

# Regulation

THE CATO REVIEW OF BUSINESS AND GOVERNMENT

Antitrust Philosophies Divide  
Both the Left and Right P.18Trade's Benefits Involve More  
than Comparative Advantage P.36Regulatory Reform Requires  
Cleaning Out Statutory "Junk" P.24

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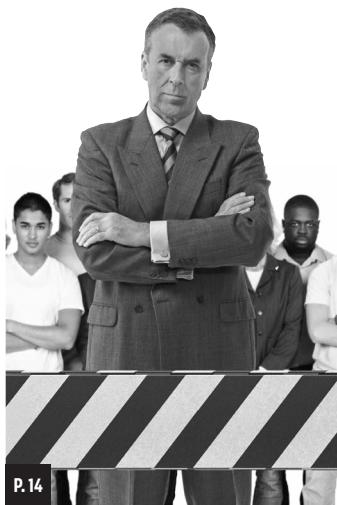
## Regulators' War on Entry-Level Jobs

Government pushes  
employers toward the  
conventional  
and the  
college-educated



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## 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 transaction 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 vigorish, offering rates as low as 2% to high-volume betters. 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.

## BRIEFLY NOTED

# 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



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

KENNETH W. COSTELLO is a principal specializing in energy and the environment at the National Regulatory Research Institute.

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. Regrettably, 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

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

## Can We Cut Government Spending?

BY RYAN H. MURPHY

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Healthier 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

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

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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.

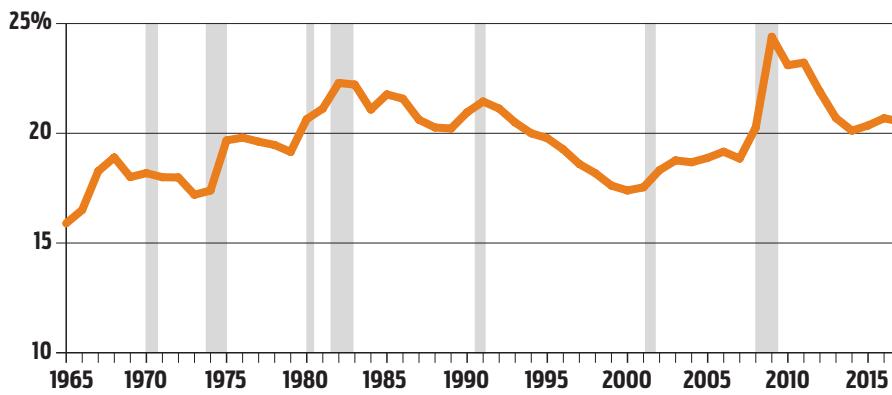
Second, despite the headwinds of rising entitlements for the elderly across all advanced economies, there are several examples of countries that have managed to cut transfers and subsidies over the last 35 years.

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

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-

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

*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-

## 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

	<b>Lost GDP</b>	<b>Lost consumer welfare</b>	<b>Lost wages per data worker (% of monthly salary)</b>	<b>Lost domestic investments</b>
<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. R

# Back to the Future of Arbitration

## *Should businesses be so hostile to class actions?*

BY RICHARD A. BOOTH

In the 1999 movie *Office Space*, the (more or less) good guys hatch a plan to divert to themselves fractions of cents that their sleazy employer Initech had apparently been overcharging its customers by rounding up billings. Had any customer discovered Initech's scam, he might have filed a class action seeking a refund for himself and all others who had been cheated. But the chances are that the customers committed themselves to arbitrate disputes and waived any right to join a class action when they signed a purchase order or clicked "Agree" on Initech's website (if it had a website in 1999). So the firm could settle up privately with any customer who complained—maybe even under a nondisclosure agreement—and would not need to change its ways.

Until recently, there was some doubt whether such waivers were enforceable. But last October, the U.S. Senate voted to rescind a new rule promulgated by the Consumer Financial Protection Bureau (CFPB) that would have overridden these now ubiquitous provisions barring consumers from joining any class action. So consumer class actions are pretty much dead in the financial industry, at least for now. But business may regret this apparent victory.

To be sure, the CFPB is itself controversial. It is an odd agency born of the 2010 Dodd-Frank Act and seen by many conservatives as the pet project of Sen. Elizabeth Warren (D-Mass.). It is not overseen by a bipartisan panel of commissioners, but rather by an appointed director. That director *was* Richard Cordray, who began his tenure via an attempted recess appointment by President Barack Obama and whose statutory successor has since been replaced by President Trump with Mick Mulvaney (who also continues to serve as director of the Office of Management and Budget).

That controversy aside, the Senate vote was no doubt influenced by a Treasury Department report issued the day before the

vote, lambasting the CFPB and the rule. The most striking feature of the report is its title, "Limiting Consumer Choice, Expanding Costly Litigation: An Analysis of the CFPB Arbitration Rule."

Limiting consumer choice? Really?

In practice, consumers have zero choice whether to agree to arbitration. Indeed, they seldom know that they have done so until they complain. But in the era of fake news, it seems Treasury is entitled to its own facts.

The Treasury critique may seem persuasive: Only 13% of consumer class actions result in recovery, of which 31% goes to plaintiff attorneys. And just 4% of class members claim their average \$32.35 share of successful class recoveries. Treasury says this means that consumers place little value on class actions. But if only 4% bother to seek payment when they are already entitled to it, how many will initiate arbitration?

The likely effect of abrogating the CFPB rule is that financial institutions will escape the need to answer *at all* for abusive practices. No doubt that was the real goal.

But the CFPB rule was not about compensation or compliance or consumer choice. The idea that consumers will choose a bank or credit card based on whether it comes with arbitration or permits class actions is ludicrous. The rule was about *deterring* business practices that gouge consumers, so to focus on consumer recovery misses the point. The focus should be on the payout by the wrongdoers and not on who gets the money.

There is no doubt that class actions can be abused by unscrupulous plaintiff attorneys. The mere threat of liability to a class comprising thousands of consumers (or investors) may be enough to induce a defendant to settle even if the claim is frivolous. Indeed, it is quite rational to do so if the case can be settled for less than the cost of seeking dismissal in court. And there are law firms that have made a business of exploiting the math.

On the other hand, there is no doubt that class actions can be beneficial. As the U.S. Supreme Court stated in *Califano v. Yamaski*



(1979), class actions can save “the resources of both the courts and the parties by permitting an issue affecting every [class member] to be litigated in an economical fashion” where “the amounts at stake for individuals may be so small that separate suits would be impracticable”—that is, too costly to try one at a time.

Moreover, an individual plaintiff cannot simply declare an action to be a class action. Under Rule 23 of the Federal Rules of Civil Procedure, the court must approve the lead plaintiff and lawyer (among other things) before the action can be certified to proceed as a class action. If the court does not do so, the case reverts to a simple lawsuit between plaintiff and defendant.

To explain: A class action is an ordinary lawsuit in which the plaintiff asserts claims typical of those of many other potential plaintiffs. So the plaintiff seeks to act as a representative for hundreds or thousands of others with similar claims. One might think of it as a test case in which the claims of absent class members are actually tried and settled. Since the named plaintiff serves as a fiduciary for absent class members, he or she must be found to be worthy: not only to be typical, but also to be an adequate representative. But a lead plaintiff who is subject to an agreement to submit to arbitration—who has no right to be in court in the

first place—can hardly be an adequate representative for absent class members (although they may have no right to be in court either). Indeed, defendants routinely oppose class certification on such grounds—and prevail—thus sending plaintiffs back to bilateral trial or arbitration of their individual claims.

#### AVOIDING THE BILL OF PEACE?

It is surprising that business has been so hostile to class actions because they provide a way to adjudicate numerous small claims all at once, thus precluding never-ending bother by the Lilliputian swarm. It is telling that when the class action first emerged under English law, it was called a Bill of Peace. One would think that the prospect of dispensing with the claims of thousands of consumers all at once—cutting off the claims of absent class members who may not even know they have a remedy—would be quite attractive.

Alas, abrogation of the CFPB rule returns us to the legal world as it was following the 2011 Supreme Court decision in *AT&T Mobility v. Concepcion*. There, the plaintiffs had signed up for cell phone service and a free phone. When AT&T sent them a bill for the sales tax on the phone—\$30.22—they sued and sought to litigate the matter as a class action. But the contract of sale

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included an agreement to arbitrate and a class action waiver. The trial court and the Ninth Circuit ruled that the class action waiver was unconscionable and thus unenforceable under a California statute as interpreted by the state's courts because it effectively precluded anyone from suing for such a small sum.

The Supreme Court reversed, holding that California law was preempted by the Federal Arbitration Act (FAA) adopted by Congress in 1925 to assure that contracts to arbitrate would be enforced. In the majority opinion, Justice Antonin Scalia emphasized that an agreement to arbitrate is just that: a bilateral contract in which two parties have agreed to arbitrate any dispute. As a legitimate private contract, it should be enforced as written, particularly in light of the FAA. But Justice Scalia also observed that class arbitration is oxymoronic—that a class action is inherently inconsistent with arbitration (although the Court had previously suggested quite the opposite regarding cases in which the parties agree to class arbitration).

In the end, the argument from contract (and the FAA) proves too much. An agreement to arbitrate is just that: an agreement between two parties to handle a dispute between the two of them. I cannot waive your rights. You cannot waive my rights. So how is it that the rights of similarly situated consumers to join forces under established rules of civil procedure has disappeared as a result of many individual one-on-one contracts that supposedly affect only the rights of the signatories?

To be clear, the CFPB rule would not have affected *bilateral* arbitration provisions. Rather, it would have prohibited banks and other financial firms from relying on such provisions to avoid litigating a class action in court. But it is not clear that the FAA policy favoring the enforceability of agreements to arbitrate ought to apply to class waivers. A class waiver is not an agreement to arbitrate. It is an agreement to refrain from exercising a right. It is black letter law that a waiver will be strictly construed. As such, a waiver is quite different from a positive agreement to arbitrate a claim. The fact that a class waiver has been attached as a rider to an agreement to arbitrate does not mean the rider falls within the FAA.

## DANGER OF ABUSE?

Moreover, the danger of abusive class actions is overblown. Again, the rules require that the court approve both the individual representative plaintiff and class counsel. Thus, the court has the power to remove and replace both plaintiff and lawyer if necessary to protect the interests of the class. In addition, the court must approve the definition of the class, thus determining who is or is not a member and the scope of the action. Perhaps most important, the court must approve the voluntary dismissal or settlement of the action: once filed, a class action may not be dropped because the plaintiff or lawyer has a change of heart (say) as a result of being paid off individually by the defendant.

Thus, the only real danger of abuse comes from failure of the courts to do their job. Indeed, several state courts became havens for class actions, presumably because judges were less than rigor-

ous in enforcing the rules. Thus, Congress passed the Class Action Fairness Act (CAFA) of 2005, which among other things provides for the transfer of a state-court class action to federal court if the amount at stake is \$5 million or more.

The bottom line is that a class action does not belong to the individual—or lawyer—who files it. The point is emphatically illustrated by *Standard Fire Insurance Co. v. Knowles* (2013), wherein the named plaintiff and her lawyer agreed in advance that the class would seek a total award of less than the \$5 million limit that would trigger removal of the case under CAFA from an Arkansas state court to federal court. The Supreme Court rejected this tactic because neither the class lawyer nor the class plaintiff can bind absent class members until the court certifies the action as a class action. To repeat: how is it that the rights of similarly situated consumers to join forces under established rules of civil procedure disappeared as a result of many individual one-on-one contracts that supposedly affect only the rights of the signatories?

## WHAT ABOUT PUNITIVE DAMAGES?

Assuming that we want consumers to be made whole, how should we go about it?

Consider the recent litigation about bank overdraft fees generated by some banks' practice of clearing big checks before small checks, thus resulting in a fee for each overdrafted small check. It is unlikely that the aggregate effect of the practice would even be considered in bilateral arbitration. The bank would likely argue that the dispute is with *this* customer, who should have read the fine print and been more careful with his money. And even if a few consumers prevail, why would the bank change its ways? In contrast, a class action can address distinct *collective* interests of consumers.

Proponents of arbitration argue that it is quick and cheap because it can dispense with many of the niceties of litigation in court. But it is also private. There is typically no published opinion. Thus, the public is deprived of information about their rights and remedies. And the law ossifies.

In the absence of a class action, punitive damages or some specified financial penalty may be necessary. If a wrong is difficult to detect or victims may not always sue, the wrongdoer may not be deterred from bad behavior by the prospect of paying up when caught—especially if the wrongdoer gains from the wrong. Thus, the law imposes treble damages for antitrust violations and disgorgement plus treble damages in cases of insider trading.

If there is no such statutory remedy, punitive damages can address the problem. For example, if there is a 20% chance that a consumer will notice an overcharge and a 50% chance that a consumer who notices will sue, it makes sense to award damages equal to ten times the individual harm in order to deter the defendant from overcharging others. Merely to make the consumer whole is no way to deter the seller from continuing the practice.

Surprisingly, the Supreme Court held in *Mastrobuono v. Shears* *Lehman Hutton* (1995) that punitive damages can be awarded in arbitration. Before *Mastrobuono*, well-settled state law prohibited

punitive damages in arbitration. Traditionally, the courts viewed punitive damages as more in the nature of a criminal fine or penalty based on harms suffered by others not present in a bilateral arbitration. But the Supreme Court ruled that this sensible doctrine was trumped by the FAA. Sound familiar? As in *Concepcion*, the Court ruled that the FAA trumped the common law.

Should we rely on a class action where we calculate the aggregate loss and write everyone a small check? Or should we rely on individuals to sue in isolation and seek punitive damages where the aggregate recovery may be some multiple of the gain to the wrongdoer?

Needless to say, the prospect of a big award of punitive damages will motivate consumers—and their lawyers—to ferret out wrongs. But what is to prevent multiple lawsuits for punitive damages with the possible result that defendant businesses pay out far more than their ill-gotten gains and the losses suffered by consumers—especially when word spreads that the courts are handing out free money? It was just such a feeding frenzy that led the Second Circuit Court of Appeals, in *Roginsky v. Richardson-Merrell* (1967), to overturn an award of punitive damages in a classic opinion by Judge Henry Friendly (at a time when class actions had scarcely been born). Do we really want a legal system based on the illogic of the lottery? One can well imagine defendant companies crying “Uncle!” and seeking the protection of class action status.

In short, punitive damages are a poor substitute for a class action, and especially so in arbitration. Estimating the chances of detection and recovery is better suited to a court that is attuned to public policy and sees many cases. Moreover, if punitive damages are intended in part to be exemplary—to set a public example—how exactly does that work in arbitration where the reasoning and decision remain private?

To be clear, the rationale for punitive damages disappears in a consumer class action. If all of the victims of a scam are party to the action, there is no need to multiply the damages. Moreover, one would think that business would prefer such a Bill of Peace—settling all claims likely for cents on the dollar—over bilateral arbitration with the possibility of repeated awards of punitive damages. Apparently not. Could it be that business reckons it will escape the need to answer *at all* for abusive practices because few consumers will bother to file claims?

### PURPOSE OF DAMAGE AWARDS

A lawsuit serves two important functions. One is compensation: to make whole someone who suffers harm at the hands of a wrongdoer. The other is deterrence: to discourage wrongdoing by imposing compensation. Ideally, these two functions complement each other. As Judge Learned Hand explained in the legendary 1947 decision in *United States v. Carroll Towing*, the law should provide compensation to victims only if the cost to avoid the harm is less than the cost of the harm itself. Ronald Coase made essentially the same point in a classic 1960 *Journal of Law & Economics* article, “The Problem of Social Cost,” for which he got a theorem named after him—not to mention a Nobel Prize.

If compensation is too generous, there will be too many lawsuits and potential defendants will be too cautious. That is essentially what has happened with securities fraud class actions where defendant companies gain little or nothing from the so-called fraud but where the damages that may be claimed by plaintiffs are so generous that almost every case that survives a motion to dismiss quickly settles for the entire amount of any insurance carried by the defendant.

The problem is quite the opposite in most consumer class actions where aggregate compensation is a small fraction of ill-gotten gains. Punitive damages seek to address this imbalance typically by awarding some multiple of compensatory damages to reflect the unlikelihood of detection and legal action. Quite aside from the contradictions inherent in what amounts to a criminal penalty payable to a lucky individual plaintiff rather than the state, the calculus of probabilities is speculative at best. Indeed, the law resorts to broad-brush concepts that seek to capture the intent of defendants (like Initech) who bank on not getting caught or pursued.

It does not help that one often hears the argument from consumer activists that punitive damages are intended to punish wrongdoers—that the idea is to inflict real financial pain because otherwise the defendant will treat the award as nothing more than a cost of doing business. Quite to the contrary, the point of punitive damages should be to assure that businesses as well as individuals bear the full cost of their economic activities. In other words, we *want* businesses to internalize such costs. Given that many lawyers and judges (including the Supreme Court) seem not to understand how punitive damages should work, it is little wonder that defendants quake at the possibility of an award of punitive damages in a class action, notwithstanding the contradictions inherent in such a result. No doubt such fears were responsible in part for abrogation of the CFPB rule.

The tragedy is that class actions can address the problems inherent in punitive damages. By compensating all individual plaintiffs for their actual losses, there is no need to speculate about how many fail to recognize that they have been harmed or fail to complain. And given that only a small fraction of consumers who understand their rights would seek redress, do we really care that some of the recovery goes to the lawyer who organizes the effort?

### CONCLUSION

The Treasury Department prevailed in the Senate by focusing attention on compensation and poking holes in the idea that consumers are made whole by class actions. But the focus should be on deterrence—the payout—not the recipient.

While it is easy to calculate how much consumers receive, there is no good way to measure the effects of deterrence. How do we quantify the benefit of preventing schemes that do not materialize because a thoughtful businessperson foresees the prospect of a class action?

No empirical study is likely to show the best way to prevent a one-off scam that is unlikely to be repeated. But that is no reason not to get the rules right—or at least to try. R

## ANTITRUST

# Antitrust's Unconventional Politics

*The ideological and political motivations for antitrust policy do not neatly fit the standard left/right dichotomy.*

● BY DANIEL A. CRANE

Antitrust law now stands at its most fluid and negotiable moment in a generation. The bipartisan consensus that antitrust should focus solely on economic efficiency and consumer welfare has quite suddenly come under attack from prominent voices calling for a dramatically enhanced role for antitrust law in mediating a variety of social, economic, and political friction points, including employment, wealth inequality, data privacy and security, and democratic values. To the bewilderment of many observers, the ascendant pressures for antitrust reforms are flowing from both wings of the political spectrum, throwing into confusion a conventional understanding that pro-antitrust sentiment tacks left and antitrust laissez faire tacks right.

On the left, the assault on the consumer-welfare-oriented status quo has migrated from reformist organizations like the Open Markets Institute and anti-corporate progressives like Sen. Elizabeth Warren (D, MA) to the House Democratic Leadership, which has staked the 2018 midterm elections on an economic platform including antitrust reform as a centerpiece. In the Democratic Party's center, the formation of a House Antitrust Caucus and reform bills introduced in both the House and Senate underscore increasing political traction to jettison the consumer welfare status quo. The Democrats' antitrust plank in their "Better Deal" platform asserts that consumers are but one of several classes that antitrust should protect, with workers, suppliers, and small business taking on equal status. Significantly, the document launches harsh criticisms of the past 30 years of antitrust enforcement as excessively lax—a period over which a Democratic president oversaw antitrust enforcement more than half of the time. The Democratic leader-

ship has made clear that it does not intend to exclude the Clinton and Obama administrations from its criticism and that it intends to advocate a major, trans-partisan rethinking of antitrust policy.

On the right, President Trump has attacked concentrated economic power in "Big Media" and his Justice Department has launched a surprising, aggressive challenge to the AT&T-Time Warner vertical merger. Trump's trustbusting might be dismissed as a feature of his idiosyncratic populism or, less charitably, abusive vendettas against corporate political foes such as CNN and Amazon, but the reformist sentiment on the right is far from limited to the president. Similar sentiments have been expressed by such diverse conservative figures as activist Steve Bannon, who wants to turn Google and Facebook into public utilities, conservative economist Kenneth Rogoff, and Trump's decided political foe Bill Kristol, who criticizes conservative icon Robert Bork's consumer welfare standard and proposes a significant reinvigoration of the antitrust laws to limit the growing power of tech's "Big Five" (Amazon, Apple, Facebook, Google, and Microsoft). *The American Conservative* magazine recently turned on Bork with surprising ferocity, asserting that "whereas prior generations of lawmakers protected the American citizenry as businessmen, entrepreneurs, and growers, Bork led a revolution that sacrificed the small producer at the altar of efficiency and cheap goods."

