Fred Korematsu, challenged his internment order in court. He took his case all the way to the Supreme Court, where he lost in 1944. Despite the subsequent rehabilitation of Korematsu, to whom Bill Clinton awarded the Presidential Medal of Freedom in 1988, the Supreme Court had never overturned this infamous decision. Minow expressed the fear that *Korematsu v. United States* could be used as a precedent, including in public health scares.

That was true until very recently. Minow published her chapter before the 2018 decision in *Trump v. Hawaii*, where the Court finally and forcefully repudiated

Korematsu. Wrote Chief Justice John Roberts in the majority opinion, “*Korematsu* was gravely wrong the day it was decided,” and “has been overruled in the court of history.” That’s a point for the more optimistic contributors to *Can It Happen Here?* It is not a little ironic that what led the Court to revisit and repudiate *Korematsu* was Trump’s travel ban—though the Court did ultimately allow a watered-down version of the ban to take effect.

A ray of light is not the sun. Some of the legal scholars who contribute to Sunstein’s book show a naivety that does not bode well for the future. Yale law professor John Balkin is correct when he writes that “Trump is merely a symptom ... of a serious problem with our political and

constitutional system.” The 45th president is “straight out of central casting for demagogues: unruly, uncouth, mendacious, dishonest, and cunning.” But Balkin’s article is in large part a succession of clichés typical of the sort of establishment thinking that dutifully prepared the terrain for Trump: for example, the government is at the service of the “[political] donor class” and has been unable “to reconcile globalization with democracy,” the implication being that the former must yield to the latter and the individual to the collective.

New York University law professor Stephen Holmes also offers a disappointing chapter. He makes some interesting points against gerrymandered elections and polarized primaries, the danger of temporary democratic majorities, “competitive overpromising” (Holmes’ emphasis) by politicians, the opaque security state, and the power of government to control dissent by using government agencies. But his grist is buried under the shaft of bad economics and pure clichés or contrivances such as “the weakening of the welfare state,” “the puppets of global finance,” economic insecurity, the disappearance of the citizen-soldier and its power to bully the rich, and so forth. Add a few meaningless or confused mantras such as “memory loss at the collective level” and “society’s sense of future possibility.” For good measure, Holmes evokes “a society where a loaded firearm is just another household appliance.” Unwittingly, he demonstrates one reason why one-third of the American electorate voted for Trump.

Holmes exemplifies the statist elite suddenly surprised that the vast power they advocated for, and granted to, the state is being used by politicians not of their own tribe. They don’t realize that tyranny, not nirvana, is what happens when people put all their hopes in government, as Anthony de Jasay argues (notably in his 1985 book *The State*). How can these elites complain so much about government’s actions and yet not question its power? They had taken over the government and were pushing their brand of soft fascism when Trump displaced them.

Government power / It is remarkable that virtually none of the contributors to *Can It Happen Here?* mentions government power as a major reason for the danger of authoritarianism. What about reducing that power, regardless of whether it is the Democrats or the Republicans who would hold it? Chain Leviathan! Most of the contributors, on the contrary, seem to love government power, provided it is used to impose their own preferences. (I interpret Tyler Cohen’s argument about why authoritarianism can’t happen in America as the mere empirical hypothesis that the more power government gets, the less it can use that power in arbitrary ways.)

It is true that government power may result from people’s authoritarian tendencies. But statecraft, if such a thing can be beneficial, should include preventing these tendencies from expressing themselves in police and military actions. If the state is justified, it must be to temper, not amplify, mob clamors.

Despite its failings and establishment biases, *Can It Happen Here?* presents interesting theories about the possible roads and obstacles to tyranny. Some of the chapters are remarkable. And even the book’s failures and biases can teach something. It is by eliminating error that we approach the truth. R

Minding the Consequences

REVIEW BY GEORGE LEEF

I had heard about Nassim Nicholas Taleb for years, going back to his 2001 book *Foiled by Randomness*, which *Fortune* named one of the 75 “smartest books we know” in 2005. Taleb followed that with *The Black Swan* in 2007 (probably his most famous work), *The Bed of Procrustes* in 2010, and *Antifragile* in 2012. But I had not read any of his books until his latest, *Skin in the Game*. For reasons that aren’t explained, he calls these five books “The Incerto” and describes the whole project as “an investigation of opacity, luck, uncertainty, probability, human error, and decision making when we don’t understand the world.”

