

## BRIEFLY NOTED

# Can Your Neighborhood Bookie Compete With the Internet?

BY IKE BRANNON

In the olden days, people who wanted to bet on the local sports team had few options other than their neighborhood bookie, who could usually be found ensconced in a local bar. With the right introduction, he would gladly allow a gambler to place a bet on nearly any event he wished, and would even extend credit.

Today, however, things are different. The mob, which was the primary sponsor of major sports gambling for most of the past century, is quiescent and the humble neighborhood bookie faces new competition from sports books in Las Vegas and on the internet. With the Supreme Court having recently invalidated the 1992 Professional and Amateur Sports Protection Act, which outlawed sports gambling in most states, more states are likely to get in the game. Legal internet wagering that does not involve overseas bookies will probably become possible in the near future as well.

In a world awash in legal betting and more on the way, how are bookies faring in the 21st century? Quite nicely, it appears. Despite some practices that seem almost antiquated, the economics of gambling tilts toward the local, illegal betting syndicate in many places. Against the odds, the local bookmaker has prospered against the legal competition.

**Special odds, special customers** / The first advantage that bookies have over Vegas and much of the internet is the ability to price discriminate, or offer different odds to different customers. They do this in two different ways. First, bookies usually increase the point spread for the hometown team to take advantage of those people who bet with their hearts instead of their heads. For instance, while the Chicago Bears may have to win by 5 points over the Lions to pay off

for betters in Las Vegas, in Chicago they may have to win by 8.

Aha, a clever person might say, why don't I bet on Chicago in Las Vegas, where I get a better point spread, and bet *against* Chicago in Chicago, where the odds now favor their opponent? This way, if Chicago wins by more than 8 points I win in Vegas alone, if they win by less than 5 points I win in Chicago alone, but if they win by a margin between 5 and 8 points I win in *both places*.

While this may appear to be a no-lose situation, it fails to account for the bookie's fee for taking the bet. This cost—also known as “vigorish” (after the Russian word for “winnings”) or “juice”—amounts to 10% of the bet in most places, an extremely durable and consistent percentage.

Koleman Strumpf, a Wake Forest University economist, has researched the economics of gambling using private data from several bookies. He argues that the constancy of the “vig” was partly the product of mob-coordinated collusion. Its existence means that unless the arbitraging bettor can expect to have the final point margin fall between the two point spreads more than 10% of the time, then the transactions costs of the bets will eat up any profitable arbitrage opportunities. Strumpf found those arbitrage possibilities were invariably wiped out by the vigorish.

The local neighborhood bookie can also price discriminate based on the idiosyncrasies of individual bettors. If, for instance, a particular bettor always wagers on his beloved team, the point spread given to him

by the bookie will start to slide up above what is given to other bettors. Indeed, one of Strumpf's sources of information is a transcript of an audiotape where two bookies mock a regular customer for failing to recognize the relatively poor point spreads that they give him, spoken in language reminiscent of *The Sopranos*.

**Letting it ride** / One myth that Strumpf debunks with his research is the notion that bookies go to great lengths to avoid putting themselves at risk from game outcomes. The point spread ideally is set so that an equal number of bets is placed on both teams, leaving the bookie off the hook. However, prognosticating how people are going to bet is difficult, and having a game with uneven bets is not unusual. However, should a bookie find himself with a lot more money riding on one side, he often doesn't do anything about it.

What could he do? For starters, he could change the point spread to attract commensurately more bets on the low-money team, but this exposes the bookie to a possible disaster. Suppose a point spread that favored Oakland by 10 points over San Francisco drew \$20,000 more in bets on San Francisco on the first day. The bookie could lower the spread to new bettors to 8 points in the hope that this would balance the bets on both teams. However, consider what would happen should Oakland win by exactly 9 points. He now has to pay the early San Francisco bets *and* the late Oakland bets, and he's out \$40,000. To avoid such possibilities, many bookies refrain from setting the point spread until a day or two before the actual game, giving them time to see how the point spread in Las Vegas has settled.

Bookies do not often lay off bets with another book to insulate them from risk. With sufficient liquidity, an occasional imbalance in bets ought to be something a bookie can withstand. Despite what Strumpf regards as relatively low earnings for such a service (he estimates average bookie income of around \$200,000, mostly tax-free of course), he suggests that they usually do not face liquidity constraints.

**The competition** / The biggest threat to the neighborhood bookie is the rise of offshore betting houses that can be reached via the internet. Such venues remain far from the long arm of the law (and the mob, so far) and have several advantages. First, the internet gambling sites generate enough volume to compete on the vigorous, offering rates as low as 2% to high-volume bettors. Second, the internet bookies can exploit their vast data to exercise much more sophisticated price discrimination than bookies.

One curiosity that Strumpf discovered was that neighborhood bookies are very reluctant to store their data on computer, and almost to a man they continue to use the same sorts of books used for the past 100 years. They may find it easy to remember that Neil from Carroll Gardens always bets on the Knicks, but there probably are other gambling patterns they could exploit if they used computerized tools. The internet bookmakers are doing precisely that.

However, bookies are ahead of the internet in offering credit to bettors. This service is a way to develop loyalty among customers, who are more likely to try to bet their way out of a losing streak. Of course, collecting on a debt can be tricky. One way that bookies deal with this is through surrogates, who bring new bettors to the bookie. In exchange for providing the bookies with fresh bets, the surrogates receive a proportion of the losses of their bettor. The beauty of the arrangement, at least for the bookie, is that the surrogates are also on the hook should the bettor attempt to renege on a debt. With such motivation, it's clear why bettors fear the consequences of unpaid gambling debts. Such a system seems ill-suited to the faraway headquarters of the internet gambling sites.

Congress appears unlikely to pass new legislation that restricts gambling at the federal level, although various stakeholders—mainly casinos—have begun to lobby



for restrictions to be placed on sports gambling in some way to limit their competition from the internet or non-Vegas locales.

The practice of placing bets with local bookies is neither inherently more nor less virtuous than betting in Las Vegas. Journalist Alan Erhenhalt noted in his 1995 book *The Lost City* that the local betting syndicate in Bronzeville, an African-American neighborhood in Chicago, was a central ingredient of the close-knit community of the 1940s and 1950s. To be sure, some of the less salutary aspects of local bookmakers offend our sensibilities. But just as the mob was purged from Las Vegas, could such heavy-handed tactics be purged locally? The answer may depend on whether bookmaking is legalized; the fact that sports gambling has long been largely illegal explains why the mob is the greatest purveyor of sports bookmaking.