Standing against the anti-incumbent challengers from both political wings is a broad, bipartisan establishment center seeking to defend the consumer welfare framework. Until recently, this establishment center seemed far from unified. Since the rise of the Chicago School view of antitrust in the 1970s, antitrust law has been contested on terms that seemed generally to track left/right political ideology, with those on the left favoring more aggressive intervention and those on the right more laissez faire. But the rising tide of calls for a radically different version of antitrust has led to a circling of establishment wagons around the consumer



welfare standard. Left-leaning organizations that once led the charge for more aggressive enforcement now find themselves defending the consumer welfare idea in principle, even while calling for more aggressive enforcement within that paradigm. Meanwhile, conventionally conservative or pro-business organizations continue to defend the consumer welfare standard against assaults from their own right flank.

Although unconventional in present terms, the emerging political dislocations over antitrust policy reflect longstanding ideological ambiguities about and within the anti-monopoly tradition. In particular, the current political fracturing over antitrust is best understood by examining three ideological friction points that have emerged periodically within American history:

- the ideological ambiguity surrounding the association between large scale in business and government
- the shifting meaning of “monopoly” from exclusive grant of government privilege to purely private power and a related question about the sources of monopoly power
- pragmatic concerns about the ability of the capitalist order to survive without regulatory interventions to smooth its roughest edges

Taken in the context of these longstanding friction points, the strange bedfellow coalitions uneasily rising around contemporary antitrust reform aren’t that strange at all.

### BRANDEIS AND BORK AS IDEOLOGICAL TOUCHPOINTS

Although American antitrust policy has been influenced by a wide variety of ideological schools, two influences stand out as historically most significant to understanding the contemporary antitrust debate.

The first is a Brandeisian school, epitomized in the title of Louis Brandeis’s 1914 essay in *Harper’s Weekly*, “The Curse of Bigness.” Arguing for “regulated competition” over “regulated monopoly,” he asserted that it was necessary to “curb[] physically the strong, to protect those physically weaker” in order to sustain industrial liberty. He evoked a Jeffersonian vision of a social-economic order organized on a small scale, with atomistic competition between a large number of equally advantaged units. His goals included the economic, social, and political. As explained in a dissenting opinion by William O. Douglas in the 1948 *Columbia Steel* case, Brandeis worried that

size can become a menace—both industrial and social. It can be an industrial menace because it creates gross inequalities against existing or putative competitors. It can be a social menace—because of its control of prices.

The Brandeisian vision held sway in U.S. antitrust from the Progressive Era through the early 1970s, albeit with significant interruptions. Its spirit animates a long chain of important cases from *Chicago Board of Trade* in 1918 (authored by Brandeis himself)

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to TOPCO in 1972, and a string of congressional reforms including the Clayton and Federal Trade Commission Acts of 1914, the Robinson-Patman Act of 1938, and the Celler-Kefauver Act of 1950.

The ascendant Chicago School of the 1960s and 1970s threw down the gauntlet to the Brandeisian tendency of U.S. antitrust law. In an early mission statement, Bork and Ward Bowman characterized antitrust history as “vacillat[ing] between the policy of preserving competition and the policy of preserving competitors from their more energetic and efficient rivals,” the latter being an interpretation of the Brandeis School. Chicagoans argued that antitrust law should be concerned solely with economic efficiency and consumer welfare. “Bigness” was no longer necessarily a curse, but often the product of superior efficiency. Chicago criticized Brandeis’s “sympathy for small, perhaps inefficient, traders who might go under in fully competitive markets.” Preserving a level playing field meant stifling efficiency to enable market participation by the mediocre.

Beginning in 1977–1978, the Chicago School achieved an almost complete triumph in the Supreme Court, at least in the limited sense that the Court came to adopt the economic efficiency/consumer welfare model as the exclusive or near exclusive goal of antitrust law. (Adoption of Chicago School interpretations of consumer welfare and policy positions on particular competitive practices would occur neither immediately nor completely.) In 1979, citing Bork, the Court declared that “Congress designed the Sherman Act as a ‘consumer welfare prescription.’” Over time, the maxim that antitrust law should protect “competition rather than competitors” became canonical. Brandeis had been displaced by Bork.

If the last three or four decades of U.S. antitrust policy have largely belonged to Bork—at least at an ideological level—the Bork vs. Brandeis dichotomy is far from settled. The voices at the cutting edge of the rising reformist movement—particularly those aligned with the influential Open Markets Institute—explicitly style themselves as a “New Brandeis” school in order to re-up the historical contest between the Brandeisian and Chicago School orders.

### THE LINGERING SHADOWS OF JEFFERSONIANISM AND HAMILTONIANISM

Although it is conventional to understand Brandeis’s anti-bigness ideology as an aspect of Progressivism standing in contrast to Chicago’s big business conservatism, the story is historically more nuanced. Brandeis’s preoccupation with “bigness” was not limited to large corporate scale; he was also deeply concerned with large governmental scale generally, and a large-scale federal government in particular. As George Washington University law professor Jeffrey Rosen observed in a June 2016 article in *The Atlantic*, “Denouncing big banks as well as big government as symptoms of what he called a ‘curse of bigness,’ Brandeis was determined to diminish concentrated financial and federal power, which he viewed as a menace to liberty and democracy.” Brandeis styled himself a Jeffersonian and his ideology resonated with the Jeffersonian preference for small-scale yeomanry and localized political organization.

In lionizing large corporate scale, the Chicago School aligned itself with the Hamiltonian vision for a robustly mercantile society grounded on powerful financial and economic institutions. By doing so, Chicago always risked alienating the libertarian right, with its affinity for Jefferson’s vision of small-scale government and industrial production. Many libertarians have found it hard to attack bloated government without also worrying about bloated business. (Witness the rise of the Tea Party, which arose in large part as a reaction to corporate bailouts.) Influential libertarians like Friedrich Hayek saw a role for antitrust law in curbing monopolistic abuses because they understood unfettered corporate power as a threat to personal liberty.

The divide between the competing Hamiltonian and Jeffersonian ideals on organizational scale and their implications for efficiency and liberty thread through antitrust’s intellectual and ideological history, often disrupting conventional political alignments. Teddy Roosevelt, a deep admirer of Hamilton, was comfortable with large scale in both government and business. Far from a “trustbuster,” Roosevelt opposed breaking up Standard Oil, viewing large aggregations of capital as inevitable and necessary—so long as they were superintended by a strong federal government. Roosevelt’s affinity for large-scale government and business earned him the epithet of “socialist.”

That charge was hyperbolic, but not directionally implausible. In the late 19th and early 20th centuries, American socialists looked with suspicion on the antitrust laws because they viewed the rise of the Gilded Age trusts as salutary stepping stones to government appropriation of the means of production and industry. Socialist presidential candidate Eugene Debs, himself the defendant in an antitrust prosecution, argued:

Monopoly is certain and sure. It is merely a question of whether they will be collectively owned monopolies, for the good of the race, or whether they will be privately owned for the power, pleasure and glory of the Morgans, Rockefellers, Guggenheims, and Carnegies.

Conversely, influential conservatives in antitrust’s formative era favored aggressive antitrust enforcement as an antidote to the simultaneous aggrandizement of government and business. In the crucible election of 1912, William Howard Taft argued against Progressive proposals to create a new Federal Trade Commission, asserting that his administration’s aggressive enforcement record demonstrated how traditional prosecutorial and common law processes could obviate the need to create new large-governmental organizations to combat big business. Taft’s pro-enforcement saber-rattling reached such a crescendo that Wall Street began to wonder whether Roosevelt might be the candidate more sympathetic to their interests.

The New Deal, too, saw the Democratic Party equivocate between contending Jeffersonian and Hamiltonian impulses on the question of governmental and business scale. The first New Deal period, from 1933 to early 1935, was dominated by the National

Industrial Recovery Act, which encouraged a centralization of both governmental and industrial power. Brandeis led the charge on the Supreme Court to strike down the NIRA in 1935, warning the White House that the Court would not tolerate continued centralization of business or governmental power. From 1935 until the beginning of the war, the New Deal administration followed a policy of aggressively Brandeisian antitrust enforcement. Then, facing a need to mobilize big business for the war effort, the administration abruptly shifted course and embraced a “business commonwealth” model of partnership between big government and big business.

After the war, the perception that industrial concentration in Germany and Japan had fueled the rise of fascism contributed to a two-decade period of intensive antitrust enforcement—particularly against mergers—launched by the Celler-Kefauver Act of 1950. Here again, the ideology of the anti-monopoly movement was ambiguous in conventional left/right terms. The anti-monopolist Sen. Estes Kefauver (D, TN) warned that the consequence of further industrial concentration would be government takeover, and that could lead either to fascism on the one hand or socialism or communism on the other. Other proponents of the act argued that the antitrust laws were “one of the greatest bulwarks against communism” and that the rising tide of industrial concentration was driving the country toward “collectivism.” It is no coincidence that the most anti-consolidationist statute in American history was passed during the period of the Red Scare.

The ambiguity in the relationship between corporate scale and governmental scale has translated into a historical ambiguity in the politics of antitrust enforcement. Just as the two major contemporary political parties each blend contradictory Hamiltonian and Jeffersonian elements, so too antitrust ideology has not neatly tracked left/right dichotomies. On a statistical basis, civil antitrust enforcement by the government peaked during the conservative Nixon and Ford administrations. The Chicago School rode the wave of Ronald Reagan’s decoupling of the curse of bigness; bigness was a curse in the government only, not in business. But Chicago’s decoupling of the ideological aversion to large scale in government and business is not inevitable and may be, in historical perspective, anomalous. As historian Richard Hofstadter has written, American feelings about large organizational units in government and business have generally tracked in parallel. Historically, it is no anomaly that small-government conservatives would find common ground with Brandeisian progressives in resenting the growth and power of large-scale industrial firms, which are not so easily distinguished from large-scale governmental agencies.

### THE SHIFTING MEANING OF “MONOPOLY”

The ideological valence of the anti-monopoly principle is ambiguous in contemporary left/right terms, owing in large part to a historical shift in the meaning of the word “monopoly,” particularly in its popular and pejorative senses. Is a monopolist a private firm that corners a market through nefarious or shrewd

tactics? If so, the law’s anti-monopoly response codes “regulatory” and “interventionist” in left/right terms. Or is a “monopoly” a cronyist intervention by the state to prevent free market competition? In that case, the anti-monopoly principle codes as “deregulatory” and “free market.” Both of these senses of “monopoly” have been used historically, and their contemporary manifestations remain tangled.

Throughout much of the Anglo-American anti-monopoly tradition, “monopoly” primarily denoted a governmental grant of an exclusive privilege—a “letters patent” in the sense of the classic common law case. Until the late 19th century, the American anti-monopoly tradition was concerned primarily with governmental cronyism and exclusive privilege. Over time, however, the primary legal meaning of “monopoly” has shifted from the government-granted to the purely private.

This shift became apparent in U.S. antitrust law in 1943 when, in *Parker v. Brown*, the U.S. Supreme Court held the Sherman Act inapplicable to anticompetitive structures created by state regulation. *Parker* grew out of the Supreme Court’s post-1937 constitutional jurisprudence rejecting *Lochner*-era judicial scrutiny of regulatory schemes impairing property or contract rights. Just as the post-1937 constitutional dispensation would avoid second-guessing state regulatory judgments in favor of judicially preferred economic theories, so too the courts would reject efforts to use the Sherman Act to the same effect (to the dismay of conservatives, who favored the judiciary as a bulwark against over-regulation).

From one perspective, *Parker* stood the meaning of “monopoly” on its head. Whereas the primary meaning of “monopoly” in the Anglo-American tradition had been a governmental grant of exclusive privilege—an interference with the natural rights of other market participants—that primary sense of “monopoly” was now to be excluded altogether from the Sherman Act’s anti-monopoly legal regime. Only purely private monopolies—the second sense of the word discussed above—would be covered by antitrust.

The *Parker* doctrine of state action immunity from antitrust has not developed to immunize state regulation from Sherman Act preemption as strongly as *Parker*’s language would suggest, and the doctrine’s evolution continues. In the push and pull over the doctrine’s boundaries, it has largely been advocates of the Chicago School’s consumer welfare approach who have argued for narrowing state-action immunity on the view that states systematically distort competitive processes for the benefit of rent-seekers. This simultaneously pro-antitrust and deregulatory perspective tracks that strand of the anti-monopoly tradition accusing the government as culprit.

### ARE PRIVATE MONOPOLIES THE PRODUCT OF GOVERNMENTAL INTERVENTION?

This ambiguity over the meaning of “monopoly” and its attendant legal and policy implications cashes out also in legal and economic discourse over the sources of monopoly power. A

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neo-classical economic view, today associated with Chicago School ideology, holds that markets are contestable and that any monopoly power gained through anticompetitive means is quickly eroded, but with one important exception: governmentally created entry barriers.

If regulation and governmental favoritism are the only important sources of durable monopoly power, then one potential policy response is not to worry about privately acquired monopoly—essentially, to turn the *Parker* state action immunity regime on its head and only police state-granted monopolies. But there is another possibility flowing from the opening premise, which is to hold that any observed instances of genuinely durable monopoly power must be the result of some seen or unseen governmental distortion. In this latter view, when what at first blush may seem to be purely private monopoly power persists over time, there must be some underlying governmental distortion accounting for it. Then, this argument goes, even committed libertarians should favor antitrust intervention to terminate the monopoly.

This view is not hypothetical; it explains some of the right's historical affinity for antitrust enforcement despite the right's otherwise laissez faire predilections. The clearest case in point is the 1983 consent decree breaking up AT&T. How did the largest anti-monopoly corporate breakup in history occur at the hands of the Reagan administration and its decidedly Chicago School Justice Department? The answer lies in Assistant Attorney General Bill Baxter's conviction that AT&T was exploiting its status as a regulated monopolist to stifle competition. What has come to be known as "Baxter's law" posits that rate-regulated monopolists may extract monopoly profits from vertically integrated markets without running afoul of the "one monopoly profit" theorem. Suspecting government regulation as the deep source of AT&T's persistent monopolistic behavior, the conservative Reagan administration was willing to break it up.

Similar suspicions that "Big Tech" companies like Google and Facebook are the monopolistic beneficiaries of subtle governmental cronyism show up today on the political right. That Big Tech tends to be associated politically with the Democratic Party only furthers these perceptions. Those inherently suspicious of governmental interventions in markets may understand Big Tech as the unnatural spawn of governmentally granted privilege and private greed. Conversely, those more sympathetic to governmental intervention may find nothing alarming about the multiple ways in which Big Tech appropriates governmental benefits through such vehicles as intellectual property law, government subsidies, or the Digital Millennium Copyright Act. But these matters divide the left as well. The Open Markets Institute was forced out of the progressive-leaning New America Foundation over Open Markets' criticisms of Google. In light of the contestable boundaries of the public/private divide and the shifting meaning of monopoly, it is not surprising to see political alliances fraying over antitrust reform.

## PRAGMATIC CONCERN OVER ANTITRUST'S ALTERNATIVES AND CAPITALISM'S SURVIVAL

A final reason that the politics of antitrust sometimes confound the conventional left/right divide has to do with the pragmatic sense that some regulatory interventions may be necessary to preserve capitalism politically, and that antitrust may be the least objectionable one. This "antitrust or else" perspective has characterized the politics of antitrust from the beginning.

The conventional view that Congress intended the Sherman Act to seriously undermine the trusts is balderdash. The 51st Congress that passed the Sherman Act was dominated by industrial magnates who wanted to avert more radical reforms. Speaking on the Senate floor in 1890, Sen. John Sherman (R, OH) warned his brethren—many of whom were controlled by the trusts—that Congress "must heed [the public's] appeal or be ready for the socialist, the communist, and the nihilist." Sherman thus conceived of his eponymous antitrust statute as politically necessary to diffuse more radical political movements—as a sort of Band-Aid on capitalism.

The idea that antitrust legislation and enforcement are necessary accommodations to public demand has a long pedigree in both conservative and more progressive circles. Writing in 1914, William Howard Taft described the Sherman Act as "a step taken by Congress to meet what the public had found to be a growing and intolerable evil." Notably, he did not share the public's concern nor attribute such a concern to Congress. Similarly, Theodore Roosevelt was relatively unconcerned with the trusts personally, but "saw the trust problem as something that must be dealt with on the political level; public concern about it was too urgent to be ignored."

Beyond the concern that, absent antitrust, capitalism itself might succumb to reformist pressures, there is a more modest possibility that, absent antitrust, political pressures would lead to overregulation. Antitrust and administrative regulation are conventionally viewed as alternatives to address market failures. From the Reagan administration to the Financial Crisis of 2008, the overall arc of American law involved simultaneous deregulation and relaxation of antitrust enforcement. If popular dissatisfaction with the economic status quo grows, demand might grow to pull either the regulatory or antitrust lever. Those ideologically committed to a light governmental hand on the market might prefer the antitrust alternative.

It is hard to judge at any given moment how much political support for antitrust intervention is motivated by genuine concern over monopoly and competition, and how much of it derives from the fact that, in the face of popular demand for a governmental cure to a perceived evil, it is often easier to delegate the solution to antitrust than to propose a regulatory solution. From the Sherman Act forward, however, it is certain that antitrust has often been deployed as a foil to more interventionist forms of regulation. The ideological and political implications of that move are complex and not neatly housed in left/right categories. R

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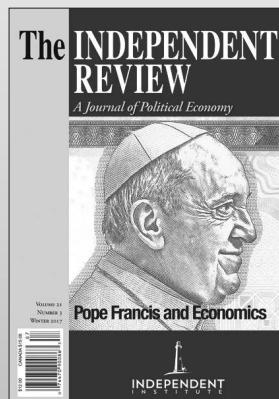
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## REGULATORY REFORM

# Cleaning Out the Statutory Junk

*How can we push lawmakers to discard the legislative trash?*

BY DAVID SCHOENBROD

**O**n April Fool's Day of 2018, an abandoned Chinese satellite named Heavenly Palace fell out of orbit and plunged into the Pacific Ocean. There's a half million pieces of detritus in orbit ranging in size from inoperative satellites like Heavenly Palace, which weighed nine tons, to stray nuts and bolts. Most of this space junk stays aloft, but because it travels at speeds six times faster than a bullet, even a small piece can kill an astronaut or ruin a working satellite. Fortunately, engineers have developed defenses against space junk.

"Statutory junk" is my term for the mishmash of statutory commands to administrative agencies that have accumulated over the decades and now are having unintended consequences. Enforceable in a court of law, even a few words of statutory junk can thwart a statutory purpose or impose unnecessary burdens on the public. Unfortunately, Congress typically fails to protect us from the statutory junk.

The Supreme Court spotted a particularly big hunk of statutory junk in a decision rendered a few months before Heavenly Palace fell to earth. *National Association of Manufacturers v. Department of Defense* arose from the Clean Water Act's requiring a permit from the U.S. Environmental Protection Agency or the Army Corps of Engineers for any discharge of a pollutant, including fill, into "the waters of the United States." "The waters of the United States" clearly includes more than just navigable rivers, but it doesn't include backyard puddles. Drawing the line somewhere between puddles and navigable rivers determines whether huge numbers of manufacturers, developers, farmers, highway departments, individual homeowners, and others must get permits. The stakes are high because the permit process is onerous even if the activity does no significant environmental harm. Yet, where the activity does such harm, the process is vital.

DAVID SCHOENBROD is a professor at New York Law School and author of *DC Confidential: Inside the Five Tricks of Washington* (Encounter Books, 2017).

To draw this line, the EPA and the Corps jointly issued a regulation in 2015. The question before the Supreme Court was not, however, the validity of this regulation but rather in what court to file the many cases challenging its validity. The choice was between a single court of appeals or multiple district courts.