That’s quite an undertaking.

Taleb currently holds a part-time post as professor of risk engineering at New York University’s Tandon School, but he began his career as a market trader who faced risk every day. He was very good at that, making enough money that he was able to devote increasing amounts of his time to reading, thinking, and writing. His views are shaped by his distinctive career path. He maintains that “the knowledge we get by tinkering, via trial and error, experience, and the workings of time—in other words, *contact with the earth*—is vastly

superior to that obtained through reasoning, something self-serving institutions have been busy hiding from us.” (Emphasis in original.)

Ignoring long-term consequences / The book’s principal concern is that decisions are often made by people who don’t stand to directly gain if the decisions prove right or lose if they prove wrong. That is, these decision-makers have no “skin in the game.” For Taleb, this is not just an incentive problem but also a moral one because he believes decision-makers are obligated to be “sharing in harm, paying a penalty if something goes wrong.”

His first example of a disastrous decision made by people without skin in the game is the Obama administration’s 2011 intervention in Libya. Encouraged by intellectual “interventionistas” who claimed that Muammar Qaddafi had to be removed from power because he was a

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dictator, the United States helped Qaddafi's enemies overthrow him. The result has been an even worse regime in Libya that tolerates slave markets. The trouble with allowing people who have no skin in the game to make such decisions, Taleb argues, is that they think only about the immediate effect of their decisions and not the subsequent effects, that they don't distinguish between multidimensional problems and their single-dimensional understandings, and that they don't learn from feedback.

Another case where the lack of skin in the game led to ruin was the housing bubble and subsequent banking collapse. Here is Taleb's analysis of the crisis:

Because of the accumulation of hidden and asymmetric risks in the system, bankers, master risk transferors, could make steady money from a certain class of concealed explosive risks, use academic risk models that don't work except on paper, then invoke uncertainty and a blowup ... and keep their past income.

He calls this "the Bob Rubin Trade," after the former treasury secretary who has been criticized for protecting derivatives from stronger regulation, and then watched as derivatives played a key role in the housing bust.

The bankers' avoidance of a harsher reckoning is grating, but that is not the worst legacy of the collapse. He writes,

But the worst casualty has been free markets, as the public, already prone to hating financiers, started conflating free markets and higher orders of corruption and cronyism, when in fact it is the exact opposite: it is government, not markets, that makes these things possible by the mechanism of bailouts.

That's exactly right.

He likes markets because they don't only create incentives for actors to think hard about the risks they take, but also have the wonderful feature of removing those who keep making mistakes. Support systems evolve when participants

have skin in the game, but they don't when actors can transfer risks. The book is loaded with pithy sayings and the one he employs in this discussion is, "You'll never fully convince someone that he is wrong; only reality can." Reality here means suffering losses.

The author's love of the symmetry of markets leads him to espouse what he calls the Silver Rule: *Do not treat others the way you would not like them to treat you.* Under this more robust version of the Golden Rule, people are instructed to mind their own business and not try to compel others to do what is good for them. This rule works at all scales—family members, your barber, nations. Taleb approvingly quotes Isocrates, an Athenian orator of the fifth century B.C.E., who said, "Deal with weaker states as you think it appropriate for stronger states to deal with you." The First Amendment, he observes, also embodies Silver Rule thinking: I can practice any religion I want, but I must allow you the same freedom; I may contradict you, but you may equally contradict me.

There is danger any time we depart from such symmetry. The greatest threat to democracy, he argues, "is the slippery slope in the attempts to limit speech on grounds that some of it may hurt people's feelings." Obviously, he knows what is happening on many of our college campuses.

Similar considerations lead him to argue that common law is superior to regulation. The fundamental rule of the former — if you harm me, I can sue you — has led to a balanced, adaptive legal system that grew from the bottom up. Government regulation, in contrast, is not very adaptive, often unbalanced, and prone to being captured by interest groups that can use the system to transfer costs to others.