**Peoria tale** / In the interest of full disclosure, I should note that my great-grandfather and namesake operated a gambling establishment in Peoria, IL in the years before and during World War II, and the money earned from this business paid for my college education and my siblings'. Gambling was then legal in the city, but the mob provided and maintained the slots for the saloon and ran the constant poker game, splitting the profits evenly with my great-grandfather—net of the payoffs for government officials, of course.

After the war, Peoria cracked down on

gambling for a very good reason: it was inexorably connected to the organized crime and corrupt government that plagued the city. There appeared to be no way to combat the latter problem without getting rid of gambling as well.

In the 1990s, legal gambling returned to Peoria in the form of a riverboat casino, which thus far appears to be free of organized crime and has not appreciably increased the corrupt behavior by government officials in the area. Peoria has its share of citizens with gambling problems, of course, but the riverboat casino has provided entertainment for area residents as well, without the need to travel to an Indian reservation or Las Vegas. The influx of tourists to Peoria (not typically considered a tourist destination) has provided numerous well-paying jobs for the community.

Peoria still has its share of neighborhood bookies, ubiquitous enough that even I, a non-gambler who is now only an occasional visitor to my hometown, know more than one person there who takes action on college football games. My friends in Peoria who take part in the weekly betting pools at our neighborhood bar rarely go to the riverboat casino, and I doubt they would do so even if the police broke up their betting pools instead of participating in them.

Just because something is impossible to stop does not mean it should be legal, of course. At the same time, determining the legality of an activity based on the size (and political acumen) of the seller makes little sense. If gambling is fine for large casinos and the government, it is difficult to see why a prohibition should exist for bookies or internet sites. Explicit legality (and not the tacit legality that exists in most places) would quickly give recourse to gamblers worried about a kneecapping from Skinny Pete, being forced to pay usurious interest rates, or other unsavory practices commonly associated with shady bookies.

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# How's Your Trade War Going?

✦ BY PIERRE LEMIEUX

Last March, after announcing tariffs of 25% on steel and 10% on aluminum, President Trump tweeted that “trade wars are good, and easy to win.” This seems predicated on the strange theory that Americans win when their government impedes them from buying what they want to buy.

A national government imposing tariffs (or other customs barriers) uses its own country's consumers and importers as hostages when it threatens foreign governments against harming its exporters. What a protectionist retaliation threat really means is, “If you harm your own consumers with your tariffs, I will hurt mine with my tariffs!” No wonder that protectionism was dismissed by Adam Smith and David Hume in the 18th century. Smith did concede that retaliatory tariffs could be good—if they prompted the targeted government to back off—but he didn't hold out much hope for that happening.

**Trade war casualties** / Ask American steel and aluminum consumers if a trade war is good. Not unexpectedly, by the end of April, aluminum prices were up by about 10% in America according to data from InvestmentMine, a research consultant. American manufacturers of steel products are complaining about higher prices for their input. According to the *Wall Street Journal*, the steel and aluminum tariffs are the darkest cloud over the booming chemical industry in America. Ultimately, of course, American consumers will pay the price.

Even from the very imperfect metric of jobs, the steel tariff is very likely to be detrimental. Many more Americans are occupied in steel-using industries (around 2 million) than in steel-making (140,000). Economists at the Federal Reserve Bank of New York concluded that “the 25 percent steel tariff is

likely to cost more jobs than it saves” (*Liberty Street Economics*, April 19, 2018).

More important, the tariffs will destroy value by making consumers pay more than the real cost for what they want.

At the time of this writing in early May, it is still too early for a quantitative assessment of the effect of tariffs that Trump imposed on washing machines in January. (See “Putting 97 Million Households through the Wringer,” Spring 2018.) However, according to preliminary data from the Bureau of Labor Statistics, the (domestic) producer price index of all major household appliances increased 1.3% between January and April, while household appliance prices had been stable for several years before. As these data cover all major household appliances, they suggest that the effect of the tariff on the price of washing machines is substantial—which is not surprising as that was precisely the aim of the protection requested by domestic producer Whirlpool.

**Targeting China** / Ask American farmers if trade wars are good. China is the second largest market for American agricultural exports (and was *the* largest as recently as 2016). U.S. pork and sorghum have already been hit by retaliatory tariffs or “deposits,” and threatened tariffs have reduced Chinese purchases of American soybeans and corn. The Chinese market accounts for half of American exported soybeans, the largest agricultural export. American farmers are starting to hurt, but Trump suggested that they could be compensated by special subsidies. So the U.S. government is going to tax Americans to offset some of the damage from taxing Ameri-

cans. “Saturday-morning-cartoon central planning,” quipped Sen. Ben Sasse (R, NE).

On the one hand, the U.S. government helps farmers, making them more dependent on government. For example, the Foreign Agricultural Service of the U.S. Department of Agriculture markets American agricultural products abroad, notably through its many offices in China. On the other hand, the same government impedes farmers' exports through its trade policy. Government planning has never been a model of rationality, except from the viewpoint of politicians and organized interests.

Much could happen by the time this article is released. The new 25% tariffs that were announced on \$50 billion in Chinese imports could be imposed. A promised retaliation by the Chinese government would likely follow. More damage would be done if the trade war intensifies. The U.S. government has its sights set not only on China but also on Europe and on North American Free Trade Agreement countries (and some other countries). The risk that a trade war could precipitate a recession is significant. Alternatively, trade tensions could abate, perhaps because of stock market resistance and pressure exerted on Trump.

Isn't it astonishing that so much depends on one single man in Washington, DC? In this respect, Trump may have as much power over the national economy as his Chinese counterpart.

A trade war hurts consumers, but it also disrupts production. As supply chains have become more integrated (and efficient) across borders, more businesses are taking the side of consumers over special interests. In early April, 107 trade groups, led by the National Retail Federation and the Information Technology Industry Council, warned the U.S. House of Representatives against launching a trade war. It is becoming clear that the current protectionism only benefits a small number of large producers and their few employees.