In her opinion for the unanimous Court, Justice Sonia Sotomayor noted powerful policy reasons favoring jurisdiction in a single court of appeals. This choice would speed a final decision on the validity of the regulation and avoid disputes about the individual permits having to be litigated in two separate cases. Nonetheless, the Court concluded that jurisdiction must be in multiple district courts because that's what the statute's language dictated. The same problems will likely repeat themselves when the Trump administration promulgates its replacement of the 2015 rule.

Congress had never thought about how its jurisdictional text would apply to a challenge to a regulation defining "the waters of the United States." Lawmakers could have avoided the unintended consequences with just a few words of new text. The need for it was apparent: the regulation had been pending at the agency level for years and the statutory language on jurisdiction was well known to practitioners in the field. The lawmakers' failure to act meant that, on top of the time that will be wasted because of the statute's inadvertent choice of jurisdiction, years were wasted litigating where to file the challenges to the regulation.

As illustrated by this example, statutory junk is neither pro- nor anti-regulatory protection. It is pro-stupid.

This article argues that elected officials in Congress and the White House can organize themselves to protect us from statutory junk and describes how they can do so. First, however, it discusses why junk has become so common in administrative orbit.

## THE JUNK'S CAUSE

There wasn't much junk in the short, vague statutes of the Progressive Era. They simply told agencies in essence, "Here's a



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problem, solve it." In recent decades, however, Congress began enacting a new sort of regulatory statute.

An early example is the 1970 Clean Air Act. It directed the EPA to issue regulations sufficient to protect health from every harmful pollutant everywhere in the United States by statutorily set deadlines. It, moreover, gave citizens the right to sue should the EPA fail to carry out any of its duties. On this basis, the bill's chief sponsor, Sen. Edmund Muskie, claimed that "all Americans in all parts of the country shall have clean air to breathe within the 1970s."

In, say, 1940, a promise that the federal government could deliver such concretely specified outcomes requiring the regulation of tens of thousands of major pollution sources and millions of minor ones would have seemed laughable. Washington in 1940 worked with carbon paper and adding machines, but by 1970 it had Xerox machines and computers. It, moreover, had a track record of great accomplishments: winning World War II, inventing the atomic bomb, harnessing nuclear power, building the interstate highway system, passing important civil rights legislation, and landing people on the Moon.

Around 1970, lawmakers began feeling pressure to guarantee popular outcomes because voters had lost faith in the Progressive Era's promise that expert agencies given broad mandates and insulated from politics would necessarily make correct choices. Meanwhile, judicial protection of civil rights in the 1960s suggested that the courts could protect statutorily specified rights.

Finally, the new way of legislating made life easier for lawmakers. They could take credit for making the popular promise of healthy air, but skirt the specifics of how to do so. That would be up to the agency and would come later. No wonder the Clean Air Act passed almost unanimously.

As it turned out, the EPA could not meet the statutory deadlines without imposing draconian burdens on the economy and voters, such as taking most of the cars off the road in Southern California. Legislators ended up blaming the agency for missing deadlines for healthy air, and also for regulatory burdens the EPA did impose.

Having claimed credit for the popular and shifted blame to the agency for the unpopular, legislators came to see statutory commands as political profit centers and so issued more and more of them. There are, believe it or not, 940 passages in the 1990 version of the Clean Air Act that state the EPA administrator "shall" do a certain task. Many of those commands must be carried out repeatedly. The commands, moreover, are not brief. The statute has as many words as a typical 450-page book.

Because the commands are based upon circumstances that may have changed or understandings falsified by experience, they often are stupid. Consider the statute's command that sources emitting more than "250 tons per year" of regulated pollutants obtain a particular sort of permit requiring an arduous process. The statute set the threshold at 250 tons so that only a small number of big polluters such as large power plants would have to get the permits. But the threshold as applied to regulate green-

## REGULATORY REFORM

house gases, which get emitted in immensely larger quantities than the previously regulated pollutants, would require permits for so many more sources—even high schools—that the process would grind to a halt. So the EPA decreed a special threshold for greenhouse gases that began at 100,000 tons rather than 250 tons.

In *Utility Air Regulatory Group v. EPA*, a majority of the Supreme Court ruled the EPA cannot disregard such clear statutory text. To avoid paralyzing the permit process, the Court interpreted the statute to exclude greenhouse gases from the pollutants that trigger the permit requirement, but nonetheless require greenhouse gas emissions of sources to be regulated if some other pollutant triggers the permit requirement.

One might disagree with the Court's opinion or the agency's finding that greenhouse gases are a danger, but not the point that the case illustrates: there's junk in the statute.

**Breaking the logjam** / Because of the controversy over climate change, one might understand Congress's failure to address this particular piece of Clean Air Act statutory junk. But that does not explain Congress's systematic failure to clean up statutory junk.

In the hope of getting rid of some of the junk in environmental statutes, New York Law School and New York University School of Law launched the "Breaking the Logjam" project in 2007 to show Congress and the president to be elected in 2008 how to update these obsolete statutes. None had been updated since 1990. The project brought together environmental experts from across the political spectrum. We focused on how to reform the statutes so that agencies could clean the environment more cost effectively rather than on how clean was clean enough.

The leaders of the project—Richard Stewart, former chair of the Environmental Defense Fund; his colleague on the NYU faculty, Katrina Wyman; and I—wrote a book, also titled *Breaking the Logjam*, stating the project's recommendations. The book received favorable endorsements from high environmental officials appointed by presidents of both parties.

When Stewart and I met with people from both parties on Capitol Hill, they praised the project's recommendations and said they wished that Congress had already enacted them. After all, the recommendations would produce a better environment at less cost. Yet, they doubted that they could get them enacted. Why? Because updating the statutes would require legislators to take responsibility for hard choices on how clean is clean enough. On the other hand, if they left the statutes unchanged, they could continue to pin most of the blame on agencies and the states for both the harm to the environment and the regulatory burdens.

Statutory junk is not confined to environmental legislation, but extends to instructions to agencies on other kinds of regulation. As Philip K. Howard observes in his 2014 book *The Rule of Nobody*, "American democracy is basically run by dead people" including "past generations of legislators."

## HOW TO MAKE LAWMAKERS RESPONSIBLE FOR THE JUNK

Because lawmakers get away with blaming agencies for the harm that statutory junk does to their constituents, making these lawmakers responsible for regulations would prompt them to pay attention. This is an age-old problem; Harvard Law School dean James Landis, a leading New Deal agency official, was frustrated that legislators criticized agencies for doing what they, the legislators, had created them to do. In his 1938 book *The Administrative Process*, he wrote that for administrative officials, "it is an act of political wisdom to put back upon the shoulders of Congress" responsibility for "controversial choices."

Landis proposed two ways to do this: bar any major administrative decision from going into effect until Congress passes a bill approving it through the Constitution's full legislative process, or allow one or two houses of Congress, acting without the president, to veto a major administrative decision. With either legislative approval or legislative veto, Landis claimed, the agency would be "the technical agent in the initiation of rules of conduct, yet at the same time ... [the elected lawmakers would] share in the responsibility for their adoption."

Congress included the legislative veto in dozens of statutes. In 1983, however, the Supreme Court found this mechanism unconstitutional because it allowed one or two houses of Congress to take legislative action without going through the Constitution's full legislative process. The next year, Justice Stephen Breyer, then a judge, wrote in his 1984 *Georgetown Law Review* article, "The Legislative Veto after *Chadha*," that Congress could, consistent with the Constitution, use legislative approval if it really wanted to be responsible for regulations. His implicit point was that Congress is none too anxious to shoulder responsibility.

**Chevron** / The blame for the harm from statutory junk falls not just on agencies that apply the statutes, but also on the judges who interpret them. Then, however, to avoid the hot seat in many cases, judges began to cite the Supreme Court's decision in *Chevron v. Natural Resources Defense Council* (1984) as requiring them to go along with agency interpretations of statutes unless the interpretation clearly contravenes unambiguous statutory text. *Chevron* does give agencies some leeway to avoid statutory junk, but it is an insufficient response.

Agencies sometimes lose despite *Chevron*, as *National Association of Manufacturers* and *Utility Air Regulatory Group* demonstrate. Even when agencies ultimately win, they and the public must first undergo years of uncertainty before administrative proceedings and judicial review produce a definitive outcome. For example, even though the agency did finally prevail in the Supreme Court's 2014 decision in *EPA v. EME Homer City Generation*, it took multiple administrative proceedings and judicial reviews to win approval of a way to interpret the Clean Air Act to skirt statutory text not designed for the problem at hand.

Although sometimes protecting the public from statutory junk, *Chevron* helps to shield legislators from responsibility for the junk by holding out the hope that, armed with *Chevron* deference, federal agencies can take care of the problem. That has the perverse consequence of further reducing the pressure on Congress to clean up the junk.

*Chevron*, moreover, comes at considerable cost to the accountability of Congress. The nondelegation canon holds that statutes should be construed, when possible, to reduce the scope of authority delegated to agencies. But *Chevron* allows Congress to delegate authority simply by writing sloppy statutes or failing to clean up statutory junk.

The Supreme Court may end up declaring *Chevron* dead, but

*Chevron shields legislators from responsibility for the statutory junk by holding out hope that federal agencies can take care of the problem. That further reduces pressure on Congress to clean up the junk.*

will likely still cut agencies much slack unless there is some other way to reduce the harm from statutory junk, such as lawmakers bearing responsibility for the harm it does.

**Attempts at responsibility** / In 1995, some members of Congress asked me to help design a bill to make legislators responsible for regulation. I suggested legislative approval tweaked with a suggestion by Judge Breyer that the bill include rules that would force prompt votes on agency regulations. The rules would bar legislators from amending the proposed regulation, limit debate, and thwart filibusters by requiring votes by a deadline.

The bill, the Congressional Responsibility Act, began to gain traction, at which point some lawmakers became concerned that its passage would mean they would have to take responsibility for hard choices. So Congress pulled a switcheroo: it passed the sound-alike Congressional Review Act, which President Bill Clinton signed into law in 1996. It gives legislators *the option of taking responsibility rather than forcing them to do so*. They hardly ever take that option. In the Congressional Review Act's first 20 years, Congress used it to negate only one regulation. Congress invoked it infrequently because presidents are apt to veto bills negating their appointees' regulations and, in any event, members of Congress are reluctant to cast votes on hard choices.

There was, however, a flurry of activity under the statute in 2017. That flurry was a function of the election of a new president with a radically different regulatory philosophy than his predecessor. The outgoing administration, assuming that its favored

candidate would win the 2016 election, neglected to take precautions available under the statute that would have helped shield its regulatory handiwork. That mistake is unlikely to be repeated. So, after its 2017 moment in the sun, the Congressional Review Act will again return to the shadows.

In any event, it's a poor way to deal with statutory junk. It provides no way to improve regulations that are suboptimal because of statutory junk or prompt the issuance of good regulations that statutory junk stymied.

**REINS** / The Congressional Review Act let legislators appear to be responsible for regulation without actually taking responsibility, but the statute's disuse made that pose increasingly unconvincing. To strike a more convincing pose, work began in 2009 on a bill based upon the Congressional Responsibility Act bill, but with many perverse twists.

One gets a sense of the perverse twists from its title, "Regulations from the Executive in Need of Scrutiny Act" (REINS), which blames the executive for regulatory burdens. Yet, the ultimate source of these burdens is Congress, whose statutes are structured to maximize the political advantage to legislators rather than the net benefit to their constituents.

In addition to Landis's pro-responsibility process, REINS contains many anti-regulatory features. It would command agencies to reduce the cost of existing regulations to fully offset the cost of any new regulations. So, REINS's sponsors would shift to the agencies blame for the cuts in regulatory protection needed to deliver on the popular promise of limiting regulatory burdens. Both REINS and the Clean Air Act try to promise the popular and shift blame for the unpopular, but in response to the opposite poles of the political spectrum. Thus does blame-shifting promote polarization.

Worse still, the command in REINS to cap regulatory costs potentially clashes with the commands in many existing statutes to increase regulatory protection. There is no evidence that the bill's sponsors have thought through how these clashes should be resolved. Years of litigation would be required to decide how agencies should respond to such clashing commands. This would sow uncertainty, which hurts economic growth.

Yet more uncertainty would come from another provision of REINS that abolishes any existing regulation that Congress does not approve within the next 10 years. This provision allows a member to call for separate votes on any such regulation and also for separate votes on conditions for its approval. This is an unworkable procedure for the huge number of current regulations, and so most of them will disappear, but it will be years before business knows which ones will stay and which will go. So, again, uncertainty would hurt economic growth.

## REGULATORY REFORM

The House has passed REINS legislation for many years, but its anti-regulatory, junk-strewn twists have kept it from getting the bipartisan support needed to get by a filibuster in the Senate. No Democratic senator supports it. So REINS lets its sponsors pretend to want to be responsible without ever having to shoulder responsibility.

**Responsibility for Regulation Act** / Congress should take responsibility by passing what I call the Responsibility for Regulation Act. As detailed in my recent book *DC Confidential*, it would include the Landis legislative approval of major regulations and Breyer's fast-track legislative process, but exclude the anti-regulatory features of REINS.

It would work today even though Congress is more polarized than it was in 1938 or 1984. The polarization is heightened by Congress members claiming credit for popular goals but washing their hands of responsibility for specific regulatory actions. That is how lawmakers can be for regulatory protection without being responsible for regulatory burdens or against regulatory burdens without being responsible for less regulatory protection. In contrast, if lawmakers were actually forced to vote on concrete regulations—for instance, one that cuts pollution from power plants by a given percentage—those who vote “Yea” would be responsible for both cutting pollution and inflicting regulatory burdens, and those who vote “Nay” would be responsible for both tolerating pollution and avoiding regulatory burdens.

So, for example, Republican legislators would find that voting reflexively against climate change regulations would come at a political cost when, according to a 2017 Rasmussen poll, “56% of likely U.S. voters favor an EPA regulation that requires a one-third drop in carbon dioxide emissions from power plants over the next 13 years, while 33% oppose such a regulation.” And so, too, Democratic legislators would find that voting for President Obama’s Clean Power Plan would have come at an unnecessarily high political cost because, as a result of statutory junk, the Clean Air Act forecloses efficient ways to cut greenhouse gases. In sum, lawmakers on both sides of the aisle would be more balanced than their present posturing sounds.

Lawmakers’ responsibility for both regulatory costs and benefits would trigger a series of constructive changes. Agencies, to get their regulations approved, would propose regulations that balance competing concerns in a way likely to garner majority support in Congress. Lawmakers in turn would want to enable agencies to promulgate regulations that achieve more protection with lower burdens. To help them do so, they would want to get rid of statutory junk. They would finally have a personal political incentive to do so.

To take advantage of all these improved incentives, communication between Congress and agencies should begin before the agency promulgates the rule. To that end, the new bill should require agencies to alert Congress of proposals of major rules and any way that, in the agency’s opinion, current statutes would prevent the agency from promulgating what the agency considers to be an optimal rule. Then, at the proposal stage, legislators

could, at their discretion, hold hearings, introduce legislation, or communicate with the agency individually or through committees. In addition, the bill should include a provision that adds an extra 30 days to the deadline for a final roll call vote if a majority of the agency’s oversight committee in either chamber signs a petition calling for a hearing after promulgation.

With Congress having a real incentive and a process to deal with statutory junk, courts should be more willing to cut back the leeway that they give agencies.

## WOULD CONGRESS EVER TAKE RESPONSIBILITY?

Although seemingly allergic to responsibility, legislators might just enact a pro-responsibility bill. Now, as Frances Lee demonstrates in her 2016 book *Insecure Majorities*, both parties “champion ‘all gain, no pain’ positions,” such as the Clean Air Act and the REINS bill, in order to appeal to their bases, hide the harm done to other interests, and win majorities in Congress.

Yet, this dynamic could change. One of the parties might come to find that shouldering responsibility would appeal to centrist voters and be more effective at winning majorities. Here’re some indicia:

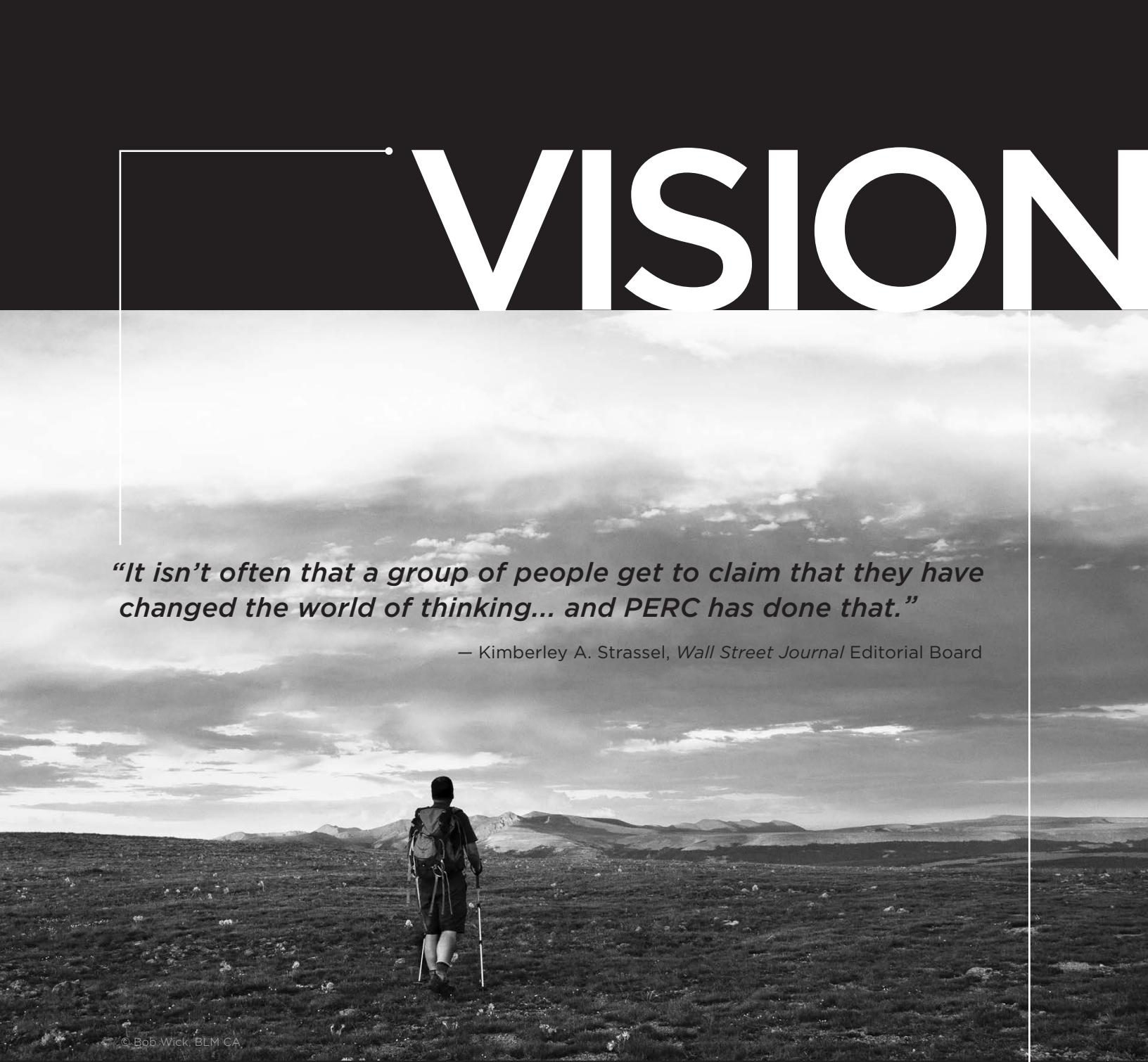
- Many voters do want elected lawmakers to take responsibility for regulations. For example, a 2017 Rasmussen poll found that voters, by a margin of 56% to 25%, believe that Congress should have to vote on major EPA regulations before they go into effect.
- Distrust of the federal government in general and Congress in particular has reached record levels in recent years. No wonder. Congress is supposed to compromise on the differences among us, but its “all gain, no pain” techniques inflame the differences and bring erratic government.
- As the parties in Congress have grown more rabid, an increasing portion of voters identify themselves as independents.