Attack of the IYIs/ Taleb's writing is often acerbic. One example is his branding of some people as IYIs (Intellectuals Yet Idiots). They have scant practical experience with the world but are brimming over with credentials and find their way into positions where they can dictate to the rest of us without any risk to their

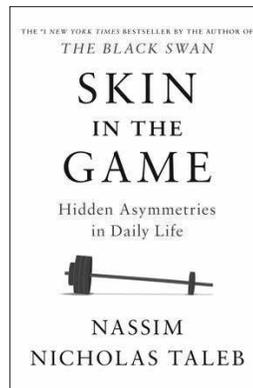
own material well-being. "The IYI pathologizes others for doing things he doesn't understand without ever realizing that it is his understanding that may be limited," Taleb writes.

Among those he brands IYIs are Ben Bernanke, Paul Krugman, Cass Sunstein, Tim Geithner, and Thomas Piketty, whose book *Capital in the Twenty-first Century* Taleb eviscerates. (See "An Unintended Case for More Capitalism," Fall 2014.) Sadly, despite that book's errors, its argument that government must do more to redistribute income caught on with IYIs and the larger class of people

who want wealth without taking any risks.

Academia also suffers Taleb's scorn. In his telling, there is a vast class of university administrators who hold sinecures and professors who don't have skin in the game (when tenured, anyway), which gives them license to engage in parasitic behavior. Of the latter, he writes, "If you say something crazy you will be deemed crazy. But if you create a collection of, say, twenty people who set up an academy and say crazy things accepted by the collective, you now have 'peer-reviewing' and can start a department in a university." Research, particularly in the social sciences, devolves into a pointless game where academics pursue their own agendas "at variance with what their clients, that is, society and the students, are paying them for."

And speaking of education, Taleb offers an observation that is sure to make him enemies in the education establishment. The level of wealth in a nation, he states,



Skin in the Game: Hidden Asymmetries in Daily Life

By Nassim Nicholas Taleb

279 pp.; Random House, 2018

is not a result of the level of education. It's the other way around. Countries that have become wealthy (thanks to the efforts of risk-takers) can afford to squander lots of money on a risk-free class of teachers and administrators who provide formal (but often useless) education. They do little to enhance the production of wealth but they absorb a great deal of it. Politicians and education insiders who want Americans to believe that the path to greater prosperity is for more of us to attend college have a resolute opponent in Taleb.

In the field of medicine, both doctors and patients have skin in the game. But in recent decades, another class of people—hospital administrators—has become much more powerful. Administrators are addicted to metrics that measure the supposed efficiency of the hospital. Unfortunately, their obsession with metrics can put doctors' skin in *the wrong game*. Trying to boost certain numbers while reducing others can lead to decisions that are less than optimal for the patient.

Conclusion / Everywhere Taleb looks, he sees damage and waste resulting from the actions of people who don't have skin in the game. He's trying to teach us a lesson of the utmost importance.

Readers should be prepared, however, for his writing style. At turns, it is funny, brash, and self-absorbed. While we're learning about the problems caused by people who don't have skin in the game, readers also learn of the author's aversion to pricey restaurants where the presentation is far more important than the food, his disdain for fancy exercise equipment (good old barbells are more to his liking), his debates with elitists, and much more. Readers will also find interesting excursions into religion, history, and philosophy that sometimes seem rather tangential. Most problematic of all is Taleb's way of tossing out sharp insights but then doing little to develop them.

Nevertheless, I find myself looking forward to his next book. The man understands how the world works and is eager to take on the IYIs who don't.

Not Your Typical Bank Collapse

REVIEW BY VERN MCKINLEY

Since the beginning of the global financial crisis in 2007, dozens of books have been written about the collapse of individual financial institutions. Many of these have focused on large institutions in the United States such as Lehman Brothers, Bear Stearns, and AIG. Fewer books have been written about banks that collapsed

in other advanced markets, such as the United Kingdom. Fewer still have been written about banks in emerging markets.

Kabul Bank in Afghanistan was one such institution that failed in the aftermath of the September 11, 2001 terrorist attacks, the ensuing U.S. invasion of Afghanistan, and the subsequent "nation building" exercises by U.S. forces. Its story is the subject of *The Tragedy of Kabul Bank*.