The Trump administration's invocation of national security as justification for some of the tariffs is mainly a protectionist excuse. So are, in large part, its allegations

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? Answering Common Objections to Free Trade* (Rowman & Littlefield, 2018).





of Chinese intellectual property (IP) theft. “IP theft” covers many different things: (1) counterfeit or pirated products, (2) actual theft (often cyber theft) of trade secrets, and (3) the Chinese government’s requirement that foreign firms that establish a presence in China enter into joint ventures with local firms, which often involve technology transfers to the latter. The second form of “IP theft” certainly looks like real theft, but the first one is debatable, especially under the absolutist, criminalizing view of the U.S. government. (Interestingly, as Stanford law professor Paul Goldstein notes, the U.S. government did not protect foreign copyrights until 1890 and waited another century before joining the major international copyright treaty.)

Concerning the third form of IP “theft,” the “forced” technology transfer, of course it’s not nice for the Chinese government to directly or indirectly require technology transfers or provide “incentives” for them, as the U.S. trade representative often complains. But nobody is forcing American firms to establish business in China. One can export to the Chinese market from the United States or else simply ignore the Chinese market altogether. Technology transfer is only one of the conditions that profit-maximizing corporations accept voluntarily in order to access markets in liberty-challenged places. None of this would happen in an ideal world, but the U.S. government should be content to make America ideal for liberty.

Moreover, ordinary courts, even Chinese courts, are often available to enforce IP claims. International treaties could address remaining problems. Using trade sanctions to solve problems of IP protection, says Goldstein, “is like performing microsurgery with a sledge hammer.”

**Free to consume and compete** / One official justification for the trade war with China is that Chinese exporters are subsidized or otherwise assisted by their government and thus have unfair advantages when competing against American companies. The fact that Chinese producers and Chinese taxpayers are forced to subsidize their exporters does not justify the U.S. government’s further reducing the freedom of Americans—their freedom to import, in this case. If other people’s oppression were a good justification for undermining liberty, trade and everything else would be a race to the bottom: the least-free in the world would dictate everybody else’s level of freedom. It would be better to let Americans be free to import and let American businesses compete, even if they are not on a level playing field.

The notion of a level playing field is highly suspicious anyway. Where in the world or even inside America is there a level playing field? And how do you measure the tilt of this metaphorical field? Is it a tilt that average wages are 40% lower in Mississippi than in California? Directly or indirectly, governments intervene in the economy, including the federal and state governments in America. Public expenditure on education, for example, is higher in America (4.2% of gross domestic product) than in Germany (3.7%). Would this justify German firms complaining that they face an unequal playing field?

Moreover, if entrepreneurial private companies need protection in order to compete with Chinese state companies or subsidized “private” ones, where is the advantage of private enterprise? We might as well install a Chinese sort of economy in America. In reality, the more Chinese firms are dependent on—and run by—their

government, the less efficient they will become. The more state-controlled Chinese society becomes, the more likely Chinese taxpayers won’t be able to continue subsidizing their government’s cronies.

Some may respond that there already is only a relatively small difference of degree between Chinese and American state capitalism. If that is the case, indeed, America might not be able to maintain its historical economic advantage. But that would be caused by too little free enterprise here, not too much.

The U.S. government should not worry about poor Chinese taxpayers and straight-jacketed businesses in China. We may hope that they will improve their dire situation with time. But there is little we can do about what’s happening in China except to give an example of economic freedom and efficiency, which will not be done with protectionism. But the U.S. government can do a lot about freedom at home by not impeding American consumers and businesses that want to import from, or invest in, foreign countries.

**Losing the war** / Even if retaliation against foreign protectionism were to succeed in opening trade, it would strengthen the false idea that what we give up in trade (exports) is more important than what we obtain (imports). As James Mill wrote in his 1824 *Elements of Political Economy*:

When one country exchanges ..., the whole of its advantage consists in the commodities imported. ... This seems to be so very nearly a self-evident proposition, as to be hardly capable of being rendered more clear by illustration; and yet it is so little in harmony with current and vulgar opinions that it may not be easy, by any illustration, to gain it admission into certain minds.

Thus, a strategy of retaliation, even if successful in the short run, may actually compromise free trade in the longer run.

A related question is whether America could lose the trade war by being sidelined because American protectionism pushes toward the East the center of gravity of

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world trade. This is not impossible as far as formal trade agreements are concerned. From this point of view, pulling out from the Trans-Pacific Partnership might have been America's first trade war defeat. Trump may now be realizing this, as he voiced a wish to reenter the agreement. But it must not be forgotten that trade agreements are not the essence of free trade, and that the Trans-Pacific Partnership was as much about regulating trade as about freeing it.

What's important is whether Americans remain free to import and whether American businesses can freely pursue opportunities wherever they see them. Alas, the same protectionism that leads the U.S. government to disengage from the formal world trade system is likely to undermine the freedom of American consumers and businesses to make their own individual decisions on where to buy or invest in the wide world. R

a high price, contrary to what some environmentalists have argued.

In combating climate change, some states like California seem to adopt a moral imperative to eliminate both fossil fuels and (puzzlingly) nuclear power from the mix of a utility's generation portfolio. Studies and real-world experience have shown that such a scenario could drive up electricity rates substantially, reduce the reliability of electricity service, and inflict harm on the overall economy.

Studies have also warned that reducing greenhouse gas emissions to the so-called "80 by '50" target" (i.e., reducing carbon dioxide by 80% by 2050, the target of many climate advocates) would be prohibitively expensive and hard to achieve without the continued operation of nuclear power plants. One can ask whether California and other states are more intent on ending nuclear power than mitigating climate change. They believe that aggressively switching to renewable energy and electrification is the optimal strategy for fighting climate change. All eyes will be on what transpires in these "green" states from this grandiose experiment.

**Whose benefit?** / Before proceeding with any action, states should ask themselves what benefits electrification and high reliance on renewable energy offer relative to the costs. It is unlikely that any state would realize net benefits if the intent of these actions is solely to mitigate carbon emissions. It is somewhat puzzling why a state on its own (like California or New York), without cooperation from other states or the federal government or other countries, would revamp its energy sector at a high transition cost for a policy goal that would largely benefit the rest of the world.

If I were a state regulator, I would think twice before prioritizing climate change over the economic welfare of the citizens of my state, especially when it involves subsidies from those who stand to benefit little. Isn't constituent welfare supposed to be the chief concern of state utility regulators?