Besides, many members of Congress are not just incumbent reelection machines. Some want to be proud of the work they do. Some want to be part of an institution that is not despised. Some want to be statesmen.

Regulation as usual is under threat from another direction. A small group, the Madison Coalition, has gotten the legislatures of 26 states to pass resolutions calling for Congress to propose a constitutional amendment that would, in essence, put Landis’s legislative veto into the Constitution. The support to date is still short of what is needed to amend the Constitution, but that a small group with scant resources has gotten so far in a few years suggests the vulnerability of the present, responsibility-shirking system. Still, I prefer the Responsibility for Regulation Act to the constitutional amendment because statutes are easier to get, easier to change, and Congress could use the act only to vote on major regulations rather than individual cases.

I don’t know what the future will bring. But the political parties in Congress may well find themselves in a race to show they are willing to shoulder responsibility. R

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## INTELLECTUAL PROPERTY

# The Same Old Song

*Instead of yet another regulation-heavy music copyright law, Congress should change its tune and empower market forces.*

● BY THOMAS M. LENARD AND LAWRENCE J. WHITE

When Spotify went public earlier this year, the company faced a \$1.6 billion lawsuit alleging that it was streaming such hits as Tom Petty's "Free Fallin,'" the Doors' "Light My Fire," and tens of thousands of other songs without obtaining the necessary licenses and compensating copyright holders. Spotify has not been the only target of such action. Apple Music and other streaming services have also been hit with copyright infringement lawsuits.

The basic problem is that Spotify and other streaming services are trying to license music using a set of arcane procedures and institutions that, in some cases, haven't changed in a century, to use on a platform that didn't exist even a few years ago. While it is difficult to understand the full details of this system, it is easy to understand that it is a mess. Given that streaming services now account for more than 60% of music revenues and digital downloads account for another 20%, the gap between the highly regulated world of music licensing and the realities of the market will grow increasingly large.

There have been some recent efforts to modernize music licensing. But all too often these efforts fall back on more regulation rather than a greater reliance on market processes. They are just slightly newer choruses of the same old song.

## THE PROPERTIES OF MUSIC

Music is a classic example of a good with non-trivial initial fixed ("first-copy") costs and low (often near zero) marginal costs. To create music, composers and songwriters must devote effort to creating a song. Similarly, embodying that song in a sound recording requires the production efforts of musicians and/or vocalists, as well as recording technicians, producers, etc. But once the song exists in recorded form (or even as sheet music),

the marginal costs of distributing it to users are relatively low—and in the digital age they are realistically close to zero.

If copies of the song can be distributed without restriction, competitive markets are likely to drive the price of the distributed song to (near) zero. In that case, the creators will be unable to recoup their costs, which will discourage the initial creation. This is a familiar tension between the short-run desirability of allowing information (and music is clearly "information") that already exists (which has all of the properties of a "public good") to be sold or distributed at its marginal costs and the long-run desirability of providing incentives for the information to be created in the first place.

The solution to this problem is to give creators a property right—a right to license (and thereby also to exclude)—that would allow them to recoup their costs and earn a profit (if, of course, their creation meets a market test). And, indeed, there is such a property right in the United States and most other countries: copyright. In the United States, music has been covered by copyright since 1831. Initially, music copyright just protected composers and/or the publishers of sheet music against unauthorized copying of that sheet music. Copyright protection was extended to cover public performances of music in 1897. A decade later, music copyright (in 1909) was extended to cover "mechanical" reproductions such as piano rolls, physical recordings, and (as of the mid-1990s) digital downloads. And in the mid-1990s, a new law established a separate copyright to cover the creators (i.e., the recording artists and/or the recording companies to whom the artists might assign their rights) of sound recordings.

Under current law, copyright lasts for the life of the creator plus 70 years or, if the copyright is owned by a corporation, 95 years after publication. After the expiration of the copyright, the music enters the public domain, and anyone can freely copy it.

## THE UNDERPINNINGS OF WELL-FUNCTIONING MARKETS—AND THE PROBLEMS FOR MUSIC

Well-defined, enforceable property rights are a necessary condition for well-functioning markets. Low transactions costs are also

THOMAS M. LENARD is president emeritus and a senior fellow at the Technology Policy Institute. LAWRENCE J. WHITE is the Robert Kavesh Professor of Economics at New York University's Leonard N. Stern School of Business.



important. And, as public real estate registry rolls have illustrated, having a central registry of who owns what rights can enhance the functioning of markets where the goods and services that embody those rights are traded.

Unfortunately, the characteristics of music—plus some idiosyncratic features of the U.S. market—have impeded freely functioning competitive markets in music licensing and distribution. Instead, the markets have been heavily regulated.

If music copyright owners are going to enforce their owner-

ship rights, they need to be able to sign licensing contracts with users, monitor their music use, collect the appropriate royalties, and enforce the property right against infringers. But the infrastructure for such efforts is unlikely to be complementary with songwriting or song-recording talents. And in a country the size of the United States—with tens of thousands of music distribution outlets (e.g., terrestrial radio stations, TV stations, theaters, nightclubs, bars, restaurants, music halls)—the contracting, monitoring, royalty collecting, and enforcement efforts would be substantial, especially in the pre-digital era. In the digital era, streaming services need to obtain rights to tens of millions of songs to operate successfully.

Unsurprisingly, intermediaries have sprung up to help with these transactions costs. For songwriters and composers, music “publishers” began undertaking the intermediary function when sheet music was the primary way that music was distributed. For performing artists, it has been the recording companies (which are frequently described as “record labels” or even just as “the labels”). But the economies of scale in contracting,

monitoring, royalty collecting, and enforcement by the early 20th century appeared to be beyond even the largest music publishers, and the first of a series of collective “performing rights organizations” (PROs) to carry out these functions—the American Society of Composers, Authors, and Publishers (ASCAP)—was formed in 1915. It was followed in 1930 by the Society of European Stage Authors and Composers (SESAC) and by Broadcast Music Inc. (BMI) in 1939. Most recently, a new PRO, Global Music Rights (GMR), was formed in 2013. ASCAP and BMI dominate this area.

## INTELLECTUAL PROPERTY

Similarly, after “mechanical rights” became protected, the National Music Publishers Association in 1927 formed a PRO-like subsidiary, the Harry Fox Agency, to carry out these functions with respect to mechanical rights.

It was no accident that, when Congress created the copyright for sound recordings in the 1990s, it anticipated that a PRO would be needed. But rather than allow the market to develop one or more PROs for those rights, it authorized the Librarian of Congress to designate the PRO. SoundExchange, which was originally a subsidiary of the Recording Industry Association of America and was subsequently spun off as a nonprofit organization, is that designated PRO.

Perhaps surprisingly, despite the presence of (literally) a handful of PROs, a comprehensive database of who owns what rights with respect to music distribution has not come into existence. The existence of “blanket licenses” that are made available by the PROs—which allow a user to distribute all of the music that is in a PRO’s repertoire—has traditionally reduced the need for such a database. The institution of the blanket license has clearly reduced transactions costs. But the absence of that database has recently impeded efforts by digital streaming services, such as Pandora, to negotiate effectively with individual music publishers for distribution rights. It also makes it more difficult to identify and pay rights holders, which at least partly accounts for the nonpayment problem and consequent lawsuits against Spotify and other streaming services.

One other special institutional feature of music licensing is worth noting: in the area of mechanical rights and for some categories of distribution of sound recording rights, compulsory licenses are required by statute. This means that, so long as a music distributor meets a modest set of requirements, an owner of mechanical or sound recording rights must grant a license to the distributor. But, of course, the question of “at what price?” remains. Arm’s-length bargaining in the shadow of such a requirement is difficult at best, and it is no accident that regulated rather than market-based pricing dominates the pricing of these rights.

## THE COURT AS REGULATOR

Centralizing performance rights functions in a few large PROs reduced transactions costs, but it also led to the accretion of market power. ASCAP became a locus of market power for the selling of music performance rights vis-à-vis the broadcasters and other distributors of the music by becoming the common agent for thousands of otherwise-competing composers/songwriters and music publishers. This arrangement drew a government response: the Antitrust Division of the U.S. Department of Justice sued ASCAP in 1934 and again in 1941, arguing that ASCAP’s collective setting of royalty rates for its thousands of otherwise-competing members constituted a violation of the Sherman Act.

These suits were eventually settled with a consent decree in 1941. The decree allowed ASCAP to continue functioning as

a collective licensor for its members, an implicit recognition of the PRO’s role in reducing the contracting and monitoring transactions costs for its members. However, the decree—including subsequent modifications—placed restraints on ASCAP’s actions. Perhaps in hopes of not foreclosing a more competitive market, the decree precluded ASCAP from requiring exclusivity from its members—i.e., members of ASCAP are free to license their works outside of the ASCAP framework. Prospective licensees also must have the option of licensing individual pieces of music from ASCAP rather than being required to take a blanket license. However, distributors do typically obtain blanket licenses for the entire catalogue of works from ASCAP and BMI, and from the smaller SESAC and GMR.

The ASCAP decree specified that the Federal District Court for the Southern District of New York would arbitrate disputes when prospective licensees and ASCAP could not agree on terms. A similar suit against BMI in the early 1940s was settled with a similar consent decree. As a result, the Southern District is often described as “the rate court” for these disputes, and two judges in the Southern District—one for ASCAP adjudications and one for BMI adjudications—have become the de facto regulators of these license terms—including pricing—for musical compositions.

Royalty rates for the SESAC and GMR music catalogues are negotiated directly with users. There are no government consent decrees for those latter two PROs that apply when the parties fail to agree on terms.

## DEVELOPMENT OF NEW DISTRIBUTION TECHNOLOGIES

As the analog era gave way to the digital era, Congress attempted to modernize music licensing by enacting the Digital Performance Right in Sound Recordings Act (DPRA) in 1995 and the Digital Millennium Copyright Act (DMCA) in 1998. These acts expanded copyright protection to public performances of sound recordings through new digital audio transmissions, including the then-emerging satellite services that were the predecessors to SiriusXM and subsequent internet-based streaming services such as Pandora and Spotify.

The Copyright Royalty Board (CRB), consisting of three administrative judges appointed by the Librarian of Congress, establishes rates for sound recording performance rights for distributors such as satellite radio and non-interactive streaming services like Pandora. Different statutory standards are applicable to different categories of services; for example, the CRB’s rates for SiriusXM are different than those for Pandora. The licenses are compulsory: the rights owners cannot refuse a licensing request at the CRB-determined rates. SoundExchange collects and distributes the royalties and also participates in CRB proceedings on behalf of the copyright holders.

Interactive digital services like Spotify are exempted from the CRB process and instead negotiate directly with the performing artists and labels.

Terrestrial radio broadcasting does not currently require sound recording licenses, although legislation to change that has been introduced in Congress. The argument for exempting terrestrial broadcast radio from paying this category of royalties was that the playing of music on terrestrial radio was a form of free promotion for the records and their artists (or the record labels that had assembled and paid the artists) and thus the latter group(s) were already being compensated by the broadcasters.

### THE LICENSING MARKET

While the music distribution system has grown more competitive and changed dramatically with the introduction of new technologies, the music licensing system hasn't kept pace. Using any piece of music or recording requires obtaining multiple licenses, each of which has its own rules. Some licenses are compulsory, some are not. Most royalty rates are set in administrative or judicial proceedings. Some are established by direct negotiation between rights holders and licensees.

The market for music rights largely consists of three regulated markets: one for musical composition public performance rights; a second for sound recording performance rights; and a third for mechanical reproduction rights. For example, Spotify and other "interactive" streaming services must obtain licenses to sound recording and composition performance rights, as well as "mechanical licenses," in order to stream a song legally. Mechanical rights—the rights at issue in the recent spate of lawsuits—include the right to reproduce and distribute copyrighted songs through permanent digital downloads, interactive streams, or other media. Mechanical licenses are compulsory, and their rates are determined in CRB proceedings.

### THE MUSIC MODERNIZATION ACT

Several music licensing proposals are now pending in Congress, the most significant of which is the Music Modernization Act (MMA), which recently passed the House of Representatives. The MMA is intended to solve the problem that is at the root of the Spotify and similar lawsuits, which involves nonpayment of royalties for mechanical rights. The bill has received widespread support from most parts of the industry, including music publishers and songwriters (who own and license these mechanical rights), and digital interactive streaming services (who purchase the licenses).

Ameliorating the nonpayment problem, as the MMA aims to do, would be an improvement over the status quo. However, the MMA reinforces many of the long-standing aspects of music licensing that hinder competition: compulsory licenses, blanket licensing by a music collective, and regulated rates by the CRB. It does little to create a more competitive licensing regime with more direct negotiation between rights holders and licensees, which should be the long-run goal. This is indeed the same old song.

Central to the MMA is a Musical Licensing Collective (MLC), which would be designated by the Register of Copyrights (similar

to the earlier designation of SoundExchange for sound recording rights). The MLC would be empowered to grant blanket mechanical licenses for interactive streaming or digital downloads of musical works. It would be responsible for collecting royalty payments from music services and distributing those payments to songwriters and publishers.

Would such a monopoly collective have too much market power? The MLC would perform the same functions that existing PROs perform with respect to public performance rights for musical works. But those PROs—ASCAP, BMI, SESAC, and GMR—compete with each other. New PROs can and do enter this market.

The MLC would also perform the functions with respect to mechanical licenses that firms like the Harry Fox Agency, Music Reports Inc., and newer companies such as Audiam and Loudr, already do. Would these companies be driven out by the MLC?

The litigation resulting from nonpayment of royalties suggests dissatisfaction with the way this function is now being performed. However, there is no reason to believe that a government-certified nonprofit organization, facing no competition, would perform better.

In the absence of alternatives, the quality of service to the publishers and songwriters is likely to suffer. The MMA legislation envisions a process for reviewing the MLC's performance every five years and possibly designating a new MLC, but this represents a limited form of competition and in practice may be difficult to implement.

The MLC also would be charged with creating and managing a database of mechanical rights. A music database is a potentially pro-competitive outcome of the MMA. Accurate and easily obtainable information on who owns what is a necessary precondition for a more competitive licensing regime with more direct bargaining between rights holders and licensees. However, combining the database with the other functions of the MLC would add to its market power.

Creating a useful database may require a push from the government, such as is provided in the MMA. However, a number of nongovernmental groups are already working on this problem. The Open Music Initiative—a venture of the Berklee College of Music, the MIT Media Lab, and others—is developing an open source protocol for identifying music rights holders using blockchain technology. Other initiatives, such as Dot Blockchain Music, are developing music rights management systems based on blockchain. SoundExchange has put together a database of the songs for which royalties are being held in escrow by the Copyright Office because the licensee could not identify who to pay. They will make the database available to publishers for free.

The danger is that a government-sanctioned effort would crowd out these private efforts and eliminate competition between various databases and database technologies. Ultimately, without competition, the MLC is more likely to settle on an inferior technology.

This discussion raises the question of whether the economies

## INTELLECTUAL PROPERTY

of scale in maintaining a music database are large enough that it should be considered a natural monopoly. If so, we might be less worried about the MLC emerging as a monopoly. However, we should still be concerned about the process of gaining a monopoly position through a government certification process rather than market competition on the merits. The presence of a number of private-sector entities working in this area suggests that competition—either within a multi-firm market or as competition for the market—would produce good results.

Even if policymakers determine that the government should provide assistance in some form to the creation of a music rights database, it doesn't follow that the database function should be combined with the license administration function. And even if the database were a monopoly, the licensing function—which includes administering payments to rights holders—could and probably should be competitive. Entities that perform that function—such as ASCAP and BMI—are agents of the publishers and songwriters, who would benefit from competition for their business.

Under the MMA structure, it's not clear if publishers or songwriters would be able to withdraw from the MLC and bargain directly with the streaming services. The existence of the compulsory license would make that difficult.

The MMA envisions a database operated by the MLC, which presumably is only concerned with mechanical licenses. If the MLC's database becomes the definitive database, shouldn't it also include information on other rights, such as performance and sound recording rights? Wouldn't a comprehensive database increase licensing efficiency? Admittedly, a more comprehensive database would be more difficult to assemble because it would require data from a much broader scope of entities.

### COMPETITION IS ATTAINABLE AND ALREADY OCCURRING

The goal of more competition is attainable. There are numerous examples of direct negotiation in this otherwise highly regulated sector. Interactive streaming services already negotiate directly for sound recording rights, which suggests that direct negotiation could also work for other rights, including the mechanical rights that are the subject of the MMA. A recent CRB rate proceeding provided evidence of negotiated contracts between record labels and non-interactive services Pandora and iHeartMedia. Pandora has negotiated an agreement with Music and Entertainment Rights Licensing Independent Network ("Merlin"), which represents thousands of independent music labels. iHeartMedia has negotiated agreements with both major and independent labels. The elimination of existing compulsory licensing provisions would surely encourage more negotiation.

Pandora has negotiated contracts for composition public performance rights with the major publishers. The smaller PROS—SESAC and GMR—are not subject to the antitrust consent decree and therefore are unregulated.

New companies that act as agents for rights holders are springing up. Merlin, mentioned above, represents thousands of independent record labels. Kobalt has developed a digital rights management platform that helps artists and publishers collect royalties from streaming services. Kobalt collects royalties directly for 8,000 artists, including Paul McCartney, and 500 publishers, including Disney. It may well be that in a digital era, the monitoring and other PRO-like functions that are important to rights holders are easier to accomplish and require less scale than was needed in the pre-digital world.

### MUSIC LICENSING REFORM: SINGING THE SAME OLD SONG

Whenever an opportunity for pro-competitive reform of music licensing arises, policymakers seem to revert to the traditional regulatory model that discourages competition. They never miss an opportunity ... to miss an opportunity. The MMA—with its reliance on compulsory licensing, blanket licensing by a marketing collective, and regulated rates—is the latest of several recent examples.

Another example involves ASCAP and BMI, which have operated since 1941 under antitrust consent decrees that encourage blanket licensing of their entire catalogues and provide for regulated rates by the antitrust rate court. But music publishers now want the ability to withdraw their catalogues partially from the PROs in order to negotiate directly with the new streaming music platforms. With that aim, the publishers initiated a review of the consent decrees by the Justice Department's Antitrust Division. The Division concluded in 2016 that it would not seek to modify the decrees to permit partial withdrawal. This would have been an opportunity to encourage a more competitive market with more direct bargaining between rights holders and distributors.

Yet another example involves the payment of royalties by terrestrial radio. As indicated above, unlike every other music platform, old-fashioned terrestrial radio stations—by statute—pay no royalties (for sound recording rights) to record companies on the theory that radio stations provide a promotional service. Some in Congress are attempting to do away with this zero-price rule. But rather than allowing market forces to determine the royalty for radio play, the Fair Play Fair Pay Act proposes to incorporate radio into the current regulatory system with CRB-determined royalties.

The current highly regulated system for licensing music is largely an artifact of the analog era of music distribution and performance. The digital technologies now available make it possible for competition to replace much of the traditional regulatory structure for music licensing and rate determination.

Unfortunately, this won't happen until lawmakers sing a different song. The tune and lyrics ought not to be hard to learn; after all, Congress—after many decades of requiring spectrum regulation—endorsed the flexible markets that competitive auctions have brought for wireless spectrum usage. Perhaps Congress just needs to sing that song in a different key. R

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# Brain-Focused Economics: More Than Just Comparative Advantage

*Economists since Adam Smith have understated the welfare gains from free trade.*

◆ BY RICHARD B. MCKENZIE

**W**hen his administration imposed substantial tariffs on steel and aluminum imports in early 2018, President Trump ignored more than two centuries of economic thinking and research. That scholarship fortified Adam Smith's key insight in *The Wealth of Nations*: tariffs and other trade restrictions are (except under very narrow conditions) counterproductive. They restrict the scope of markets, curb scale economies (especially those generated through specialization of labor and other resources), encourage rent seeking, and ultimately undercut employment and synergetic growth in the jobs, incomes, and wealth of trading nations. (See "How's Your Trade War Going?" p. 4.)

As sound and powerful as Smith's free-trade arguments are, modern economists who have followed in his intellectual footsteps continue to underestimate the gains from unfettered trade. Accordingly, they also underestimate the short- and long-term economic damage done by the type of trade restrictions Trump has imposed, even without the compounding damage of retaliatory trade barriers erected by other countries.