The book's author is Abdul Qadeer Fitrat, the former governor of Afghanistan's central bank, Da Afghanistan Bank (DAB). After graduating with a degree in economics from a top university in Pakistan, Fitrat pursued a Master's Degree at Wright State University in Ohio. I am particularly interested in his story because I worked in Afghanistan intermittently from 2004 to 2009 and met Fitrat on a few occasions.

After some chapters tracing his difficult upbringing in northeastern rural Afghanistan and his time in Pakistan and the United States, Fitrat discusses his early career when he led Banke Millie, a small Afghani bank, beginning in 1993. He began his first stint leading DAB as acting governor in 1995, during a period of triple digit inflation. That stint came

to an end when the Taliban took power in 1996: "Tens of thousands of people fled Kabul by cars, trucks, motorcycles, and

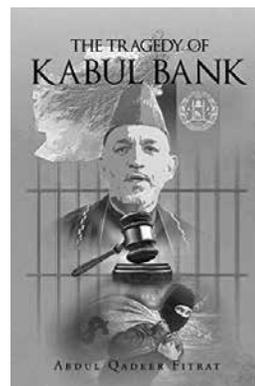
horse-driven carts; people even fled on foot."

The overthrow of the Taliban allowed him to return to DAB as first deputy governor in early 2002. This would lead a few weeks later to his first meetings with Afghani President Hamid Karzai just after Karzai ascended to the presidency. In that meeting, Karzai pleaded with Fitrat to stay in Afghanistan: "Please do not go back; we will put you in a good position. It would be better to serve your nation here."

Fitrat would again become the leader of DAB in early

2008, this time as the official governor. His task was monumental as he describes it: "When I started work at the Central Bank in January 2008, I felt it was in serious need of fundamental reforms almost in every direction."

Instability begins / By November 2008, the Afghani banking system was showing initial signs of severe stress. A tiny bank named Development Bank of Afghanistan (DBA) was running low on cash to pay for deposit withdrawals. As told by Fitrat, the circumstances behind the creation of DBA could be found in a *Mission Impossible* script:



The Tragedy of Kabul Bank

By Abdul Qadeer Fitrat
496 pp.; Page
Publishing, 2018

VERN MCKINLEY is a visiting scholar at George Washington University Law School and coauthor with James Freeman of *Borrowed Time: Two Centuries of Booms, Busts and Bailouts at Citi* (HarperCollins, 2018).

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Mr. Sergey Tsoy, the chairman of the bank, who was a Russian citizen with some Ukrainian connection, had established another bank in Uzbekistan called Business Bank, which had failed earlier, most probably due to fraud and mismanagement. He apparently fled to Afghanistan and established another bank in Kabul with help received from some local influential Afghans and relatives of some Afghan parliamentarians.... These individuals turned out to be part of a wider Russian mafia network. To date, the circumstance of how these individuals with such mysterious backgrounds came to Afghanistan has remained very murky.

Not surprisingly, DBA management denied any pending doom, but after an investigation it was clear that “Tsoy had defalcated more than \$21 million of people’s deposit funds from the bank.” This sum was small potatoes compared to what was to come. The next domino to fall was predictable: “Hundreds of depositors ... were queuing in front of the DBA’s offices and DAB, and soon they were threatening to resort to protests and violence.”

Bigger problems / Problem loans were beginning to build at the largest private bank in Afghanistan, Kabul Bank. Fitrat explains, “The Bush Administration was eager to present some success stories in Afghanistan at a time that its intervention in Iraq went badly wrong with growing chaos all around.” An application for an operating license from Kabul Bank in December 2003 was part of the booming banking sector. Fitrat explains that this was at a time when the capacity of personnel at the central bank was “extremely low.”

Before long, Kabul Bank was growing rapidly, with branches proliferating across the country, “some without approval of DAB,” and advertisements filled the airwaves to attract depositors. Growth accelerated when Kabul Bank became an agent bank for the government, a designation that Fitrat says may have been driven by graft. New shareholders joined the bank,

including Mahmood Karzai, the brother of the president. Fitrat explains that funds were loaned by Kabul Bank for these investments.