Within the regulatory agencies them-

## Rent-Seekers Infiltrate Public Utility Regulation

BY KENNETH W. COSTELLO

Public utility regulators should stick to their knitting: setting just and reasonable rates and taking other actions that improve the long-term welfare of utility customers. After all, the *raison d'être* for public utility regulation is to protect customers from "monopoly" utilities. Pursuing other purposes besides consumer protection only diminishes regulators' ability to achieve this objective.

However, utility regulators have proven susceptible to rent-seeking efforts by various special interests at the expense of the general public. For instance, some special interests succeed at persuading regulators—often with incomplete and slanted evidence—that the special interests' favored energy technology would best serve society and even save the world.

**Climate change** / The Federal Energy Regulatory Commission's recent development of gas pipeline certification exemplifies this. The agency is under pressure from environmentalists to consider the climate-change effect of new pipelines. While one can sensibly argue that FERC should ignore concerns over greenhouse gas emissions, the courts so far have agreed with the environmentalists.

Here's the problem: even if FERC has the obligation to consider the environ-

mental consequences of major pipeline projects, assessing their effects on climate change—let alone measuring them—overstretches the commission's capability as an economic regulator. This should in no way imply that we should refrain from mitigating climate change, but that responsibility should fall on environmental agencies and other governmental entities with more capability than FERC to address climate change. Even if FERC has an accurate measurement of net changes in greenhouse gas emissions (a big if) and a reasonable estimate of their effect on climate change, it is unclear how FERC should use that information in pipeline certification.

There is enormous uncertainty over what effect a reduction in greenhouse gas emissions would have on the economy and society in general. We need to be humble about what we know about climate change and not expend considerable resources—read: trillions of dollars—that could jeopardize people's economic well-being. Make no mistake about it, viewing climate change as an urgent problem that must be mitigated at any cost would carry

selves, emphasis on special-interest demands from clean air advocates, vendors, and others who are not utility customers has escalated to squeeze out public interest goals. Commissioners and managers are the guilty parties here, whether their political leanings are on the left or the right. One example is interest groups that regard anything less than a maximum effort to address climate change as a social injustice. But an obsession with climate change can threaten other policy objectives, like reasonable and stable rates, economic growth, and reliable utility service. California and other states may be going down this primrose road.

As pressures intensify for more clean energy sources, utility regulators have had to grapple more with the economic inefficiencies of cost socialization and subsidies. One path is for regulators to encourage distributed generation, electric vehicles,

and other new technologies, but not to give away the store. Cost subsidization can be unfair to some customers as well as to competing third-party providers. Regretfully, the evidence confirms that some states have been on the forefront of bad policies that have inflicted a regressive-tax-type wound on lower-income folks.

Utilities, regulators, and legislatures don't have to be leaders in supporting new clean-energy technologies, especially those whose futures are in doubt. As "free riders," they can learn from the experiences—both positive and negative—of so-called leading states while still contributing to greenhouse gas reduction in the long run. The followers can view activities in states like California and New York as a public good. This posture seems rational in view of the highly uncertain future of most new technologies and other developments in the electric power industry. R

## Can We Cut Government Spending?

BY RYAN H. MURPHY

**W**ealthier countries have larger governments. The question is, why?

One explanation is that many of the goods that governments spend money on are, in technical terms, superior goods, meaning that when you are wealthier, you buy more of them as a percentage of your income. Others posit that public investments in education and health contribute to economic growth by improving productivity, which in turn increases gross domestic product per capita. Alternatively, wealthier countries are able to "buy" more of something called "state capacity," which is what academics call the ability of governments to accomplish what they set out to accomplish. Half of this is clearly a good thing because it means higher quality courts and legal systems. But the other side of state capacity is fiscal

capacity, which is the ability of governments to raise tax revenue, and thus grow the government through that mechanism.

Wagner's Law, named for turn-of-the-20th century economist Adolph Wagner, posits a direct correlation between a society's wealth and the size of its government. If Wagner's Law generally holds, it could lead to a certain amount of defeatism among free-marketers and other advocates of smaller government. Over the long term, total government spending has comprised a growing percentage of U.S. gross domestic product, as depicted in Figure 1. Inevitably increasing public spending is one possible reading of Robert Higgs's "ratchet effect" found in his

classic work *Crisis and Leviathan*, where crises ratchet up the size and scope of government under "emergency" provisions, but public spending never returns to pre-crisis levels once the emergency ends. More recently, Will Wilkinson of the Niskanen Center proclaimed, "There's simply no path here to smaller government [for the United States]."

But Wagner's Law, if stated as literally true and inevitable, is wrong. There are periods of time in which national income increases but government spending as a percentage of GDP falls, as reflected in the early- to mid-1980s and mid- to late-1990s in Figure 1. The issue, then, is of degree: how frequently can government spending fall in the long run in wealthy countries, and by how much?

**International data** / To get a sense of how often wealthy countries violate Wagner's Law over time, one can look at how often governments cut the size of their states in the very long run. I did this using data from the most recent *Economic Freedom of the World* report published by the Fraser Institute (along with other Economic Freedom Network think tanks, including the Cato Institute). The specific data I examined were:

- government consumption—that is, government spending on goods and services used for direct satisfaction—as a percentage of all consumption
- transfers and subsidies as a percentage of economic output
- government investment—that is, government spending on productive assets—as a percentage of all investment

Country tables in the current edition of the *Economic Freedom of the World* report provide data for the years 1980 and 2015, so those are the years I compared for this research.

Table 1 lists the 24 members of the Organization for Economic Cooperation and Development in 1990, along with their GDP per capita in 1980 (in 2010 U.S. dollars). Three sets of columns give the three measures of government spending listed above in both 1980 and 2015. If the strong version of Wagner's Law were



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to hold, the 1980 figures would always be smaller than their 2015 counterparts. Government consumption and spending on transfers and subsidies are the clearer tests of the hypothesis, although all three measures should be given some weight if Wagner's Law is to mean that increases in the size of government are inevitable.

These measures of government spending differ in terms of how much they each vary across countries. A change of five percentage points represents a greater change for one type of government spending than another. To better express how big the changes that occurred in government spending from 1980 to 2015 really were, I calculated the standard deviation of each variable in 1980. I then divided the change from 1980 to 2015 by this standard deviation. For example, in Belgium, government consumption as a percentage of total consumption increased from 21.55% in 1980 to 31.82% in 2015. As the standard deviation among these countries in 1980 was 5.72%, Belgium's 10.27% increase corresponds to 1.80 standard deviations.