What modern free-trade economists continue to overlook in trade theory is that market participants are *not* innately prone to hone their market decisions with the precision and correctness that conventional economic theory assumes. In conventional (neoclassical) economists' idealized models of economies, the competitive market forces let loose by open trading can't improve decision mak-

ing. All decisions are assumed to be *perfect*, as in "perfectly rational."

In real-world markets inhabited by decisionmakers who have evolved flawed mental resources and thinking processes, competitive market forces can *reduce* decision-making flaws and thus lower production costs and raise real incomes by more than conventional economists have heretofore claimed. Flawed decisionmakers are led by competitive pressures, as if by an "invisible hand," toward (not to) *improved* (not *perfect*) decision heuristics that, when adopted—even grudgingly—add to the otherwise achievable gains from trade.

Let me explain those audacious claims by returning to the conventional case for open markets and then by briefly laying out a few of behavioral economists' major findings on pervasive flaws in human decision making, captured—supposedly—in an array of identified mental "biases."

## THE TRADITIONAL CASE FOR FREE TRADE

In *The Wealth of Nations*, Smith developed the essentials of modern free-trade theory. Countries will tend to export those products in which they have an (absolute) cost advantage and import those products in which they have a cost disadvantage. That means that trade between people in different countries can reduce production costs and increase the real incomes of all trading countries, achieved mainly through an improved allocation of world resources. Smith's reasoning had folksy roots: "It is the maxim of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy."

In the early 19th century, David Ricardo fortified Smith's case for free trade. Ricardo observed that mutually beneficial trades are possible even under seemingly unfavorable conditions, such

as when one country has efficiency and absolute cost advantages in all goods produced than another country. He reasoned that *comparative* costs—not absolute costs—in production matter in directing the flow of goods in and out of countries.

To make Ricardo's point, suppose that the United States is more productive than China in both aircraft *and* smartphones and, consequently, can produce more of either in total and with the same resources. However, suppose that the United States can produce an additional aircraft by forgoing the production of a boatload of smartphones. An additional aircraft built in China, on the other hand, requires forgoing the production of 10 boatloads of smartphones.

If the U.S.-produced aircraft can be sold in trade for five boatloads of smartphones, the United States can build an additional aircraft, cutting its smartphone production by one boatload, and then trade its aircraft for five boatloads of smartphones. The United States is thus better off to the tune of four additional boatloads of smartphones for domestic distribution. Similarly, China can produce one fewer aircraft to expand its smartphone production by 10 boatloads, which it can use to buy two aircraft

(or buy only one aircraft and keep the extra five boatloads of smartphones for domestic distribution).

Economists make a variety of refinements to Ricardo's basic trade theory. For example, open trade can also intensify competition in both countries, which can further lower production costs and add to efficiency and income gains. Tariffs and quotas (and other trade restrictions) will simply deny the gains from trade both countries could otherwise garner. Of course, if trade restrictions are possible, political interest groups can be expected to seek protection from international competition, furthering their own interests while sacrificing the general welfare by wasting resources on "rent seeking" and by curbing competition.

### CONVENTIONAL ECONOMIC THEORY

Economists' trade theory is generally developed on the presumption that market participants on both sides of trades, whether domestic or international, are innately endowed with exquisite decision-making prowess. In the jargon of economists, people are *perfectly rational*, which means they consider all relevant production costs, ignore irrelevant costs, and exploit all available technological



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efficiencies—without being pressed to do so. Producers and consumers innately discount accurately and consistently all future costs and benefits expected to emerge from today's decisions.

Producers also are innately inclined to maximize production in all goods up to where all gains have been exploited (or until the additional cost of the last unit produced exactly equals the additional revenue gained from its sale). Similarly, all consumers will innately maximize their welfare by extending consumption of all goods until the additional values of the last units purchased equals their respective prices.

Market structures do not affect production and consumption decision making. They can't. Production decisions within monopolies are assumed to be as flawless as they are in firms that are fully competitive. Accordingly, all producers naturally minimize production costs and fully exploit production gains, no matter their market constraints. This is to say that if an industry is magically transformed from being intensely competitive to being monopolistic (even a “pure monopoly,” or a single seller), the accuracy of owners’ and their agents’ decision making will be unaffected. The only consequential identified change is that monopolized markets will sell fewer goods for higher prices and profits than will firms in more competitive (especially perfectly competitive) markets.

Of course, this means that the advent of international trade will not—and cannot—improve decision making in conventional economic theory. There is simply no room for improvement on perfect decision making (and the underlying perfect rationality). Perfect is perfect: the idealized—and *unachievable*, for solid economic reasons—upper bound for decision-making prowess.

By the same token, in theory, trade restrictions can have no effect on the decision-making prowess of producers and consumers. Thus, the terms of trade (the exchange rate of one airplane for five boatloads of smartphones in the above example) cannot be affected by reductions in decision flaws. The only gains from trade come from exploitation of extant comparative cost advantages of trading partners.

Milton Friedman justified extreme premises in economic theory—whether perfect competition or perfect decision making (rationality)—on economic grounds. All theories, by the nature of theories, are “unreal” to one extent or another. Such unreal premises seek to make thinking about complex reality manageable. If using a sterilized, unreal premise (perfect rationality) eases the analytics and doesn't affect the accuracy of predictions, then, Friedman effectively asked, “Why not use it?” He had in mind predictions on the order of, “If the minimum wage is raised, employment will fall.”

Friedman conceded that theories could not be judged by their descriptive “realism,” but behaviorists didn't get that memo from Chicago. They effectively took Friedman at his word: all identifiable predictions of economic theories deserve scrutiny.

### BEHAVIORAL ECONOMISTS’ CRITICISMS OF CONVENTIONAL ECONOMICS

Behavioral economists, following the lead of cognitive psycholo-

gists, have spent the past half century seeking to prove the obvious (to all aside from a few hardnosed conventional economists): people are far from perfectly rational. Indeed, people's decision making has been found to be infused with “irrationalities” (or decisions that violate economists' perfect rationality premise).

Behavioral scholars Richard Thaler and Cass Sunstein have derided modern theorizing: “If you look at economics textbooks, you will learn that homo economicus can think like Albert Einstein, store as much memory as IBM's Big Blue, and exercise the will power of Mahatma Gandhi,” whereas real people have trouble remembering their passwords, finding their keys, and avoiding temptations that make them obese and lazy and leave them impoverished in their retirement. Behaviorists' documentation of pervasive human decision flaws has been so thorough and impressive that two behaviorists, Thaler and Daniel Kahneman, have received Nobel Economics Prizes.

Behaviorists have found that people fail to follow the dictates of economic theory. For example (and the examples are numerous), they:

- fail to select choice options with higher expected values.
- choose inconsistently (for example, they might choose *A* over *B* and *B* over *C*, but then choose *C* over *A*).
- discount future costs and benefits inaccurately and inconsistently.
- do not “equate at the margin” (or seek to produce where marginal costs and revenues are equal).
- weigh prospective losses more heavily than prospective gains.
- consider sunk costs.
- fail to consider opportunity costs.
- prefer pursuing business ventures with in-house resources rather than with less costly outside resources.
- can't even be counted on to obey the “law of demand” (a proposition with no necessary connection to conventional choice theory, behaviorists argue).

Behaviorists have also found that human decisions can be swayed by the comparative “salience” of choice options and by how the options are “framed” and “anchored,” even by incidental considerations. For example, when subjects (typically students in classroom or laboratories) are asked to write down the last four digits of their Social Security numbers and then asked to bid on, say, a coffee mug, behaviorists have found that those subjects with the higher last four digits tend to bid higher prices.

Behaviorists argue—rightfully (I think)—that their many findings should be expected, given humans' many cognitive limitations. Consider:

- Humans would never have evolved to be perfectly rational. If any early human tried to make decisions with the precision economists assume they do, they would have starved to death before they finalized their decisions on what to eat,

or they would have been eaten by predators as they studied carefully their frequent “fight or flight” decisions.

- All human senses are subject to limitations, as evident by the fact that they don’t see as well as hawks or smell as well as wolves.
- Human brains are biological systems and all biological systems have built-in error rates.
- Moreover, human brains don’t have the resources (mainly neurons and energy) to fine-tune decisions as well as economists assume. The demands on the brain’s limited resources from bodily functions and sensory information inflows are enormous, which means the brain must first economize on its own internal resources before it can contemplate economizing on external resources.

Behaviorists have identified at least 200 decision and behavioral “biases” and other cognitive flaws. These decision-making flaws, which are considered serious and pervasive, include availability bias, attention cascade, confirmation bias, congruence bias, hostile attribution bias, hindsight bias, hyperbolic discounting, illusion of validity, impact bias, information bias, irrationality escalation, and omission and optimism bias. This list seemingly grows by the journal publication.

Indeed, human decision making has been found to be so profoundly and consistently defective and at odds with the conventional rational premise that behavioral psychologist Dan Ariely has concluded, seemingly representing the perspective of many enthusiastic behaviorists, that people are best described as “predictably irrational.” After all, he quips, people are effectively “goslings,” with more or less the same limited mental proclivities to define and make their own life choices.

Because of humans’ decision-making shortcomings, behavioral enthusiasts have concluded that improvements in human welfare can be achieved broadly only by a government department of “choice architecture,” with hired “choice architects” responsible for devising “nudges” under the banner of “libertarian paternalism” (which, behaviorists declare, is not an oxymoron). These nudges would proscribe and “frame” people’s choices, which can only enhance welfare and which the choosers would welcome in spite of any loss in choice freedom, they contend.

The behaviorists seem unconcerned that the choice architects would be drawn from a population of predictably irrational humans, with their decisions likely as defective as those subjected to nudges.

### CONVENTIONAL ECONOMISTS’ CRITICISMS OF BEHAVIORAL ECONOMICS

Behavioral enthusiasts may have fallen prey to their own central criticism of conventional economics: they assume too much, given that so many of their findings on flawed decision making have come in large measure from relatively small samples of undergraduate students. These subjects are forced to consider choice options, many involving relative assessments of unfamiliar complex gambles, in confined and artificial classrooms and

laboratories where the subjects are given little time to make their choices and with no feedback on the flawed choices of other subjects. The choice options are not, as Nobel Lauriat Vernon Smith has argued, “ecologically adaptive,” which is to say the options are imposed by the researchers and do not emerge from choice processes familiar to or created by the subjects themselves. In behaviorists’ terms, the choices available are often “framed” to induce behaviorists’ chief finding: pervasive irrationality.

My favorite behavioral “experiment,” supposedly showing widespread irrationality, is framed this way: Student-subjects are asked to choose between a sure-thing choice option of \$800 and a gamble with an expected value of \$850 (with an 85% chance of receiving \$1,000 and a 15% chance of getting nothing). The behavioral researchers have declared the subjects’ choices to be “irrational” because upwards of 85% of them choose the lower-value sure-thing and the rest choose the gamble. But should that division be unexpected? The subjects were given little time (maybe two or three minutes) to make their choices and were given no incentive—or even permission—to confer with each other to determine the “right” choices. They also were not told about the choice division for all subjects in past experiments and were given no chance to find ways to correct the dominant “irrational” choices.

I gave my own MBA students the two options and got a similar choice division. I then gave them a paper assignment to be organized around two questions:

- Is there money being left on the choice table?
- If there is, can they think of ways to pick up the overlooked money?

Some 70% of the student teams (over several years of giving the assignment) had no problem devising several methods for making money off the “irrational” student choices, the most incisive of which was to offer students choosing the sure-thing more than \$800 to sell their choice option. My students quickly deduced that if they could entice enough of their fellow subjects to make deals, they could make the gamble a money maker.

More importantly, if behaviorists’ damning view of human rationality were on target, freeways and parking lots would look more like bumper-car rinks than fairly orderly processes in which road rage, collisions, and deaths exist but are relatively infrequent (per million miles driven). The clear majority of freeway drivers seem to earnestly seek to avoid accidents and do get to work without incident.

If behavioral enthusiasts were on target in claiming pervasive and entrenched irrationalities, we must wonder how tens of millions of sophisticated smartphones (and a million other goods) involving global supply chains could be made available for sale each year. Yes, markets are replete with mistakes, but the order achieved in most markets hardly matches the chaos that would be expected from totally defective, “predictably irrational” market participants.

Maybe both conventional and behavioral theorists have overlooked market conditions that induce participants to be more

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rational than behaviorists have found them to be absent market forces, but who will never be as rational as conventional economists assume. Maybe economists should adopt a revised perspective of scarcity and rationality. I recommend a “brain-focused economics,” described at length in my new book *A Brain-Focused Foundation for Economic Science*, that can help settle many disputes among economists—and transform our assessments of the gains from trade within markets.

## BRAIN-FOCUSED ECONOMICS

In spite of their many methodological deficiencies (which I cover in detail in my book), behavioral economists (and psychologists) are certainly correct that people are not perfectly rational, or even approximately so. They are innately prone to flawed decision making, which—if not subject to correction—will undercut efficiency, profits, and consumer welfare in markets. Perfect rationality is, indeed, perfectly irrational from the perspective of the economy of the human brain.

However, markets can help to overcome innate flaws in people’s thinking, leading to greater cost saving, efficiency, and welfare. As noted, with conventional economic theories grounded in perfect rationality, there is no way markets (or any other institutional setting) can improve (or worsen) the brain’s allocation of its own resources and decision making. With less-than-perfect decision making, improvement is not only possible but almost assured.

To accommodate behavioral findings, my proposed reformation of economics starts with a founding proposition, that people are beset with a variety of evolved, limited, and defective mental resources (mainly neurons and energy) and thinking proclivities. The human brain faces the classic economic problem—scarcity—and that necessitates less-than-perfect rationality and flawed decision making. The brain confronts a multiplicity of demands on its resources from all bodily organs and functions (including keeping the heart, lungs, and digestive track—and life itself—going) and from a vast, unrelenting, and varying inflow of sensory information. The demands on the brain are so intensive and unrelenting that it can’t possibly satisfy them all. This means that the human brain must have a rational mind of its own!

Not unreasonably, the human brain has (with a high probability) evolved to do the best it can in satisfying its demands within its constraints, which is to say that it must weigh the competing demands with the intent of maximizing its own net gain from the use of its own resources. This means the brain will make internal decisions with an evolved level of rationality, seeking to refine its decision making. But it will do that only up to the point that the additional gains (which, beyond some point, will diminish) are greater than the additional costs (which, beyond some point, will increase). Its (ever-changing) equilibrium rationality will necessarily fall short of perfect rationality. Perfection is simply not an option in nature—or in any economy, including the brain’s.

The brain will seek to reduce the pressure on its own internal resources by partially ignoring or setting aside much sensory

information and by devising heuristics for classes of decisions. Those heuristics are bound to fall short of perfection to one extent or another. The brain simply doesn’t have the resources (including time) to perfect them or ensure that its heuristics never lead to decision errors. Indeed, the brain can be expected to choose heuristics that have built-in and economical error rates because the internal costs of perfecting them can be greater than the added cost incurred from bad decisions, even when the count of bad decisions dominates the good ones.

However, a rational brain will hardly be opposed to making improvements in its heuristics *when the economics of doing so are favorable*. Clearly, even behaviorists believe the brain can learn or else they would not devote their careers to their science, disseminate their findings, and teach their classes. The human brain must use some Bayesian-type analytics and revisions as it gets feedback on its internal decisions and learns. Even very young children quickly devise an elemental decision rule when they touch a hot pot: “Don’t touch something that has just come off the stove.”

By adopting decision-making heuristics, the brain commits to a form of “decision-making portfolio management” employing many of the strategies and goals of financial portfolio managers. The brain will judge the value of its heuristics not strictly by the emergence of faulty decisions (as behaviorists seem prone to do). Decision errors are bound to emerge just as even successful financial portfolios are bound to have failed investments. The issue for the brain is whether any heuristic, and the decision portfolio organized around it, can be improved *economically*, and it is in the brain’s interest to be on the lookout for such improvements. With improvements, it can relax or satisfy unattended demands, such as the development of more dendrites or muscle mass.

A rational brain, however, will not necessarily give up immediately on a heuristic with the advent of a cluster of bad decisions, any more than an investor will give up immediately at the first sign of poor results on stocks in a portfolio. The brain will want to see evidence that the bad decisions persist because it knows that bad decisions can come in clusters for any heuristic. If the heuristic has worked reasonably well (or better than known viable alternatives), it could face a form of Clayton Christensen’s “innovator’s dilemma.” The brain may discern ways to tweak its heuristic to improve performance, which is a positive reason for hanging onto it. On the other hand, there could be a better heuristic. However, the brain could very well incur more costs by trying out replacement heuristics that prove less productive than it will incur sticking with a heuristic that yields some bad decisions but an overall successful record.

In the process of trying to use its scarce resources, the brain could persist in making bad decisions, although it does so as purposefully as it can. An economist’s brain, for example, might not give up on the law of demand when confronted with occasional evidence of an upward sloping demand curve. The *law* (and there are good reasons it is called that) has proven its worth over a wide range of applications, so it would be a waste of time and

other mental resources to run regressions every time a seemingly conflicting price change is observed.

Behaviorists see their catalog of irrationalities or decision-making failures as show-stopping evidence of the bankruptcy of conventional economics and as a scientific foundation for calls for added government market intrusions. Some conventional economists consider behaviorists' evidence a professional embarrassment or sidestep them with the Friedmanian refrain, "All theories are necessarily unreal," while others have found sufficient grounds for abandoning their deductive theories for the inductive methods of behaviorists. Still others have reviewed their work and concluded, "My models, while defective, work pretty darn well for my purposes, so why change?"

From my brain-focused perspective, I have come to see behavior-

correct decisions of a subset of their subjects, as if those subjects' choices don't matter (and so often they really don't in classroom and laboratory settings). However, subsets of "rational" decision-makers are critically important in markets, especially with time. They show the larger group of wrong decisionmakers how they can garner more value with fewer resources, and they put competitive pressures on poor decisionmakers to reform their ways.

And what of those who don't learn or are disinclined to change their wayward-thinking ways? Well, most should not be expected to last long in markets, as Friedman noted long ago. If people in business tend to ignore opportunity costs, consider sunk costs, and don't equate at the margin, their success will be limited over time (if not converted to outright failure). They will tend to lose their own financial and real resources and limit access to the additional resources of others. Consumers will tend to buy competitors' products. Investors will tend to move their financial support to those competitors who make more rational decisions from better heuristics. Even workers will gravitate toward firms that have the greatest access to resources and a greater chance of survival and prosperity.

Those people resistant to correcting their irrational ways will select out of market dealings and crowd into nonmarket settings. And those who do not self-select

out and misjudge their irrational tendencies will tend to be shown market exits, or be pressed to move off into institutional settings with less corrective competitive pressures (for example, large business bureaucracies, governments, universities, and nonprofits, where "irrationalities" may have greater staying power). In these ways, market *processes* (as distinct from separated snapshot market events, which behaviorists' experiments tend to capture) will make market outcomes far more rational than the innate, uncorrected rationalities might suggest.

Indeed, markets will tend to make persistent participants more rational—more calculating and more profit-seeking—than they might otherwise be inclined, just as markets put pressure on firms to charge lower prices than they would ideally choose.

Smith heralded the force of the "invisible hand" in markets that engineered unanticipated societal gains from trades. He and his intellectual descendants haven't seemed to appreciate just how deeply seated the power of the invisible hand is, the "fingers" that work inside the human brain. Since early humans learned to exploit trades, evolution has likely favored those who made decisions with some (relatively greater) rational care. Hence, no matter how irrational behaviorists deem people to be today, their rationality has likely improved over the eons *because* of the advent of markets (an unheralded rationality-inducing institution).

How can defective decisions made within less-than-perfect heuristics give rise to greater rationality and welfare gains than would otherwise be the case? Consider how basketball players, pressed by

*In spite of some flawed decisions, the brain is accomplishing its goal: improving its own overall rationality and increasing its chances for survival and greater prosperity for itself and its host.*

ists' findings of flawed decisions—especially when they persist, even with potentially corrective feedback loops—as evidence that the brain is likely maximizing the use of its own scarce internal resources. Overall, in spite of some flawed decisions, it is accomplishing its goal: improving its own overall rationality and increasing its chances for survival and greater prosperity for itself and its host.