After the collapse of DBA in 2008, a number of troubling items came to light involving Kabul Bank. Perhaps the most troubling was that the bank’s management “got very close to President Karzai through massive election campaign donations and other kickbacks” during his 2009 reelection. By February 2010, a *Washington Post* article exposed many of the details of corruption at Kabul Bank, including investments by bank insiders close to Karzai in

Karzai told Fitrat to lie about the forced resignations and the condition of Kabul Bank, but the effort failed because, Fitrat writes, “nobody believed us.”

luxury villas in the building real estate bubble of Dubai. Fitrat quotes the *Post* article extensively: “The close ties between Kabul Bank and Karzai’s circle reflect a defining feature of the shaky post-Taliban order in which Washington has invested more than \$40 billion and the lives of more than 900 U.S. service members: a crony capitalism that enriches politically connected insiders and dismays the Afghan populace.”

The obvious next step for DAB was to get a handle on the extent of the problems uncovered by the *Post*. There followed a direct plea from Fitrat to U.S. treasury secretary Timothy Geithner asking for help in investigating both Kabul Bank and another smaller bank: “I am writing to seek technical assistance for a forensic audit and a comprehensive on-site examination.” The topic of the audit was placed on the agenda for a meeting between Karzai and Geithner in May 2010, and Fitrat convened a meeting of shareholders to remove the bank’s chairman and chief executive officer.

Those efforts were far too late, though. Fitrat explains that a crisis “similar in impact to the Lehman Brothers collapse

in the United States” began on September 1, 2010 when a run on Kabul Bank started and DAB took control of the bank. Stories were published on August 31st in the *New York Times*, *Washington Post*, and London’s *The Telegraph* setting out the details of the closed shareholders meeting, and Fitrat summarized, “Tens of thousands of Kabul Bank depositors queued in front of its branches all over the country, demanding nothing less than all their deposits.”

Lying for Karzai / A press conference to reassure the Afghani public was convened on September 1st. President Karzai instructed

Fitrat to lie about the forced resignations and the condition of Kabul Bank. Fitrat describes this as “a Communist-style cover-up to simply calm down the wary customers.” The press conference had the oppo-

site effect because, Fitrat admits, “nobody believed us.”

Karzai, in discussions with Fitrat, blamed the American Embassy for leaking the information to reporters that triggered the run: “Kabul Bank was another conspiracy created by the West against him to destabilize his grip on power.” Meanwhile, according to Fitrat, “the president’s brother added to the panic by asking the U.S. Treasury to intervene and provide [an] immediate bailout to Kabul Bank.” Deputy treasury secretary Neal Wolin immediately rejected this request, vowing, “No American taxpayer funds will be used to support Kabul Bank.” The Afghan government would later bail out depositors.

Subsequent reviews revealed that the resulting losses were enormous. Writes Fitrat:

Teams unearthed massive fraud that shocked the national and the international community alike: they found that \$912 million in loans had been extended.... Most of this amount was fraudulently issued to owners and shareholders of the bank and their

close associates and relatives [between] 2004 and 2010.

Meanwhile, Fitrat struggled to punish the insiders who were responsible: “Most of [the] Kabul Bank suspects were the president’s closest friends from whom he received significant kickbacks before, during, and after the rigged 2009 elections.” His relationship with Karzai deteriorated after the run on Kabul Bank: “I was in a dilemma regarding how to reconcile those experts’ findings and recommendations with those irrational and sometimes stupid views of my president.”

Fleeing Afghanistan / After Fitrat delivered a very sobering public speech on Kabul Bank, his relationship with Karzai deteriorated so badly that Fitrat feared for his life. Following a business trip to Dubai, he flew to Virginia instead of returning to Afghanistan. He was treated as an outcast by many of his former colleagues in the U.S. government and at the International Monetary Fund, and has had severe financial difficulties, coming close to bankruptcy at times.

The *Tragedy of Kabul Bank* is an easy and interesting read, given the twists and turns in Fitrat’s life and in particular the

Kabul Bank episode. Disappointingly, there are many grammatical and spelling errors throughout the book. English is not Fitrat’s native language, so this is understandable, but the American publisher should have done a more thorough job of editing the book.