Table 1 highlights the countries and variables that declined from 1980 to 2015. It does indeed seem difficult to cut government consumption. Of the 24 countries, only three—Canada, the United Kingdom, and the United States—cut government consumption over this time period. The cuts in the UK and the United States were not at all trivial, though, amounting to

more than half a standard deviation apiece. Still, if this were the entire story for government spending, it would give some credence to the defeatist story regarding government spending.

However, between 1980 and 2015, eight of the 23 countries for which complete data are available cut their transfers and subsidies as a percentage of GDP, and a significant majority—19—cut their government investment as a percentage of total investment. Of those latter countries, 14 cut government investment by more than a standard deviation. The only country that *increased* government investment by at least a standard deviation was Greece.

What caused this decrease in spending is rather obvious: the West decided to stop playing soft socialism at the so-called “commanding heights” of the economies and privatized a number of government functions. That very recent historical episode, in which nearly every advanced economy in the world washed its hands of so much state ownership, certainly appears like it should count as a cut to the size of government.

**Why did it happen?** / There may be some amount of substitution between these three areas of government spending, of course. Only one country, the UK, cut its spending across all three areas. Canada is one of a handful of countries that cut its transfers and subsidies to a nontrivial degree and also cut its government con-

sumption, but its government investment ticked upward. So how should we interpret these numbers?

First, it is absolutely not true that there are inevitable barriers to reducing government investment. And there is plenty of opportunity for more reductions: public-private partnerships, which promise to shift many of the tougher issues regarding infrastructure to the private sector, are only now beginning to get off the ground. Even in the United States, which never went to the soft socialist extremes that much of Europe did, there are plenty of opportunities to privatize infrastructure—especially in airports, a step already taken in many areas of the world.

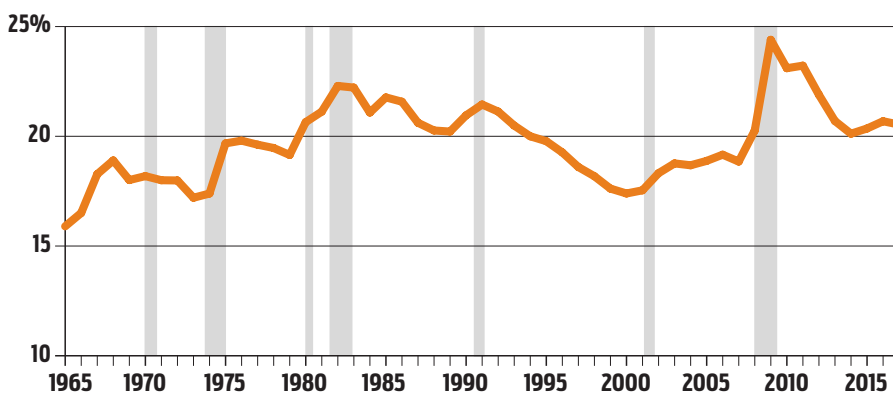
Second, despite the headwinds of rising entitlements for the elderly across all advanced economies, there are several examples of countries that have managed to cut transfers and subsidies over the last 35 years.

Third, cutting government consumption may offer a tougher task, but there are clear policy proposals to do so on the table right now. These include the termination of various privileges enjoyed by public sector unions, which in turn could lead to expenditure cuts. But it would be somewhat surprising if government consumption is the higher-hanging fruit in comparison to transfer payments, given the demographic challenges that face nearly all of these countries.

Another point of interest is that countries with a legal system originating in Britain—in this sample, Australia, Canada, Ireland, New Zealand, the UK, and the United States—are disproportionately represented among the countries in cutting spending over this time period. The importance of legal origins in determining institutional quality and outcomes is a recent finding in social science, and it is possible that this is another instance of that effect coming into play. If this is the case, this is another factor supporting the prospects of U.S. cuts in government spending.

**Conclusion** / There is little reason for small-government advocates to be pessimistic about the prospects for reducing

FIGURE 1  
U.S. Government Expenditures as a Percentage of Gross Domestic Product



government size. Government investment has fallen tremendously throughout the West, and transfers and subsidies seem to fall if there is the political will for it. The category of government spending that has been more stubborn in the recent past is government consumption, but this is with two caveats: it actually fell in the United States between 1980 and 2015, and there are rather clear-cut ways for dealing with this particular set of issues, including mitigating the effects of public sector unions. While ultimately there may be more important priorities than reducing the rate at which government spending grows, the idea that government spending cannot ever

be reduced is not supported by the analysis.

The late public choice economist Robert Tollison once said, “We’re all part of the equilibrium.” By that he meant that even though it may not look like public policy think tanks and other academic institutions have much of an effect on policy, their actions contribute to whatever public policy equilibrium we experience. This notion is supported by recent research on the effects of op-ed writing on public opinion. It would be safe to assume that if free market intellectuals cease to make the case for less government spending, we should expect more government spending in the future than we would have otherwise. **R**

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**TABLE 1**  
Categories of Government Spending by OECD Country