#### **MARKETS AND DECISION-MAKING IMPROVEMENTS**

The many irrationalities behaviorists have uncovered largely emerge in temporary, nonmarket, and often artificial settings—classrooms and laboratories—that lack ongoing, evolved competitive market pressures and the informational feedback loops endemic to markets. People in real markets face the pressure of being outproduced, outmaneuvered, and underpriced by competitors (both existing and new), with many having their fortunes and short- and long-term livelihoods at stake. They get continual, if not continuous, feedback on their relative success and failure from the submarkets they face in all directions: their many product, labor, and finance markets. People in markets are constantly scanning the activities of others for clues on how they can (and must, to one extent or another) enhance their performance through improved heuristics and resulting decision portfolios, as well as the suppression of innate tendencies toward making irrational choices. These improvements enhance their prosperity, if not survival.

Behaviorists highlight the many wrong decisions of subsets (even supermajorities) of their subjects. They tend to disregard the

## COMMERCE &amp; TRADE

the desire to win, can improve their game by practicing long hours to develop neuronal networks (misleadingly described as “muscle memory”) to routinize or automate complex moves—say, a jump shot—that can have the effect of *improving* (not perfecting) their game.

### TRADE RESTRICTIONS, RATIONALITY, AND DECISION MAKING

The thesis that I laid out at the start of this article should now be self-evident. Markets open to trade—domestic or international—do far more than allow prospective traders to exploit known comparative cost advantages. They allow the introduction of added competitive pressures, which can put downward pressure on price and production costs and upward pressure on product quality. That gives rise to the growth-inducing “creative destruction” highlighted by Joseph Schumpeter seven decades ago.

In arguing this, I simply accept the behaviorists’ admonition to conventional economists: people are not as innately rational as conventionally presumed. However, acceptance of that finding means that markets can do more than Smith, Ricardo, and all following conventional economists have assumed. Open markets, with added competitive pressures, can correct and improve (though not perfect) the errant decision-making proclivities of market participants.

Thus, competitive market pressures can improve the brain’s allocation of its own resources through the development of less-flawed heuristics (and fewer irrational decisions than behaviorists have found in noncompetitive market settings). While market participants will never meet the perfect-rationality standard of conventional economists, they will not likely sink consistently over time to the pervasive irrationality findings of behaviorists. Hence, in market-based economies, “nudges” are less relevant and necessary than behaviorists have surmised from their classroom and laboratory findings.

The conclusion here is, don’t look for ways to impose nudges. Instead, look for ways to increase competitive market pressures, one of which is to keep markets open to international trade (or, at least, don’t close them). And that added pressure can be substantial, given that U.S. international trade is upwards of a quarter of gross domestic product (and a much higher percentage for other advanced economies). The decision-making effects of open international trade can come from improved heuristics that need not remain narrowly applied to exports and imports. Those heuristics can have general applicability in much of economic life, including most parts of the domestic economy.

Of course, the arguments offered here lead to a conclusion not usually seen in conventional economics: trade restrictions should be opposed because they likely induce more irrational decision making than otherwise. These irrationalities, in turn, can induce more unexploited mutually beneficial trades. Trade restrictions thus do more damage—especially in the long run—than heretofore imagined. They set in motion people’s return to a lower levels of rational decision making, which can make behaviorists’ favored nudges all the more appealing.

### CONCLUSION

In summary, conventional economists have been on target by showing how markets can induce people to improve the allocation of scarce external resources (e.g., labor, steel, trees) through trades. But they have overlooked—no doubt, attributable to their premise of perfect rationality—how markets can improve the brain’s allocation of its own internal resources. Better allocation, in turn, can improve decision making of market participants and can increase the extent to which participants discover and exploit comparative cost advantages. Hence, trade restrictions can be expected to not only deny people in trading countries the benefits of comparative advantages, they can worsen their decisions-making propensities.

Granted, the gains from trade deduced from conventional economic models cannot be superseded, but only because those models presume that all potential gains from trade are exploited without fail. Perfect rationality combined with perfect competition leads to perfect outcomes. Such perfect outcomes are simply not achievable in a world bedeviled with scarcity.

In thinking through trade theory, we must start with where we are and ask, how can added competitive pressures from open trade lead to welfare gains? In conventional economics, the gains are limited to improved allocations of external resources. In my brain-focused approach, competitive pressures can have the added effects of improving the brain’s allocation of its own internal resources and the performance of its (less-than-perfect) decision heuristics.

Those improvements, I stress, can lead to even greater gains (or fewer losses) in the allocation of external resources. If people are as imperfectly rational as behaviorists insist they are, there is no reason to believe that they will, without meaningful pressures, minimize costs and discover their comparative cost advantages or even exploit the potential trades that are self-evident in economists’ blackboard discussions of the gains from trade.

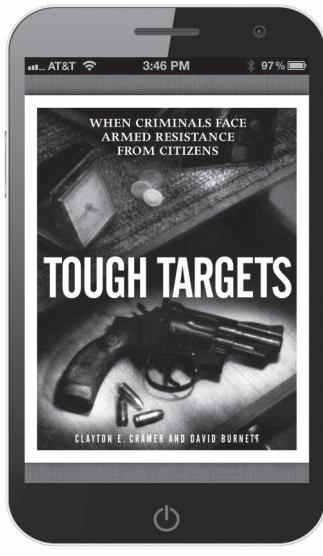
Nonetheless, economic market models do have an unappreciated didactic purpose: they suggest an array of heuristics—tagged “principles” (e.g., equate at the margin, ignore sunk costs)—that market participants might consider adopting (or employing more frequently) if they want to survive, if not prosper, under market pressures. And the more competitive their markets, the more closely they will need to follow them, instead of following their innate decisionmaking biases. R

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## LABOR

# How Labor Regulation Harms Unskilled Workers

*As government expands regulation of employers, they will increasingly turn to fewer, higher-skilled workers and automation.*

● BY WARREN MEYER

Last January, economist and *New York Times* columnist Paul Krugman tweeted something that I, as a business owner, found astonishing. He wrote, “There is no evidence—none—that regulation actually deters investment.”

I am not an economist by training, so perhaps this statement is true in aggregate across the economy. But I know from personal experience that it is not true at a granular level. My company has exited from certain businesses and locations in direct response to changing regulations, and I know others have as well. As a minimum, I believe that labor regulation is shifting investment away from businesses that employ unskilled labor and toward businesses that employ skilled labor or increasing levels of automation.

In my business, which staffs and operates public campgrounds, I employ about 350 people in unskilled labor positions, most at wages close to the minimum wage. I had perhaps 40 job openings last year and over 25,000 applications for those jobs. I am flooded with people begging to work and I have many people asking for our services. But I have turned away customers and cut back on operations in certain states like California. Why? Because labor regulation is making it almost impossible to run a profitable, innovative business based on unskilled labor.

Why is this important? Why can't everyone just go to college and be a programmer at Google? Higher education has indeed been one path by which people gain skills and opportunity, but until recently it has never been the most common. Most skilled workers started as unskilled workers and gained their skills through work. But this work-based learning and advancement path is broken without that initial unskilled job. For people

unwilling, unable, or unsuited to college, the loss of unskilled work removes the only route to prosperity.

The academic and public policy communities generally discuss the effects of government interventions into labor markets piecemeal, teasing out the effects of a particular regulation (such as an increased minimum wage) in isolation. As an entrepreneur, I don't have that luxury; I must comply with literally hundreds of labor regulations simultaneously. En masse, these regulations have substantial negative effects on the ability of firms like mine to profitably employ workers, particularly the unskilled.

The purpose of this article is not to dissect the costs and benefits of any one particular regulation, but to survey the mass of regulation to demonstrate how the accretion of many different, presumably well-intentioned rules to protect workers can, in total, have exactly the opposite effect, making it difficult for companies to profitably employ unskilled labor and for those workers to develop and advance.

I will survey the field of labor regulation in four categories that roughly correspond to the effects these regulations have on business viability: 1) regulations that directly raise the price of labor; 2) regulations that add risk to hiring workers, and that can make unskilled workers particularly risky to hire; 3) regulations that add fixed costs for employers, increasing the minimum viable size of a company; and 4) regulations that limit business formation and growth by making it harder to pursue new and innovative labor models.

## REGULATIONS THAT DIRECTLY RAISE THE PRICE OF LABOR

The most easily identifiable regulations that hamper employers are those that impose direct costs on the hiring and retention of workers. Below are some prominent examples.



**Minimum wage** / Perhaps the most visible of these regulations are minimum wage laws. The federal government sets a minimum wage of \$7.25 an hour (lower for workers who receive tips and higher for private workers making products or performing services for the government). However, many states and even cities have minimum wage laws that impose much higher requirements. The highest are Washington state at \$11.50 an hour and Massachusetts and California at \$11 an hour. Many of these state laws have escalators that are programmed to take the minimum wage to \$15 over the next several years, while cities like Seattle are already at \$15 an hour for larger employers. (See “A Seattle Game-Changer?” Winter 2017–2018.)

The minimum wage for certain activities like government construction projects is even higher. For example, under the Davis–Bacon Act a laborer who places and picks up orange cones around a federal highway project in California has a minimum wage of \$43.97 an hour (and yes, the wage rules are that detailed).

**Payroll taxes** / Employers pay several percentage-based taxes on

wages. Essentially sales taxes on labor, these are above and beyond similar taxes paid by the employee. Employers pay taxes for Social Security, Medicare, state and federal unemployment insurance, and—in some states like California—disability insurance.

While most of these taxes are fixed and predictable, unemployment insurance premiums can scale upward for businesses that are seasonal or have a lot of employee turnover (particularly given that many states are not very diligent about ensuring recipients are really looking for work, a supposed requirement of most unemployment benefits). In total, the employer share of payroll taxes starts at around 8% of wages. For businesses that hire a lot of transient or seasonal unskilled labor, these taxes are as high as 16% of wages.

**Workers' compensation** / All states require employers to pay for workers' compensation insurance for their employees, a no-fault insurance program that covers both lost wages and the cost of health care from workplace injuries (even those not resulting from employer negligence). When first implemented, workers' compensation was inexpensive, with claims costs dominated by lost wage

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payments. As health care costs have increased, however, so too have premiums. Premiums generally are calculated as a percentage of wages and range from as low as 1% for skilled office workers, to 10% of wages for outdoor and maintenance workers, to as much as 50% of wages in certain injury-prone professions like roofing.

**PPACA** / The Patient Protection and Affordable Care Act (PPACA), more commonly called “Obamacare,” represents an enormous and complex new set of regulations on businesses. Perhaps the most costly of these are the insurance coverage requirements. The law defines minimum health insurance policy features, and employers must pay penalties if they provide employees coverage below the minimum. Firms that provide insufficient health insurance (or no insurance at all) face penalties of \$2,000–\$3,000 per employee per year. Consider a worker earning \$8 an hour for 2,000 hours a year (roughly full-time). This penalty acts as an effective 12%–19% additional tax an employer must pay for employing the worker, while providing compliant health insurance can cost even more.

**Mandatory employee leave** / Both federal law and most states have requirements to provide workers in a variety of situations (e.g., illness or pregnancy) with unpaid leave and full rights to return to their same job after the leave is over. California has a mind-boggling 14 categories of leave that employers must provide, including: paid sick leave, kin care, pregnancy disability leave, voting leave, jury duty and court attendance leave, crime victims leave, leave for victims of domestic violence, sexual assault, or stalking, organ donor/bone marrow donor leave, family crisis leave, volunteer civil service/emergency responder leave, Civil Air Patrol leave, military spouse leave, military and reserve duty leave, and school visitation leave. In most cases, providing this leave seldom creates a big problem for businesses, though it can create some awkwardness (e.g., what does one do with good workers who filled in for employees on leave, fire them when the leave is over?).

More recently, though, states have been adding requirements for paid rather than just unpaid leave. States like California and Arizona, for example, require employers to give workers up to three days a year of paid sick leave, an equivalent of a 1.2% tax on wages. Led by the District of Columbia, activists are pushing states to require companies to provide up to eight weeks of paid family leave. If that benefit were to be taken once every two years, it would be the equivalent of a 7.7% tax on the wages of young people in their reproductive years.

**Effects** / Taken together, these regulations substantially increase the minimum cost of employing even the least-skilled workers. In a location with a \$15 minimum wage, the actual all-in cost per hour with taxes and minimum benefits might be as high as \$21 an hour. It is very hard to run a profitable business employing unskilled workers at these sorts of costs.

Consider my business for example. A typical campground we operate requires perhaps two hours of labor per week per campsite,

so an increase from the federal minimum wage to a \$15 minimum wage might add \$22 a week per site in wages and related costs. Since we typically make \$2 to \$3 per week in profit per site, most or all of these extra costs will be passed on to our customers. Given typical campsite occupancy of 2.5 days per week and \$23 a night camping rates, customers would have to bear a 40% price increase to cover a \$15 minimum wage. In the end, we increase prices where we can and exit the business where we cannot.

Our relatively low net income margin of 5% (for comparison, in 2016 Microsoft and Google had margins of 23% and 27% respectively) is not unusual for companies that depend on low-skill labor. Almost by definition, firms that depend on low-skill workers to deliver their product or service have difficulty establishing barriers to competition. It's difficult to do anything uniquely innovative when much of the work is performed by employees with limited skills. As soon as one firm demonstrates there is money to be made using low-skill workers in a certain way, it is far too easy for competitors to copy that model. As a result, most businesses that hire low-skill workers will have had their margins competed down to the lowest tolerable level.

Thus, as in my campground example, the least likely response to regulation-induced labor cost increases is a reduction in profits because profits have already been competed down to the minimum necessary to cover capital investment and keep owners interested in the business. The much more likely responses will be increased prices and reduced employment. In the long-term, companies will substitute capital for labor, reducing employment even further.

## REGULATIONS THAT INCREASE BUSINESS RISK

But regulations that directly impose costs are not the only ones that hamper employment. Another category of troublesome regulation imposes increased risk, which in turn harms firm profits and viability. Here are some examples.

**Liability for bad employee behavior** / The legal system places much of the liability for an employee's actions not on the employee but on the firm's owners. A business can put in place policies and training mandating the proper treatment of other employees and customers, but if one knucklehead out of a company's dozens or hundreds of employees decides he is going to harass someone or discriminate against certain races or religions, the owners (and not the employee) can and will get sued. Such lawsuit defenses are expensive even when the firm ultimately prevails; I have never seen a suit for even the most absurd of claims settled without spending at least \$20,000 in legal expenses.

**Reduced hiring information** / Given firms' liability for employees' bad behavior, employers reasonably would like to vet employees quite diligently. However, regulations increasingly limit the information one can gather in the hiring process, greatly increasing the risk of hire. Examples include “Ban the box” (which limits employers' ability to ask about past criminal convictions), restrictions

on using credit checks on potential employees, and more recent restrictions against asking employees about their past salary and employment status. In addition, litigation has also made reference-checking much harder because many firms will not respond to reference checks because of fear of lawsuits over negative references.

**Restrictions on terminating employees** / In several ways, regulations increasingly make terminating poorly chosen employees more difficult. For example, equal employment rules give employees who fall into a number of legally protected classes (e.g., certain races, ethnicities, and genders) enhanced rights to file lawsuits or other legal complaints for things like unfair termination. It seems that no person in history has ever believed that his or her firing was fair, so employees may challenge even well-justified terminations. Termination can thus be costly and time-consuming, as extra steps are often taken in the termination process in anticipation of potential future legal action.

Another increasingly frequent source of legal challenges to terminations has been created by “whistleblower” laws. The

but as potential liabilities, fewer people are going to be hired.

One potential way employers can manage this risk is to shift their hiring from unskilled employees to college graduates. Consider the risk of an employee making a racist or sexist statement to a customer or coworker (and in the process creating a large potential liability for the company). Almost any college graduate will have been steeped in racial and gender sensitivity messages for four years, while an employer might have an hour or two of training on these topics for unskilled workers. Similarly, because good information on prospective employees—credit checks, background checks, reference checks, discussions of past employment and salary—all have new legal limitations, employers who hire college graduates benefit from the substantial due diligence universities perform in their admissions process.

### REGULATIONS THAT INCREASE FIXED COSTS

Besides adding to the direct and indirect costs of each employee, government regulations impose a number of fixed costs on employers. These further dampen employment by affecting firm viability. Consider the following examples.

*Firms' liabilities for the actions of a poorly selected employee are rising, yet regulations are making it harder for employers to get good hiring information and to terminate employees who present threats to the workplace.*

law protects employees who report potentially illegal corporate activities to regulatory or law enforcement agencies. As a business owner, I want my employees to report impropriety because I want to fix the problem. However, over the past several years, firms have started to see some employees, when anticipating termination for poor performance (and even after such termination), make accusations against the company so they can then challenge the termination as unjust retaliation for the claims they have made.

**Effects** / It used to be that the worst human resource risk a company faced was hiring employees who simply did not justify their salary. However, given the current body of regulation, any poorly selected employee is a potential ticking bomb who, through bad behavior with customers or other employees, could tie up the company for years in expensive litigation or regulatory actions. But as a firm's liability for the negative activity of a poorly chosen employee rises, regulations are making it harder to get good information to make better hiring choices, while simultaneously making it harder to terminate employees who were poorly chosen and present threats to the workplace or customers. When employers begin to look at their employees not as valuable assets

**Payroll and PPACA compliance** / Payroll and the rules that govern it—wage and hour laws, sick day accruals, tax payments to multiple authorities, garnishments, W-2s—have become so complex that most companies cannot manage their own payroll. In certain states, for example, companies can be fined or sued for violations as small as using the wrong font on payroll checks. In response, businesses—even small ones—pay thousands or tens of thousands of dollars a year for third-party payroll firms to manage this process. Similarly, in 2016 new rules went into effect requiring companies to put in place extensive tracking systems for their employees' health insurance status and eligibility, including detailed annual reporting that must be sent to every employee and the government. Many firms like mine have been forced to pay a vendor at considerable expense to do this paperwork.

**Reporting** / My small company is deluged with reporting requirements to the government, many of which touch on employment. For example, my firm is required to collect the race, ethnicity, and gender of employees and report this information annually to the government. In 2016, the federal government announced that this annual reporting requirement will, in 2018, be expanded from tracking employees in about 80 race/job/gender combinations to tracking them in 3,600 race/job/gender/income categories. (This expansion has been suspended by the Trump administration—at least for now.)

It is an unusual day in my office when I do not get yet another letter from some state or federal agency—the U.S. Occupational

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Safety and Health Administration, its state-level equivalents, labor departments, census bureaus, tourism boards—that wants something filled out on my business. Whether it be the number of labor hours worked in Florida or the number of employees who received first aid in California, some government agency somewhere always wants more data.

**The micro-regulation minefield** / Beyond the more well-known regulations we have mentioned, states and municipalities have hundreds, even thousands, of other detailed employment-related laws under which even a conscientious employer can find itself facing enormous fines and legal penalties. There are far too many of these to list, but I will discuss one example: the lunch break law in California.

In California, employers have an affirmative responsibility to make sure employees take their lunch break. If the employee chooses to work through the break or even works through the break despite explicit employer mandates not to do so, the employer is still liable for penalties. My company tried several approaches to documenting when employees worked through lunch by choice (say, to get more hours of work or to go home earlier), but all eventually failed. When we allowed employees to work through lunch at their own request, we were later successfully sued for giving them this opportunity.

**Ex post facto law** / Compliance with a bewildering array of regulations is hard enough, but many regulations are poorly worded or don't take into account the full variety of working arrangements that exist in the private sector. One is often forced to guess exactly what is legal. In the case of California's lunch break law, for example, the "safe harbor" for compliance shifted several times as the rules were tested in court cases. Frequently companies find that compliance strategies they thought were legal have to be reworked as regulations are clarified in the courts. As a result, my company pays thousands of dollars each year to attorneys who review our employee handbook, compliance systems, timesheet process, and a myriad of other details for necessary changes. In California, we do this twice a year because it is so hard to keep up with the state's massive amount of regulatory change.