It is difficult to say how accurate Fitrat’s account is, but at least one author (*Washington Post*’s Joshua Partlow) comes to many of the same conclusions regarding the deep-seated corruption within the Karzai family. What is clear is the enormous challenge of supervising banks in deeply corrupt emerging markets. R

Working Papers ⇨ BY PETER VAN DOREN AND IKE BRANNON

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

Expensing

“Information Sets and Dynamic Scoring,” by Aaron Betz. SSRN, forthcoming.

For most people, the debate over depreciation schedules for investment is soporific. But for tax policy cognoscenti, the topic is incredibly contentious.

There are two broad approaches for the tax treatment of investment. One way would be to require companies to incrementally deduct an investment over the life of the asset. For instance, if a company buys a \$100,000 truck that it expects to be in service for 10 years, then it would deduct \$10,000 of expenses from its income each year for a decade. We call this “straight-line” depreciation.

The other approach would be to allow the company to fully deduct (or expense) the investment the year the company purchases the truck. We refer to this as “full expensing.”

For C corporations, the U.S. government has typically done something between these two extremes. Since 2001, the United States has had some version of “bonus depreciation,” whereby companies can immediately deduct some proportion (typically 50%) of new investment. Between 2008 and 2017, Congress extended or altered bonus depreciation eight times.

The 2017 tax reform implemented full expensing through 2025, although the authors of reform hope that a future Congress makes that permanent. Full expensing effectively reduces the cost of capital investment because firms receive the tax break sooner. For the \$100,000 truck and a company paying an effective tax rate of 25%, full expensing provides \$25,000 tax savings at once,

rather than the \$2,500 a year for the next decade. Companies would rather have their tax savings up front and put that money to work right away.

However, we do not know how much depreciation schedules matter. If we believe firms are fully rational, then the fact that expensing makes investment less expensive should mean that we would see more investment when bonus depreciation effectively reduces its cost, and even more if we allow full expensing. After all, that is the rationale for full expensing.

However, Betz argues that the data suggest bonus depreciation does not have much of an effect. If he and others who have made similar observations are correct, then we should focus our efforts on reducing the tax burden on business activity via lower corporate rates rather than maintaining and expanding bonus depreciation.

Betz gives two broad explanations for why we may not see the results we would expect from a move to bonus depreciation. The first is that the investment multiplier—that is, the effect on economic activity from any investment—varies across the business cycle. Alan Auerbach and Yuri Gorodnichenko have found that that the effect of bonus depreciation is countercyclical, so that we get a bigger bang for the buck when the economy is going poorly than when it is growing. If companies perceive this to be true, then we should see more investment when economic growth slows, which is generally when the government tends to implement bonus depreciation schemes, at least until the 2017 tax act.

That implies that companies see a higher payoff for capital investment, *ceteris paribus*, when the economy is going poorly, so they are more inclined to invest already when the tax incentives for investing go up. That makes it difficult to discern precisely how much bonus depreciation matters to investment.

PETER VAN DOREN is editor of *Regulation* and a senior fellow at the Cato Institute. IKE BRANNON, a contributing editor to *Regulation*, is a senior fellow at the Jack Kemp Foundation and president of Capital Policy Analytics.

IN REVIEW

But a larger problem—one articulated by University of California, San Diego economist Valerie Ramey—in discerning how investment incentive schemes matter is that firms' expectations of future tax policy matter. If companies know that bonus depreciation will definitely last only a couple of years, then they will make a concerted effort to push new investment—or accelerate already-planned investment—into the bonus depreciation window. However, if companies know there is a chance that a bonus depreciation scheme will be extended into the future, the urgency of increasing investment today disappears. That perception would be regrettable because bonus depreciation has historically been the wrench in Congress's toolbox in combating a recession.

To look more closely at this issue, Betz constructs a model with “monopolistically competitive” (some market power, but not much) firms, a central government levying taxes, and an economy in which 18% of firms can take advantage of bonus depreciation when offered—the low fraction being another reason why bonus depreciation may not be terribly effective. He finds that expectations of bonus depreciation have a huge effect on its effectiveness at stimulating investment.