Country	GDP per Capita, 1980 (Thousands of 2010 U.S. dollars)	Government Consumption as a % of Total Consumption			Transfers & Subsidies as a % of GDP			Government Investment as a % of Total Investment		
		1980	2015	Difference in Standard Deviations	1980	2015	Difference in Standard Deviations	1980	2015	Difference in Standard Deviations
Australia	29.79	23.23	23.99	0.13	10.10	12.75	0.41	28.40	12.27	-1.83
Austria	27.63	24.82	27.44	0.46	22.10	25.62	0.55	44.50	12.98	-3.57
Belgium	27.43	21.55	31.82	1.80	26.00	28.71	0.42	26.80	10.21	-1.88
Canada	31.77	28.83	26.92	-0.33	14.50	9.62	-0.76	12.60	16.11	0.40
Denmark	36.38	34.01	35.23	0.21	20.80	21.10	0.05	25.00	18.80	-0.70
Finland	25.66	24.93	30.60	0.99	14.30	23.74	1.47	23.30	19.93	-0.38
France	26.96	23.55	30.28	1.18	26.10	28.27	0.34	27.40	16.76	-1.21
Germany	26.06	26.30	26.30	0.00	17.60	25.68	1.25	25.70	10.83	-1.68
Greece	19.14	14.69	22.34	1.34	8.59	22.51	2.16	32.00	47.58	1.77
Iceland	26.65	22.21	31.86	1.69	10.60	8.70	-0.30	15.30	20.00	0.53
Ireland	17.11	21.96	26.89	0.86	17.50	16.51	-0.15	24.60	9.57	-1.70
Italy	24.45	19.75	23.69	0.69	20.90	24.94	0.63	25.90	13.25	-1.43
Japan	25.49	14.29	25.83	2.02	9.20	23.75	2.26	19.60	15.93	-0.42
Luxembourg	42.64	17.75	36.14	3.22	N/A			22.00	20.86	-0.13
Netherlands	30.08	22.22	36.22	2.45	29.40	24.61	-0.74	14.80	18.19	0.38
New Zealand	22.38	22.59	24.56	0.34	21.90	14.06	-1.22	30.80	16.66	-1.60
Norway	48.54	28.57	35.16	1.15	22.10	17.68	-0.69	35.90	21.10	-1.68
Portugal	12.39	16.76	21.59	0.85	16.30	20.61	0.67	42.20	13.56	-3.25
Spain	17.44	16.45	25.11	1.52	12.30	21.23	1.39	27.10	11.04	-1.82
Sweden	31.09	36.25	36.53	0.05	24.70	20.59	-0.64	41.20	19.29	-2.48
Switzerland	54.89	16.68	17.36	0.12	13.40	14.93	0.24	N/A		
Turkey	4.99	15.89	18.52	0.46	6.00	14.65	1.34	40.00	21.66	-2.08
United Kingdom	21.87	26.62	22.99	-0.64	15.80	15.15	-0.10	29.10	16.25	-1.46
United States	28.73	21.21	17.50	-0.65	10.90	14.87	0.62	17.71	16.10	-0.18

SOURCE: *Economic Freedom of the World: 2017 Annual Report*, Fraser Institute, Sept. 28, 2017.



## BRIEFLY NOTED

# USDA Is Supposed to Regulate Animal Health, Not Animal Happiness

BY HENRY I. MILLER AND JEFF STIER

Last December, regulators at the U.S. Department of Agriculture ruffled a lot of feathers by withdrawing a regulation published on the final full day of the Obama administration that would have created new requirements for producers of “organic” eggs and poultry. Called the Organic Livestock and Poultry Practices (OLPP) rule, it would have, among other things, specified that to boast the coveted “USDA Organic” seal, animals would need to be raised with certain minimum amounts of space, light, and access to the outdoors.

USDA officials offered several rationales for first delaying and then withdrawing the Obama rule. First, they argued that by being overly prescriptive, the rule could discourage the development of new, innovative organic farming practices that would both meet humane standards and also keep costs under control. Second, the Trump USDA interpreted the relevant enabling statute more narrowly than the previous administration and judged that the rule exceeded statutory authority. Finally, the USDA said that “withdrawal of the OLPP also is independently justified based upon USDA’s revised assessments of its benefits and burdens and USDA’s view of sound regulatory policy.”

The notice itself included many passages justifying the withdrawal, including:

- “The OLPP final rule consisted, in large part, of rules clarifying how producers and handlers participating in the National Organic Program must treat livestock and poultry to ensure their wellbeing.... [The Agricultural Marketing Service] is proposing to withdraw the OLPP final rule because it now

believes [the Organic Foods Production Act (OFPA)] does not authorize the animal welfare provisions of the OLPP final rule. Rather, the agency’s current reading of the statute, given the relevant language and context, suggests OFPA’s reference to additional regulatory standards ‘for the care’ of organically produced livestock should be limited to health care practices similar to those specified by Congress in the statute, rather than expanded to encompass stand-alone animal welfare concerns.”

- “USDA believes that it may not lawfully regulate outside the boundaries of legislative text ... and that it lacks the power to tailor legislation to policy goals, however worthy, by rewriting unambiguous statutory terms. Rather, USDA believes it may properly exercise discretion only in the interstices created by statutory silence or ambiguity and must always give effect to the unambiguously expressed intent of Congress.”

- “The OLPP final rule is a broadly prescriptive animal welfare regulation governing outdoor access and space, transport, and slaughter, among other things.... USDA’s general OFPA implementing authority was used as justification for the OLPP final rule.... But nothing in Section 6509 authorizes the broadly prescriptive, stand-alone animal welfare regulations contained in the OLPP final rule. Rather, section 6509 authorizes USDA to regulate with respect to discrete aspects of animal

production practices and materials: Breeder stock, feed and growth promoters, animal health care, forage, and record-keeping. Section 6509(d) is titled ‘Health Care.’ Subsection 6509(d)(1) identifies prohibited health care practices, including sub-therapeutic doses of antibiotics; routine synthetic internal parasiticides; and medication, other than vaccinations, absent illness.”

**Fundamental problem** / Many large-scale organic egg producers applauded the USDA’s withdrawal of the OLPP rule because it would have required them to modify their facilities at significant expense. But proponents of the rule cried foul at the change in course. For them, the rule would have been a financial boon, inasmuch as they were already generally conforming to the standards they had spent years lobbying for. The rule would have permanently protected their businesses from larger-scale producers who sought to enter the organic marketplace with innovative animal welfare approaches.

The *Washington Post* quoted the outraged comments of Jesse Laflamme, co-owner and CEO of egg producer Pete and Gerry’s Organics: “What’s so upsetting is that there is such a gap between what organic consumers expect and what these factory farms are producing.”

Therein lies the fundamental problem with the premise of government standards for organic agriculture, whether it involves the production of meat and eggs or farming of grain, fruits, and vegetables. The entire enterprise is driven more by what the purchasers of organic products expect or feel, rather than any evidence-based criteria. They often resemble the members of a religious cult. People should be free to exercise their beliefs, to be sure, but the government should not be in the business of codifying or promoting them.

Why, then, did the USDA become involved in organic certification in the first place? When the organic standards were promulgated in 2000, then–secretary of agriculture Dan Glickman was unequivocal about the fundamental meaningfulness

HENRY I. MILLER, a physician and molecular biologist, is the Robert Wesson Fellow in Scientific Philosophy and Public Policy at Stanford University’s Hoover Institution. JEFF STIER is a senior fellow at the Consumer Choice Center.

ness of the organic designation:

Let me be clear about one thing, the organic label is a marketing tool. It is not a statement about food safety. Nor is “organic” a value judgment about nutrition or quality.