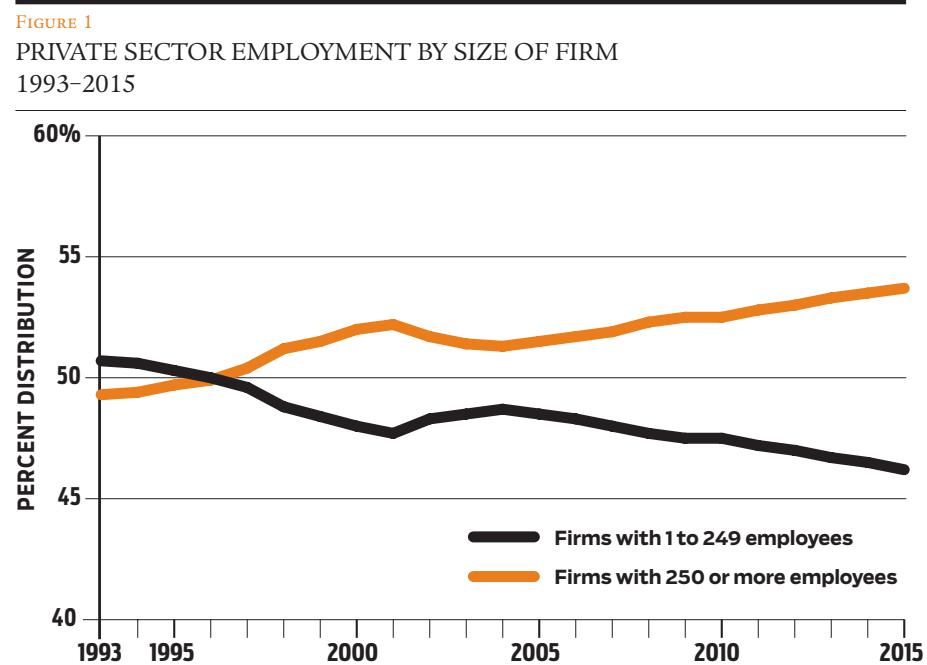
**Presumption of guilt** / While nominally most labor law conforms to the same criminal and civil legal standards of guilt and innocence that obtain in the rest of the justice system, in practice employers often bear the burden of a presumption of guilt with regulatory bodies. We must prove ourselves innocent.

I will offer one example from my own

experience. My firm had a routine labor audit by a state labor department. Mostly it went well, but somehow one timesheet for one week had been lost for a single employee. The investigator asked the employee to estimate his hours worked that week. On every other timesheet for years, he had reported 30–40 hours per week. For the missing timesheet, the employee retroactively claimed 128 hours, or a bit over 18 hours a day. This was obviously absurd and any reasonable person would have rejected this estimate as opportunistic and exaggerated. But my company eventually had to pay for 128 hours (40 regular hours and a whopping 88 hours of overtime) because we could not prove absolutely that the worker did not work what he claimed.

**Effects** / Most of these regulations impose fixed costs and do not increase the cost of hiring decisions at the margin. In other words, if I already am paying for a payroll system, an onboarding system, and an injury reporting system, hiring one more person does not cost me much more. However, all these expenses, by raising the fixed overhead costs of a business, tend to increase the minimum size a business must be to remain viable. For example, \$20,000 in fixed costs to manage these regulatory issues is likely a trivial expenditure for a multi-million-dollar corporation, but for a company with revenues of only \$100,000 a year it can be backbreaking. Perhaps even worse for many small businesses, the only person who can usually manage this compliance work is the owner, causing the one person who typically drives growth and improvement in the business to spend much of his or her time worrying about compliance issues instead.

I am embarrassed to admit that this mass of regulation has probably helped my business. As one of the two or three largest



firms in a niche industry, we have been able to absorb these costs while most of our smaller competitors have left the business. Fifteen years ago I used to find myself bidding against small family firms operating in just a single location; now, I only see competition from the larger multi-location firms like mine.

On a macro scale, we would therefore expect that as these fixed costs imposed by regulation rise, employment will shift from smaller to larger companies. This is indeed what the United States has experienced for over two decades, as shown in Figure 1.

One reason for this decline is that, according to the U.S. Small Business Administration, since 1992 most of the new small businesses formed have had no employees at all. These zero-employee companies are a predictable result of the increasing regulatory costs of hiring because these sorts of business owners are generally exempt from much of labor regulation. A company in which only the owners provide labor is substantially less expensive to operate than a company with even one employee.

The decline in the relative share of employment at small businesses and the decreased job creation from new small businesses have a disproportionate effect on unskilled labor because small businesses have always been a particular source of opportunity for less educated workers. In 1998, before most of these declines in small business employment share, 52.2% of small business employees had high school diplomas or less, while just 44.5% of larger company employers had this level of education.

### REGULATIONS THAT DISCOURAGE NEW AND INNOVATIVE BUSINESS MODELS

In addition to the costs discussed above, regulations can also restrict the use of new and different business models, thereby hurting firm flexibility and innovation. This is bad for business, consumers, and the economy.

**Workweek and overtime rules** / All states have established a 40-hour work week and require at least 150% of a worker's wage rate—"overtime pay"—be paid for time worked over those 40 hours. Certain states have even more restrictive rules. For example, California requires overtime pay after the fifth day of work or after the 8th hour in any given day, no matter how many hours were worked the rest of the week. Massachusetts requires overtime always be paid on Sundays. In California and some other states, employers are required to give an unpaid break for lunch of at least a half hour in the middle of a shift. However, if this legally mandated break becomes longer than one hour, this work then falls under split-shift law and the employer must pay a penalty of one hour of pay to the employee for each day it occurs.

**Minimum salary** / In addition to minimum wages, the federal government and many states set what is effectively a minimum salary. This is the lowest salary at which employees are no longer required to report their work hours and thus are no longer required to receive overtime pay. In 2016 the Obama

Labor Department raised this limit, more than doubling it from \$23,660 to \$47,476. Suddenly, millions of junior managers taking their first steps toward higher trust and responsibility were faced with filling out a timesheet again. (In August of last year, a U.S. District Court blocked implementation of this rule. The Trump Labor Department is now reconsidering it.)

**Shift scheduling** / A number of cities and states have passed or are seriously considering restrictions on how employers set work schedules. Seattle's new law is typical: it requires employers to set shift schedules two weeks in advance, and applies penalties if employees are asked to work more, less, or different hours than shown on the schedule two weeks earlier. Employers also face restrictions and possible penalties when assigning employees to shifts at specific times, days, or locations of work that don't match the employees' preferences.

**Effects** / Often my employees ask me why labor law will not allow practices that would make a lot of sense in our business for both employer and employee. I tell them to imagine workers in a Pittsburgh factory, punching a time clock, working 9 a.m. to 5 p.m. Monday through Friday, working within sight of their supervisor, taking their breaks in the employee lunch room. This is the labor model regulators and legislators had in mind when writing the bulk of labor law. Any other labor model—seasonal work, part-time work, working out of the home, working unpredictable hours, telecommuting, working away from a corporate office or one's supervisor, the gig economy—become square pegs to be jammed in the round hole of labor law.

A few years ago my company was audited by a state labor department in California over workers who clean remote trailheads. One issue was the state requirement, discussed previously, concerning workers' meal breaks. In reviewing employee timesheets, the auditor asked to see written schedules so she could compare the scheduled time to the timesheets. I told her there were none. She was incredulous; how could there be no written schedules? How could she make sure we had not denied anyone a lunch break? I said we had no written schedules because employees schedule themselves—it is better for the company and way better for the employee. Employees could schedule their break—in fact, all their work—for any time they wanted so long as the work got done. Despite this being perfectly sensible both to me and my employees, the auditor's final recommendations included a notation that we should have formal work schedules, effectively asking that we take away the agency and autonomy we had given our workers.

While many businesses struggle to serve diverse customer needs within the restrictions of wage and hour laws, even more limiting to business flexibility are the new shift scheduling laws like the ones in Seattle. These regulations will make running a retail service business, at least one like my own, almost impossible. There is no way one can predict exact staffing needs two weeks in advance. In my business, it is not at all uncommon for a large group to suddenly

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show up without reservations to occupy a dozen or more campsites we expected to remain empty. How can this possibly be handled if substantial penalties are imposed by the government for paying extra help to serve these unexpected customers? Even ignoring changes in customer behavior and acts of God like major weather events, many last-minute changes to shift schedules are caused by the employees themselves. One employee gets sick, has car trouble, has an emergency, or just does not show up, and someone has to be called out to fill in the gap (particularly if first-line supervisors are no longer salaried but subject to overtime).

These rules do not just limit business flexibility in hiring hourly workers, they also make it harder to advance them. Most employers who hire unskilled workers promote much of their management from these front-line employees. Every one of the 60 managers in my company, including my chief operating officer, began in the company cleaning bathrooms. Walmart claims that 70% of their store management started in an entry-level job stocking shelves or running the register. Unfortunately, the rules increasing minimum salaries will make it harder for such unskilled workers to advance.

Certainly companies will still hire first-line supervisors even if they must be paid hourly. But the entire nature of these jobs will change. Some differences are psychological; for better or worse, management thinks of salaried workers differently than hourly workers. The same, I can say from personal experience, is true of the front-line supervisors themselves, who see a switch back to punching a time clock to be a demotion.

And some differences are real. Salaried workers can try to demonstrate that they are worthy of promotion by working extra hours and showing initiative by taking on extra tasks, something hourly workers simply would not be allowed to do for fear of incurring overtime charges. Without these minimum salary rules, young junior managers might work 60 hours a week to impress management with their diligence and dedication, signaling they were ready for promotion. With the minimum salary rules, employers will only have clock-punchers for junior managers. And once the most junior salaried workers make at least \$48,000 a year, companies will more likely consider hiring college graduates for these positions rather than promoting from their internal pool of promising unskilled workers, both because of the higher price and risk and because there will no longer be a way for unskilled workers to demonstrate that they are worthy of this trust.

## CONCLUSION

Fifteen years ago I started my current service business. I love my company and my employees. But if I had it all to do over again, I would never start a business based on employing unskilled labor. The government makes it too difficult, in far too many ways, to try to make a living employing unskilled workers. Given a new start, I would find a business with a few high-skill employees creating a lot of value.

And I don't think I'm alone. In the 1950s, 1960s, and 1970s,

there was a wave of successful large businesses built on unskilled labor (e.g., ServiceMaster, Walmart, McDonalds). Today, investment capital and innovation attention is all going to companies that create large revenues per employee with workers who have college educations and advanced skills. Only 4% of the employees at Apple, for example, have less than a college degree.

Even in large service-sector companies that employ unskilled labor, much of their investment today is in finding ways to reduce their reliance on that labor. I remember a number of years ago when the Chili's restaurant chain started putting little electronic displays on their tables. At first the displays just showed advertising and I thought they were an annoying waste of space. But over time the chain began using the devices first to accept payment for one's food and more recently to take food orders. They are progressively eliminating the need for most of their wait-staff. Every major restaurant chain is doing the same thing: investing in technology to eliminate unskilled workers. Why bother trying to figure out how to serve a rapidly evolving customer demand with workers who are limited by government in a hundred different ways in how and when they can labor? A website or iPad never sleeps, never sues, never needs a lunch break (let alone documentation of that break), never has to have overtime, and doesn't have its labor taxed.

The one exception to this lack of new opportunities in the unskilled labor market has been the gig economy, particularly companies like Uber and Lyft that provide work opportunities for hundreds of thousands of unskilled laborers. But Uber is the exception that proves the rule: it has succeeded in large part by making an end-run around most of the costly and restrictive labor regulations discussed in this article. Uber drivers are (at least as of this writing) independent contractors providing services to consumers to whom they are connected via the Uber app. Uber gives their drivers a tremendous amount of flexibility: they can set their own work schedule and shifts. Numerous regulated practices we have discussed, for which regulators fear the danger of employer abuse (e.g., lunch break timing, shift length, work-week length, split-shifting), are all entirely within the employee's control.

Uber thus provides a growing number of employment opportunities for unskilled workers. But it's not clear that this ultimately helps these workers move up the economic ladder. There is currently no clear path at firms like Uber or Lyft for drivers to advance—as cashiers can at Walmart—into supervisory positions. And while I have called Uber drivers unskilled labor (since most of us are able to drive even before we complete high school), it is not a viable work option for the very poor who don't have the resources for cars and insurance.

Thus the mass of government labor regulation is making it harder and harder to create profitable business models that employ unskilled labor. For those without the interest or ability to get a college degree, the avoidance of the unskilled by employers is undermining those workers' bridge to future success, both in this generation and the next. R

The federal government tried to take my business using civil forfeiture.

But I did nothing illegal or wrong.

I fought to protect my rights and my property.

And I won.

*I am IJ.*



*Russ Caswell  
Tewksbury, Mass.*

[WWW.IJ.ORG](http://WWW.IJ.ORG)

*Institute for Justice  
Property rights litigation*

## IN REVIEW

## The Wonder of Modern Life

REVIEW BY DAVID R. HENDERSON

**S**teven Pinker's *Enlightenment Now* is, quite simply, a fantastic book. In this fact-filled and incredibly well-footnoted tome, Pinker, a Harvard psychology professor, shows how the conditions of life for ordinary people have gotten much better, not just for those in wealthy countries, but also for most people around the world.

He shows that life expectancy has increased almost everywhere, health and nutrition have improved, and wealth and living standards have skyrocketed. The environment has improved. The destruction caused by war—and war itself—have decreased. Safety has increased and terrorism is a tiny problem. Literacy has increased. People have become generally more tolerant of others' differences and people are happier.

He attributes this progress to the Enlightenment, the four pillars of which—as the book's subtitle suggests—are reason, science, humanism, and progress. In laying out the facts and his argument, Pinker also shows a knack for the punchy, and often humorous, turn of phrase. Although he occasionally slips, as when he criticizes libertarianism, his slips are few and far between.

**Longer lives, better lives** / He opens his case by discussing why, despite the enormous improvement in human life, many people think conditions are regressing. He follows psychologists Amos Tversky and Daniel Kahneman in attributing this to the “availability heuristic.” Most people estimate the probability of an event by how easily instances come to mind. A murder happens in your neighborhood? Murder must be on the rise. A horrible terrorist incident happens in an Orlando night club? Terrorism must be a huge

problem. As a result, writes Pinker, even though the “*world has made spectacular progress in every single measure of human well-being ... almost no one knows about it*” (his emphasis).

Is there a way around the availability heuristic? Yes, and Pinker gives it: “The answer is to *count*” (his emphasis). Check the data—which is what he does.

Start with life expectancy. Just 200 years ago, the average life expectancy in the world was 29 years; in Europe and the Americas it was around 35. Today the average for the world has more than doubled—71.4 years—and for Europe and the Americas the number is about 80. Even Africa, the most troubled of the world's continents, has done well. Pinker writes, “An African born today can expect to live as long as a person born in America in 1950.”

What about the idea that for people in the richer countries, the added years of life in the last few decades aren't worth much because for most of them we are sick? Wrong. Pinker cites a study that finds that of the 4.7 years of life expectancy gained between 1990 and 2010 in the richer countries, 3.8 of them are healthy years.

In making this case, he points to doctor and public intellectual Leon Kass's claim that those added years aren't that worthwhile. In his 2004 book *Life, Liberty and the Defense of Dignity*, Kass asked, “Would professional tennis players really enjoy playing 25 percent more games of tennis?” This was presumably a rhetorical question, but my own answer would have been, “Obviously yes.” And Kass is not just some unknown misanthrope; he was chairman of President George W.

Bush's Council on Bioethics. Today Kass is a ripe 79; I wonder if his view of old age has changed.

Not surprisingly, given that life expectancy has increased in the last two centuries, so has human health. Two of the biggest breakthroughs were vaccination and wide acceptance of the germ theory of disease. Much later, on April 12, 1955, when scientists announced that the Jonas Salk vaccine against polio was safe, there were moments of silent tribute. There were also the opposite: bells ringing, horns honking, and factory whistles blowing in celebration. I was just 4 at the time, but my sister had had polio three years earlier and my father 12 years earlier. I wouldn't be surprised if there had been much joy in the Henderson household.

Pinker highlights some scientists whose names most readers won't recognize but who saved tens of millions of lives—or more. One, Karl Landsteiner, discovered blood groups and thereby saved a billion lives.

**Abundance** / A major contributor to health and life expectancy has been developments in food production and distribution. The percentage of people in the world's poor countries who are undernourished fell from 35% in 1970 to 13% in 2015. Worldwide deaths from famine were above 600 per 100,000 people as recently as the 1920s, but they aren't even detectable on a graph for the years 2010–2016.

Pinker points out that this advancement spectacularly contradicts the prediction made by Stanford biologist Paul Ehrlich in his 1968 book *The Population Bomb*. Ehrlich claimed that between then and the 1980s, 65 million Americans and 4 billion non-Americans would starve to death. Now, many of us, including me, have the opposite problem: too many calories.

Ehrlich's type of thinking led to some abhorrent public policies. Pinker notes that Robert McNamara, while president of the World Bank, “discouraged financing of health care” not because it wouldn't work, but because of his fear that it would work

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).

too well, leading to greater population.

But *why* did the food supply grow so much? One main factor was fertilizer, invented and perfected by chemists Fritz Haber and Carl Bosch, respectively, in the early 20th century. Another was the Green Revolution, initiated in the 1950s and 1960s by Norman Borlaug. Borlaug, the most important practitioner of genetic modification of wheat, “turned Mexico and then India, Pakistan, and other famine-prone countries into grain exporters almost overnight.” Incidentally, Pinker points out, contra the anti-biotechnology movement, “there is no such thing as a genetically unmodified crop.” One result of this huge progress is that we may have already reached “Peak Farmland”—the amount of acreage needed to feed humanity. To produce a given amount of food now takes less than a third of the land it took before the Green Revolution.

#### **Wealth and income inequality**

Sometimes you have to remind yourself that Pinker is not a bona fide economist because he certainly understands some of the basics of economics. In a chapter on wealth, he points out how moves toward freer markets in Eastern Europe, China, India, Indonesia, and other countries have increased wealth enormously and caused poverty to drop like a stone. He quotes a great line from Georgetown University economist Steven Radelet: “In 1976, [Chinese communist] Mao single-handedly and dramatically changed the direction of global poverty with one simple act: he died.” In 2000, Pinker notes, the United Nations was thought to be overly optimistic in vowing to cut the 1990 global poverty rate by 50% by 2015. They *were* off, but in the other direction: that goal was reached five years early.

What about income inequality? Hasn’t that increased? Actually, no. International

income inequality fell slightly from 1950 to 1990, and then fell a lot from 1990 on. Economic growth in poorer countries has been high, due in part to freer markets domestically and to increased international trade, part of which is the result of vastly lower shipping costs brought about by containerization.

Within America, notes Pinker, income inequality did grow between 1979 and 2004. But over that same time, the percentage of Americans with incomes (for a family of three) between \$0 and \$30,000 (in 2014 dollars) fell from 24% to 20%, the percentage with incomes between \$30,000 and \$50,000 fell from 24% to 17%, and

the percentage in the middle class fell slightly from 32% to 30%. Where did those people go? There’s only one direction left: up. What he calls the upper middle class—families with an income of \$100,000 to \$350,000—rose from 13% to 30% of the population.

He also cites Brookings Institution economist Gary Burtless’s finding that between 1979 and 2010, real disposable incomes for the lowest four income quintiles grew by 49%, 37%, 36%, and 45% respectively. And it’s important to note that poverty and income inequality

are two separate things. Also, if we measure poverty by what people consume rather than by their income, Pinker notes, the U.S. poverty rate has fallen from 30% in 1960 to only 3% today.

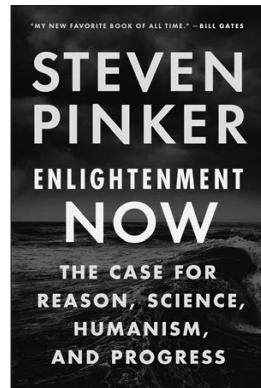
**Greener world** / Surely the environment has suffered as higher population and higher living standards have caused more pollution, dirtier lakes, and fewer forests, right? Wrong. Pinker references an Environment Performance Index that measures the quality of air, water, forests, fisheries, farms, and natural habitats. Of 180 countries that the index has tracked for a decade or more, 178 show an improvement.