His findings do not necessarily negate the importance of more generous depreciation schedules, but they do suggest that, for the policy to work as an effective stimulus, it is necessary for Congress to credibly commit to keeping it a temporary change, which is easier said than done.

Failing that, it may make more sense to simply leave depreciation alone and settle on the optimal long-run strategy for the tax treatment of capital. Betz's paper suggests that it's not entirely certain what that would be these days; if we assume that a more generous bonus depreciation necessitates a higher corporate income tax rate, it may be the case that we'd rather give up the former for a lower rate.

Robert Lucas famously told an interviewer that eliminating the tax on capital income is the closest thing to a free lunch that there is in the economy. Given the collective preoccupation with income inequality, it is hard to see us ever eliminating capital taxes. But it may be worth reminding Congress that using capital taxation to achieve social goals comes at a high cost. —I.B.

Consumer Inattention and Tax Incidence

“Hidden Baggage: Behavioral Responses to Changes in Airline Ticket Tax Disclosure,” by Sebastien Bradley and Naomi E. Feldman. August 2018. SSRN #3234195.

In previous columns, I described regulations intended to improve outcomes for consumers or job applicants that had unintended perverse results. Payday lending restrictions prevented soldiers from smoothing their consumption with no measurable reduction in excessive debt (Spring 2017). “Ban the box” laws prohibiting employers from asking about criminal history on initial job applications reduced black male employment

(Fall 2016). And bans on the use of credit checks by employers in hiring decisions reduced job creation relative to trend by 12% (Summer 2018).

But sometimes regulations enacted to assist consumers can have unexpected benefits. This paper describes one such case. A 2012 U.S. Department of Transportation rule required quoted airline ticket prices to be tax inclusive in an effort to make pricing more transparent. Under conventional economic analysis, the degree to which the taxes were “hidden” would not affect the ultimate incidence of the tax, e.g., how much of the tax is passed on to consumers and how much is “swallowed” by the airlines. The paper demonstrates that prior to the rule, when advertised fares did not have to include taxes, airline ticket taxes were almost entirely passed onto consumers. After the rule, only 25% of the ticket tax was paid by consumers. The regulation resulted in “substantial transfer of surplus from airlines to consumers.” —P.V.D.

Fiscal Rules

“Can Fiscal Rules Constrain the Size of Government? An Analysis of the ‘Crown Jewel’ of Tax and Expenditure Limitations,” by Paul Eliason and Byron Lutz. April 2015. *Journal of Public Economics* 166: 115–144 (October 2018).

To the extent that state and local governments impose taxes that have diffuse costs and enact programs that have concentrated benefits, standard economic analysis would predict excessive taxing and spending. A standard political remedy to this tendency has been statutory or constitutional limits on taxation and expenditure.

The “gold standard” of such limitations is the constitutional amendment approved by 54% of Colorado voters in 1992. The Taxpayer Bill of Rights (TABOR) requires voter approval for all state and local tax-rate increases and limits real per-capita revenue growth to either 0% or the increase from construction in local taxable property.

Did TABOR constrain public tax and expenditure behavior in Colorado? This paper compares the state's expenditures and revenues with those in other states using the synthetic control method, a recent development in econometrics. The idea is that a linear combination of states that minimizes differences on expenditures and taxes between Colorado and the synthetic “states” prior to the implementation of TABOR is a superior control than the actual states themselves.

Prior to the invention of synthetic controls, the change in Colorado outcomes would have been compared to the change in other states, allowing for unobserved differences across states that are constant and do not vary with time (difference-in-differences with fixed-effects research design). The synthetic control method allows for unobserved differences across states to vary over time.

Relative to the synthetic control, TABOR appears not to have

reduced taxes or spending in Colorado. The main reason for this, according to the authors, is that after the passage of TABOR, voters approved overrides of its restrictions. Amendment 23 (passed in 2000) mandates that expenditures for K-12 public education increase by 1% above inflation annually. At the local level, overrides of the expenditure limits have been common. Through 2011, 523 overrides on expenditure limits have appeared on local ballots and 87% passed. Some 699 votes were held to increase local tax rates, and 55% of them passed.