It’s worth repeating: the organic label is no more than a marketing tool. And it’s a cynical one, because so many unsuspecting consumers are ripped off by the higher prices of organic products, without palpable benefit. That’s why, far from setting more rigid standards for the organic label, the feds should fully extricate themselves from defining “organic.” That definition would be best adjudicated by the market, at the expense of those who are willing to pay the premium.

Organic agriculture has morphed into a massive special-interest bonanza. Annual sales of organic food in the United States now exceed \$40 billion. Federal spending on organic agriculture has mushroomed from \$20 million in the 2002 Farm Act to more than \$160 million in the 2014 version (with further increases under consideration). And according to the USDA, during the Obama administration the USDA “signed five major organic trade arrangements and has helped organic stakeholders access programs that support conservation, provide access to loans and grants, fund organic research and education, and mitigate pest emergencies.”

**Free to choose** / The government should not be putting its thumb on the scales in those ways. It is especially noteworthy that other, analogous special interests—such as the producers of kosher and halal foods—don’t receive similar government benefits. And for that they are better off.

There are enough kosher food-certifying organizations to meet a very wide range of belief systems, for example, and consumers are free to choose products only from groups that meet their standards. This approach allows those who seek to adhere to the strictest standards to have certifying agencies on which they can rely, while also allowing those who accept more relaxed standards to have a wide range of

affordable products that meet their religious needs. They are, in Milton Friedman’s memorable phrase, free to choose.

This democratized private-sector approach has had the effect of expanding the market for fresh kosher meat in the United States. In smaller communities that can’t support a market for the significantly more expensive “glatt” kosher meat (which must meet the strictest standard), kosher consumers can go to Trader Joe’s stores throughout the country and pur-

*As long as the government isn’t involved and there isn’t fraudulent advertising, we don’t care if “organic plus” produce is required to be produced on the moon.*

chase meat that satisfies a more basic and affordable kosher standard.

Some of this stratification is taking root in the organic industry already. Some true-believers are promoting a kind of stricter-standard, “organic-plus” designation. That’s fine: as long as the government isn’t involved and there isn’t fraudulent advertising, we don’t care if, in order to avoid earthly contamination, organic-plus produce is required to be produced on the moon.

The private-sector approach to certifying faith-driven food purchases expands the market and keeps cost down by allowing consumers to pay premiums that reflect their beliefs. And it doesn’t cost nonbelievers a penny.

Organic food companies know this. That’s why those who favor the OLPP are so outraged about its withdrawal. Without new, more rigid, federally mandated standards, they’re forced not only to compete among a range of organic options, but also have to justify the higher cost of their own products through marketing—at their own expense.

Organic boosterism at the federal level is not without consequences. Consumers have been snookered into believing that organic food is healthier, safer, or better for the environment than non-organic options, although the scientific evidence argues oth-

erwise. Lower crop yields are inevitable given organic farming’s systematic rejection of many advanced methods and technologies. Those lower yields, in turn, increase the pressure for the conversion of more land to farming and more water for irrigation, both of which are serious environmental issues.

Because prices for organic food are much higher, those misconceptions eat away at consumers’ buying power. And while organic marketers like to promote the idea that “organic” implies “locally grown,” the

United States is actually a net importer of organic goods, including (supposedly) organic grains from countries like China, India, Turkey, and Romania, with no way to be sure those countries adhere to “organic” standards that

even remotely resemble those in the United States. Moreover, there is documented widespread cheating in the organic designation of eggs, milk, and imported grains.

Let’s return to the OLPP rule and the USDA’s decision to withdraw it. The withdrawal elicited bitter condemnation from many organic farmers and the Organic Trade Association, whose long-standing lobbying for the rule was rent-seeking, pure and simple. The group knows its constituency, whose views were reflected in a March 2017 survey by *Consumer Reports*. In that survey, some 60% of Americans said that it is extremely or very important that animals used to produce organic food “are raised on farms with high standards for animal welfare.” Further, 54% said that it is extremely or very important that eggs labeled “organic” come from hens that are “able to go outdoors and move freely outdoors.”

We support the withdrawal of the OLPP rule, but see it only as a first step in ending the federal imposition of belief-based food-production standards. If industry and consumers want such standards, they are free to form nongovernmental entities at their own expense to develop whatever rules or sets of rules they prefer. If they do so, we—as believers in market-driven solutions—will gladly give them our blessing. R

## BRIEFLY NOTED

# The New Perils of Data Localization Rules

◆ BY IKE BRANNON AND HART SCHWARTZ

Our increasingly connected globe has resulted in more data being generated each and every year, a progression that has become geometric. The world produced more data in 2017 than in the previous 5,000 years of recorded human history combined, according to Art Landro, the CEO of Sencha, a company that develops data-centric websites and applications.

What's more, the value of data in the aggregate has increased over time, as computing power and human ingenuity advanced in tandem to apply the data to answer a myriad of questions, including such important issues as drug efficacy, crop fertility, weather forecasting, and—of course—consumer and voter behavior. So as we produce more data, we are doing more with it as well—or at least not disposing of it.

As data become more valuable, governments across the globe have responded by asserting more control over the data produced in their jurisdiction. Often these rules require that companies collecting data in a country also maintain the data in that country. Governments often justify these “data localizations” requirements by appealing to the need to ensure cybersecurity or maintain the privacy of citizens.

There are certainly a range of legitimate interests in the realm of sovereignty, security, and human rights that may conflict with economic considerations. But broad data localization requirements can tip into “data protectionism” whose effect may be to impede the continued growth of international trade. The U.S. International Trade Commission (ITC) reports that half of all global trade in services depends on access to cross-border data flows.

In short, the rhetoric and motivations for continued actions to restrict data flows across borders should always be subject to strict scrutiny.

IKE BRANNON is president and HART SCHWARTZ is a senior analyst for trade and data analytics with Capital Policy Analytics, a D.C. economic consulting firm.

**Types of data localization** / James Kaplan and Kayvaun Rowshankish, partners with the consulting firm McKinsey & Co., suggest in an article published in the *Global Commission on Internet Governance* that there are four main categories of data localization, listed below from most to least stringent:

- **Geographical restrictions on data export** (“data copy cannot leave”), which force foreign companies to create separate in-country servers or other infrastructure to hold the data. South Korea and Egypt impose a variant of this.
- **Geographical restrictions on data location** require foreign companies to retain a local replica of the data. Indonesia and Malaysia impose such rules on businesses operating within their borders.
- **Permission-based regulations** mandate that foreign companies must gain consent from their customers for cross-border data transfer. Brazil, Argentina, Switzerland, and Luxembourg each require some sort of permission before data can be transferred.
- **Standards-based regulations** allow foreign companies to move data freely but companies must ensure security and privacy for customers.

Data localization can also be classified according to whether it is *absolute* or *conditional*. Absolute measures stipulate that some combination of data storage, processing, and access must occur locally. Conditional measures, in contrast, effectively ban the exit of data from the jurisdiction by placing extremely restrictive conditions.

The ITC tracks the growth of data local-

ization worldwide. By their estimation, such measures have grown sharply over the last few years in apparent lockstep with the growth of data.

Increasing data localization has imposed higher costs on multinational firms that operate across borders. By constraining the freedom to share data across locales around the globe, these regulations force firms to hire more people in the country where the data originated rather than permitting companies to locate the operations where their staff is best-equipped for the particular task. Such restrictions concomitantly limit potential productivity gains and essentially force firms to make costly investments in local data infrastructure to comply with local content laws. Ultimately, other businesses and their consumers pay the costs of data restrictions via higher prices and less choice. In the long run, such rules ultimately create smaller, less robust markets across the globe.

**Estimated economy-wide losses** / Several organizations have conducted econometric studies to understand the economy-wide effect of data localization measures. Table 1 shows the findings of the European Center for International Political Economy (ECIPE) along several key metrics.

Other research echoes ECIPE's findings. In 2014 the ITC found that “foreign digital trade barriers” depressed U.S. gross domestic product by 0.1–0.3%, which amounts to between \$16.7 billion and \$41 billion per annum. A study conducted in 2016 jointly by the Center for International Governance Innovation (CIGI) and Chatham House estimated that digital trade barriers reduced GDP by 0.10% in Brazil, 0.55% in China, 0.48% in the EU, and 0.58% in South Korea.

**Payment companies in China** / The operations of digital payment companies in China are an excellent example of the business strategy quandaries presented by data localization measures. Digital payments in China have been rising at a stunning rate, from 6.3 per Chinese resident in 2011 to 26.1 in 2015. Considering that in developed countries such as Germany, France, and the United States, 200–400

such payments are made annually per person, and considering the 1-billion-plus Chinese population, the long-term growth potential in China is enormous for the digital payments industry.

The market includes more than traditional payments from transaction charges, transfer fees, interest income, and maintenance fees. These data can be monetized into many lucrative income streams, including targeted advertising for merchants based on smartphone location, customized information on likelihood of repayment, and precise measurements of customer tolerance of financial risk.

Developing the full scope of the business model depends upon the ownership of the data streams, and that is now problematic for non-Chinese companies. Last year China's new Cybersecurity Law took effect. Of particular concern is a mandate that "critical information infrastructure" must store personal information and other important data on servers physically located within mainland China. This clearly constitutes a data localization provision, and a very wide assortment of digital activities could be subject to it because of the vagueness of the provision.

Foreign companies thus must install and maintain data servers within China and accept the risk of unpredictable penalties as a result of the open-ended nature of the legislation. This makes sustained investment very challenging. Kaplan and Rowshankish, the McKinsey consultants, state:

Executives reported that they have severe difficulties gaining a clear and comprehensive view of the full set of regulations. Many are worded so vaguely that it is impossible, they say, to predict what is and is not allowable.... The uncertain environment makes it particularly difficult to plan and execute large technology investments.

How can digital payment companies invest in China in such a climate? Many find they have little choice but to submit: if

companies choose not to participate, their competitors can potentially grab the market and use a first-mover advantage to reap a windfall as the value of data explodes.

**Policy options** / The preponderance of global trade restrictions creates difficult

normally engage local courts in domestic legal systems, trade lawyers cannot appropriately handle such matters. In addition to the practical difficulties involved in harmonizing enforcement across widely differing domestic judicial systems, the larger Westphalian nation-state principle

**TABLE 1**  
Predicted Losses in Case of Economy-Wide Data Localization

	Lost GDP	Lost consumer welfare	Lost wages per data worker (% of monthly salary)	Lost domestic investments
<b>Brazil</b>	-0.80%	\$15 billion	-20%	-5.4%
<b>China</b>		\$63 billion	-13%	
<b>European Union</b>	-1.10%	\$193 billion		-5.1%
<b>India</b>	-0.80%	\$14.5 billion	-11%	-1.9%
<b>Indonesia</b>	-0.70%	\$3.7 billion		-12.6%
<b>South Korea</b>	-1.10%	\$15.9 billion	-20%	-3.6%
<b>Vietnam</b>		\$1.5 billion		-3.1%

Source: European Center for International Political Economy (ECIPE)

tradeoffs for tech companies and other multinationals that depend on data for their business. Governments face difficult tradeoffs as well. They wish to attract foreign investment while protecting their citizens according to their own national values of privacy, security, and human rights. They wish to adjudicate data-related disputes in their own domestic legal systems, and in a post-Edward Snowden world, they desire to avoid foreign surveillance of domestic data.

Attempts to regulate this situation through trade agreements have run aground. To some extent these failures reflect the underlying difficulty of reconciling commercial and noncommercial data. Only a fraction of the growing volume of cross-border data flows is of a financial, commercial, or transactional nature. Most personal data take the forms of emails, videos, text messages, and phone calls.

Typically, trade agreements conduct dispute resolution through panels of trade lawyers. But when cross-border data leads to disputes involving civil matters such as torts or criminal matters such as harassment, and when these disputes would

of noninterference in the internal affairs of other nations presents another obstacle.

Nevertheless, for the continued growth of global trade, some type of reciprocated balancing must take place between the needs of global businesses and the prerogatives of sovereign governments. Perhaps the place of departure could involve, at least initially, recognizing the sheer multidimensional complexity of the matter. Progress toward new solutions may proceed from awareness that most cross-border data flows are not in fact trade-related.

Could it be possible, then, to imagine a world in which each differentiated dimension of cross-border data is regulated by a separate type of agreement, within a different sphere of international law? Could law enforcement, trade, cybersecurity, and other domains each receive their own separate international agreement, so as to avoid the pitfalls of previous attempts at "all-in-one grand bargains" that fall apart if any one element cannot be agreed? In a world in which economic protectionism is on the rise, finding a new path forward for "data protectionism" is of great importance. 