The TABOR process insures that voters consent to increases in taxes and expenditures. The sponsors of TABOR assumed that voters would not consent, but they have done so much of the time. Thus, outcomes in Colorado are not dramatically different from other states. —P.V.D.

Mortgage Lending and the Housing Crisis

“Villains or Scapegoats? The Role of Subprime Borrowers in Driving the U.S. Housing Boom,” by James Conklin, W. Scott Frame, Kristopher Gerardi, and Haoyang Liu. August 2018. SSRN #3240413.

A standard explanation of last decade’s financial crisis blames “loose” lending standards by mortgage originators, particularly for lower-income borrowers, combined with the repackaging of mortgages into securities sold to investors falsely informed by misguided AAA ratings. In previous columns (Spring 2011, Fall 2012) I discussed papers presenting evidence inconsistent with this argument. Those papers compared default rates in census tracts that barely qualified for low-income housing goals with default rates in those tracts that didn’t qualify. The papers found no differences or worse outcomes among the tracts whose incomes were too high and did not qualify. In the Fall 2018 issue, I discussed a paper that found that the cumulative losses (through 2013) on all subprime residential mortgage-backed securities (MBS) issued between 1987 and 2008 were dramatically lower for subprime AAA-rated MBS (0.42%) than all AAA-rated MBS (2.3%).

This paper examines whether credit expansion to marginal borrowers was associated with housing price appreciation. The authors examine subprime mortgages (defined as mortgages to borrowers with FICO credit scores below 660) issued between 2002 and 2006. The annual share of purchase mortgages originated to high-quality borrowers (scores above 720), medium-quality (between 680 and 720), and low-quality (below 660) are remarkably constant over the boom period. Write the authors, “Counties in the top two house-price-appreciation categories actually experienced slight declines in the share of purchase mortgages to subprime borrowers, while modest increases in the subprime share of purchases occurred in counties with slower house price appreciation.”

The narrative that a reallocation of credit to subprime bor-

rowers was responsible for the boom in house prices requires a positive correlation between house price growth and the share of purchase mortgages to subprime borrowers. The analysis in this paper uncovers a robust negative correlation. —P.V.D.

Renewable Electricity

“Setting with the Sun: The Impacts of Renewable Energy on Wholesale Power Markets,” by James Bushnell and Kevin Novan. August 2018. University of California, Berkeley Energy Institute Working Paper #292.

Recent trends in electricity production have altered prices in wholesale markets and thus the economics of traditional generation. Historically, coal and nuclear plants had high capital costs and low marginal costs. They operated continuously and their output could not vary easily to match the daily demand cycle. Smaller plants fueled by natural gas or oil had lower capital costs and higher marginal costs, and their output could vary to follow demand during the day. The smaller plants’ higher operating costs were reimbursed by higher wholesale prices during the daytime and those higher prices also contributed revenue for the higher capital costs of nuclear and coal plants.

The addition of subsidized and mandated solar to this generation picture has altered the economics of electricity production. Prices in the California market are now lower during the daytime than they were several years ago. University of California, Berkeley energy economist Catherine Wolfram noted last year that prices in the Southern California market were negative during the midday for 19 days during March and April 2017. As energy economist Jonathan Lesser argued in these pages (“The High Cost of Low-Value Wind Power,” Spring 2013), those lower prices reduce the returns to traditional baseload coal and nuclear generation.

Wolfram has expanded this idea to natural-gas combined-cycle plants. She reports that, in 2017, revenues were insufficient to cover their average costs in 17 of 20 locations in PJM, the regional transmission organization that covers much of the central Atlantic and some Midwest states. The result of these lower revenues is either retirement of such plants or subsidies for them as enacted by New York and Illinois.

This paper documents an ironic twist to the returns to traditional electricity producers in California. The increased role of solar in California has increased the demand for and thus profits of natural gas turbines. Those plants are less efficient and more polluting than natural-gas combined-cycle plants, which use waste heat to produce steam and more electricity but whose output cannot be altered quickly. The demand for turbines has increased because their production can be increased and decreased quickly at sunset and sunrise. Write the authors, “Nimble generation with low capital, but high marginal, cost is complimentary to renewable energy, while high capital cost baseload plants are not.” —P.V.D.