Why did this occur? It’s not *despite* higher incomes, but *because* of them. As people grow wealthier, they want more environmental quality, not less. They get it by either providing it themselves—donating land to a trust, for instance—or pushing for regulations to reduce pollution.

One area about which Pinker worries more than I do is climate change. He admits that there are “judicious climate skeptics,” such as Judith Curry, who accept mainstream science but are optimistic about outcomes. He worries that they are wrong and that warming could be catastrophic. To his credit, though, he doesn’t do what many climate change believers do: advocate a slowdown in growth in the poorest parts of the world in order to cut carbon emissions. Instead, he advocates a solution that has worked in pretty much every area of life: technological improvement. He advocates a carbon tax, which, if you need to do something now (I’m not convinced that we do), would certainly help reduce carbon usage. But he also advocates nuclear power, arguing that regulatory hurdles in the United States have kept us from enjoying the huge improvements in nuclear technology that have been successful elsewhere. Pinker is also open to geoengineering, such as adding alkali to clouds or the oceans to dissolve more carbon dioxide in water.

**War** / Pinker, who has written extensively elsewhere about war, writes a brief chapter on it in this book. The bottom line is that the last “great-power war,” the Korean War between the United States and China, occurred over 60 years ago. Wars today are both smaller and much less bloody. That doesn’t mean there are no current tragedies of war, such as the misery of the 4 million refugees from Syria. But that is less than the 10 million displaced by Bangladesh’s war of independence in 1971.

**Crime and terrorism** / One of his outstanding discussions is on public safety. Pinker provides data showing that homicides have fallen dramatically almost everywhere over the last few centuries. Also,



**Enlightenment Now: The Case for Reason, Science, Humanism, and Progress**

By Steven Pinker

556 pp.; Viking, 2018

## IN REVIEW

more recently, the U.S. murder rate—though it rose in the late 1960s and early 1970s—is now lower than it was before that increase.

He presents fascinating data showing how granular the homicide rate is. It makes no sense, he shows, to think in terms of a high homicide rate in a country or even a state or province. You need to drill down to cities and even, within cities, to neighborhoods. He cites, as one example among many, his hometown of Boston, where 70% of the shootings take place in 5% of the city. Pinker notes that effective policing, combined with improvements in technology that take away opportunities for crime (e.g., people carrying credit cards instead of large amounts of cash are not attractive targets) have made robbing people far less appealing.

Some other notes on crime: In the United States, violence against wives and girlfriends fell by about 75% between 1995 and 2014. Rape and sexual assault fell by over 70% during the same period.

What about deaths from terrorism? Surely those are a huge problem today. Not in America. In 2015, for example, an American was 350 times as likely to be killed in a standard homicide as in a terrorist attack, and 800 times as likely to be killed in a car crash. Pinker notes that, fortunately, terrorism virtually never works in achieving the terrorists' strategic goals, although, of course, it does terrify many of us. Surprisingly, while Pinker positively cites Ohio State University political scientist John Mueller in many other places in the book, he doesn't cite—where it would have seemed de rigueur—Mueller's Fall 2004 *Regulation* article "A False Sense of Insecurity," in which he makes the case that Pinker makes.

**Safety** / Motor vehicle fatalities per million miles driven have fallen almost steadily over time and were doing so long before 1960s regulations required safer cars. Ford, he notes, offered in 1956 a safety package that included seatbelts, a padded dashboard, a safer steering wheel, and other features that would become

mandatory a decade later. Deaths from airplane crashes, fire, drowning, and occupational hazards—and even from natural disasters—have fallen fairly steadily.

How did those advances in safety come about? Pinker attributes them to "grassroots activists, paternalistic legislators, and an unsung cadre of inventors, engineers, policy wonks, and number-crunchers." While he's right about the inventors, engineers, and number crunchers, he misses the most important factor: economic growth. Safety, like environmental quality, is a normal good: the higher our income, the more safety we want. And the market responds. Safety in workplaces, for example, is not due mainly to government agencies like the Occupational Safety and Health Administration; it's due to workers becoming wealthier and demanding more safety. Employers who ignore this demand in their decisions about workplace safety will find themselves paying huge wage premiums to compensate for risk. Adam Smith, in *The Wealth of Nations*, recognized that fact 242 years ago.

**Liberal society** / Are you tired of all this good news? Pinker's not. He shows that there has been a rise in freedom of speech, the openness of the political process, and constraints on leaders' power in democracies since 1800. There was a big fall in the 1920s and 1930s (thanks to people like Lenin, Stalin, and Hitler), an increase after World War II, and then a fall in the 1960s and 1970s. Since then, the index measuring these liberal protections has climbed dramatically.

If I had more space, I could elaborate even more on the ways Pinker shows that life has improved.

Are there downsides? Yes. Pinker worries that one small mistake could lead to nuclear war and the devastation it would entail. Even here, though, he notes the decline in nuclear weapons since they reached their peak in the late 1980s. Pinker's thoughts on how to avoid nuclear war are terse and well worth reading. One way is to announce a policy of No First Use.

**Criticizing libertarians** / In his last few chapters, Pinker makes a nuanced and largely persuasive case for reason, science, and humanism that is well worth reading but difficult to summarize. One discordant note, though, is his attack on "radical libertarianism." Radical libertarians—I count myself as one—would seem to be Pinker's strongest allies. He often positively quotes, for example, Cato Institute senior fellow Johan Norberg's 2016 book *Progress*. But Pinker goes out of his way to attack them without giving sufficient citations to help the reader evaluate his criticisms.

In the conflict over climate policy during the Obama administration, for example, he writes that evangelicals opted for "radical libertarianism over stewardship of the Creation." His cited source doesn't even mention libertarianism; instead it discusses religious liberty. Elsewhere he writes that "right-wing libertarians" in "their 21st-century Republican Party version" have claimed that "raising the marginal tax rate for income above \$400,000 from 35 to 39.6 percent means turning the country over to jackbooted storm troopers." Although I, like virtually all of the hundreds of libertarians I know (right-wing or otherwise), opposed that tax hike, I don't recall any libertarian making that claim. Moreover, in a book with 1,288 endnotes, Pinker gives no citation for it. One might think he is exaggerating to make a point. That's possible, but one of the many virtues of his book is how he eschews exaggeration.

**Conclusion** / I mentioned earlier that Pinker has a knack for the pithy quote. One example is his response to Henry David Thoreau's famous claim that "the mass of men lead lives of quiet desperation." Pinker writes, "How a recluse living in a cabin on a pond could know this was never made clear, and the mass of men beg to differ."

I'll close with this. A friend recently asked me why I'm optimistic in the face of recent bad political news. I told him that I had just finished reading every page of *Enlightenment Now*. R

# Financial Crisis, Blame, Reform (Repeat)

REVIEW BY VERN MCKINLEY

Economist Allan H. Meltzer passed away in 2017. Beyond his role as a reliable critic of the Federal Reserve, one of his greatest contributions to his profession was his multi-volume history of the Fed.

Recently a number of histories of the Federal Reserve have appeared with dispersed focus on various discrete aspects of its operations. I recently reviewed Peter Conti-Brown's *The Power and Independence of the Federal Reserve* ("The Ulysses/Punch Bowl View of the Fed," Winter 2016–2017). This review focuses on *The Myth of Independence* by Sarah Binder and Mark Spindel. Both books cite Meltzer's work liberally.

Binder is a professor of political science at George Washington University and is affiliated with the Brookings Institution, while Spindel works at his own hedge fund, Potomac River Capital. The two bring to the book differing perspectives, representing both the academic world and the practitioner world.

It is useful to compare and contrast Binder and Spindel's book with Conti-Brown's, as both focus on the issues at the core of the Fed's independence: its interactions with Congress, its underlying enabling legislation, and its evolving governance. Notwithstanding these areas of overlap, the two books are very different in their approach to the topic of independence. Whereas Conti-Brown spends a great deal of time on the broad range of functions housed within the Fed, Binder and Spindel concentrate almost entirely on monetary policy. Conti-Brown also focuses much more on the individual chairmen and staff who have stood out over time and influenced the Fed's development, allowing his somewhat stronger storytelling skills to show through. In contrast, Binder and Spindel spend much of their time diving into the minutiae of the politics of the

Fed, as revealed through the recitation of vote counts on many of the 19 times that Congress chose to revisit the Federal Reserve Act after its enactment in 1913 through the Dodd-Frank Act in 2010.

**Independent or interdependent?** / The title of the book makes clear that the Fed is actually not independent of its government creators, notwithstanding the lip service given to the concept both inside and outside the government. "We challenge the most widely held tenet about the modern Fed: central bankers independently craft monetary policy, free from short-term political interference," write Binder and Spindel. They convincingly make their case that the concept of the Fed's power is still evolving when they discuss the cycle that has characterized the Fed's century of existence: "Crisis begets blame and blame begets reform."

The authors go a step further when they repeatedly argue throughout the book that

Congress and the Fed are interdependent. From atop Capitol Hill, Congress depends on the Fed to both steer the economy and absorb public blame when the economy falters.... In turn, the Fed remains dependent on legislative support.... Fed power—and its capacity

and credibility to take unpopular but necessary policy steps—is contingent on securing as well as maintaining broad political and public support.

**Three foundings** / Conti-Brown labeled the major sequential benchmarks in the Fed's early development as the "three foundings of the Federal Reserve": the Federal Reserve Act of 1913; the Banking Act of 1935; and the Fed-Treasury Accord of 1951. Three of Binder and Spindel's eight chapters of the book crosswalk nicely to these same three milestone periods.

The authors first focus on the Fed's enabling legislation, its decentralized system, and the choice of the cities for the 12 individual reserve banks by the Reserve Bank Organization Committee (RBOC). Some of the choices by the RBOC were obvious financial centers (New York, Chicago, and Philadelphia), but at the time others were not (Dallas, Richmond, and Atlanta). Binder and Spindel conclude that thanks to President Woodrow Wilson's appointments to the RBOC, "Democrats exploited their delegated power to mold a politically optimal system—one that would simultaneously attract the support of the system's member banks and benefit the credit-poor, Democratic South."

According to the authors, this decentralized system was a contributing factor to the Depression within a few decades of its creation: "The signature achievement of Wilson's administration proved incapable of generating effective monetary policy in the 1920s, contributing directly to the onset and severity of the Great Depression in the early 1930s." The aftermath of the Depression is the initial instance of crisis/blame/reform that Binder and Spindel use as a case study for their political models, as they identify two major power struggles within the decentralized Federal Reserve



**The Myth of Independence: How Congress Governs the Federal Reserve**

By Sarah Binder and Mark Spindel

296 pp.; Princeton University Press, 2017

## IN REVIEW

System: disagreements over discount rates and open market operations.

Although there were multiple amendments to the Federal Reserve Act from 1933 to 1935, the power center for governance took a decidedly Washington-based turn:

The Fed emerged far more centralized and more powerful in 1935 than its 1913 design.... The regional reserve banks retained a role in making national monetary and credit policies. But enactment of the 1935 Banking Act diminished their ability to resist policy decisions made by a reconstituted, reinvigorated Board.

The focus of *The Myth of Independence* then turns to the third and final of the three foundings of the Federal Reserve, which had even greater implications for its independence. Binder and Spindel write:

Even as lawmakers moved to centralize monetary policy decisions in Washington, the Fed did not become measurably more independent.... The Fed found itself under the thumb of the Treasury throughout the subsequent war years.

The Fed–Treasury Accord of 1951 transformed the relationship between the two major government players in the financial markets. Binder and Spindel explain:

As the ultimate buyer of U.S. government bonds, the Fed had been compelled to effectively monetize U.S. debt at a low, fixed rate. The Accord ended this clear subordination of monetary policy to fiscal authorities and empowered the Fed to set interest rates unencumbered by the Treasury's postwar financing needs.

What they bring to light is Congress's involvement in developing the Accord:

Congress was at the center of the 1951 dispute [as] ... key lawmakers empowered the Fed to reassert its control over monetary policy.... In short, the Fed–Treasury divorce allowed Congress to rebalance legislative oversight over monetary and fiscal policy.

A few years earlier, the 1946 Employment Act laid the groundwork for a clearer man-

date and enhanced accountability for the Fed's operations.

**Name, blame, and shame** / A period of strong growth and modest inflation during the years of William McChesney Martin's Fed chairmanship came crashing to an end with the stagflation of the mid- and late-1970s. Under the crisis/blame/reform cycle, a heavy dose of blame was laid at the doorstep of the Federal Reserve. As a result, the now-familiar Humphrey–Hawkins "dual mandate" of maximum employment and stable prices (with moderate long-term interest rates) was formally imposed:

The public held the Fed responsible for the economic downturn.... Lawmakers blamed the Fed as well.... Unlike previous cycles that largely endowed the Fed with more centralized power, an emboldened Congress imposed an explicit macroeconomic mandate on the Fed, and required far more transparency and accountability—enduring reforms that continue to shape Congress and Fed interdependence.

During this timeframe, there was also what the authors call "The Original Audit the Fed" movement. This transparency mandate is now largely championed by Republicans, but during the 1970s it was promoted by the Democratic Party. Not surprisingly, there was pushback from the Fed in a defense of operational opaqueness: "The Burns Fed orchestrated an aggressive lobbying campaign against each of these legislative efforts." The smoking gun for this lobbying can be found in former chairman Arthur Burns's papers, which "detailed the Fed press office's efforts to place 'horror stories' about potential audits in the *Wall Street Journal*, *Washington Post*, and other prominent news and business papers."

Unfortunately, Burns's campaign worked to keep government auditors from reviewing the most sensitive of Fed policy issues. Binder and Spindel write:

Burns's efforts paid off.... With the [General Accounting Office, now known as the Government Accountability Office] banned from auditing monetary policy

decisions, the limited audit has survived nearly four decades since its creation in the wake of the Fed's 1970s failures.

Binder and Spindel devote the final historical chapter ("The Only Game in Town") to the Fed's response to the crisis in 2008 and 2009: "Starting in late 2008, the Fed's unconventional, untested and exigent central bank tools blurred the lines between monetary and fiscal policy, exacerbating the Fed's already-tense relationship with Congress at a time of severe economic stress." Congress in particular fought the Fed on its opaque implementation of propping up the financial system:

The Fed sparked public and elite outrage. First, critics demanded public disclosure of the recipients of the Fed's loans. Given the Fed's resistance to disclosure, it took legal and ultimately congressional action to force the Fed to reveal the recipients of its emergency loans.... Lawmakers from both parties rejected the Fed's position that disclosure would undermine the effectiveness of their emergency lending programs.

Typical of previous episodes of the crisis/blame/reform cycle, "in reopening the Federal Reserve Act, lawmakers gave the Fed more responsibility while imposing more transparency and clipping some of its powers," Binder and Spindel write. The increased transparency did not include the "Audit the Fed" efforts that have now become much more of a cause-célèbre for Republicans than Democrats.

**Conclusion** / *The Myth of Independence* puts in historical perspective the evolution of the Fed's powers and its imposed restrictions, making clear that politics more than any other factor drove its creation and maintains its continued existence. Based on my reading of Binder and Spindel, the Federal Reserve Act we are left with still concentrates far too much power to influence the economy in the hands of the Fed's management and only requires minimal transparency and restrictions on the Fed's underlying operations. R

# From the Republic of Letters to the Great Enrichment

REVIEW BY PIERRE LEMIEUX

**B**orn with the 16th century, the modern era brought the Enlightenment, the Industrial Revolution, and economic growth at a rate that the world had never seen before. Northwestern University economic historian Joel Mokyr's *A Culture of Growth* traces this wondrous transformation as it occurred in the West's economy.

Mokyr leads the reader on a fascinating voyage that starts about the year 1500 and ends three centuries later. To trace the origins of the modern economy, he studies the culture that led to the Industrial Revolution, and the reciprocal influence of culture on social institutions and individual incentives.

For too many social scientists, "culture" is a sort of black box that they invoke to explain social and economic transformation, but in doing so they really say next to nothing. Recently, economists have become interested in this black box and Mokyr attempts to offer a look inside it.

He defines culture as "a set of beliefs, values, and preferences, capable of affecting behavior, that are socially (not genetically) transmitted and that are shared by some subset of society." He argues persuasively that cultural change is necessary to explain the 18th century Enlightenment and the unending flow of technological innovations that followed with the Industrial Revolution.

**Modern growth** / To appreciate what Mokyr sets out to explain, consider Figure 1, which I compiled from data by the late economist Angus Maddison. (No figure or table appears in Mokyr's book.) Note that I used linear interpolations to cover the long stretches of time for which Maddison's estimates are not available. These interpolations explain why a catastrophic

event like the Black Death of the 14th century doesn't make a blip in the line.

From Year 1 of the Common Era until the 18th century, human living standards scarcely changed. World gross domestic product per capita inched up slightly from less than \$500 per year during the first millennium, to \$616 in 1700, and \$712 in 1820. Then, production and income exploded. In less than two centuries, GDP per capita multiplied by more than 10, reaching \$7,814 in 2010 (the last year available in this series). These figures are averages over the whole world, estimated in constant 1990 dollars. In the United States, GDP per capita (again in constant 1990 dollars) reached \$30,491 in 2010.

This one dramatic transformation is the story of mankind from an economic standpoint. In comparison, the last century's Great Depression barely registered.

The resulting effect on living conditions has been dramatic. During the 17 centuries between Year 1 and 1700, the world population multiplied a paltry 2.7 times. In the following three centuries, it multiplied by more than 10. And recall that, since 1820, real GDP *per person* also multiplied by 10. Since the mid-19th century, life expectancy at birth has increased from 30 years (which is probably the maximum it had reached

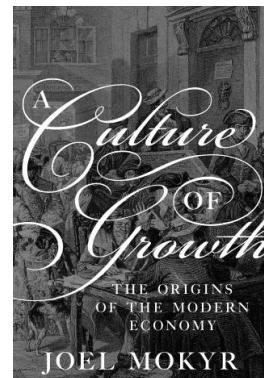
over all of previous history) to more than 70 years today. Literacy jumped. These were only some of the consequences of the "Great Enrichment."

Starting in the late 18th century, "Smithian growth" was replaced by "Schumpeterian growth." The former refers to economic growth through more efficient markets, which Adam Smith observed and promoted; the latter works through inventions, entrepreneurial innovations, and "creative destruction," to use Joseph Schumpeter's term.

Mokyr argues that this stunning new growth cannot be explained by religion, which played an ambiguous role in the acceptance of new ideas, even factoring in the Reformation. Nor can it be explained by an increase in human capital—education and knowledge—because capital increases had occurred before but had failed to launch self-sustained, explosive growth.

Besides, he notes, "the great engineers and inventors who made the Industrial Revolution were rarely well educated." Instead, they were feeding on a whole infrastructure of new knowledge.

The crucial factor in the Great Divergence shown on the chart was a new belief in progress. It required "thinking outside the box" and a "willingness to rebel against accepted practices and norms." A new culture of growth developed that made explosive growth possible.



**A Culture of Growth:  
The Origins of the  
Modern Economy**

By Joel Mokyr

400 pp.; Princeton  
University Press, 2016  
(paperback 2018)

**Culture** / How can we explain the appearance of this culture of growth? Mokyr adopts an "evolutionary approach to culture" borrowed from anthropology and evolutionary biology. Such an approach, he argues, helps understand the cultural change that created the institutions that made possible the Enlightenment and the Industrial Revolution. Cultural evolution selects the most efficient cultural elements or features, as opposed to select-

## IN REVIEW

ing individuals. This sort of evolution is rendered even more potent by the capacity of individuals to be persuaded and to consciously choose their beliefs. “Choice-based cultural evolution” leads to a more rapid spread of innovations.

Mokyr borrows from a large number of scholars in different fields. For example, he relates this culture of growth idea to Deirdre McCloskey’s “bourgeois values.” Surprisingly, however, nowhere in *A Culture of Growth* does Mokyr cite Friedrich Hayek. Many readers would like to know what, if anything, differs between Mokyr’s and Hayek’s evolutionary approach. Both authors warn against a too-servile use of the methods of biology in social analysis, but both find evolutionary theory useful. As I mentioned in a recent review of his final book, *The Fatal Conceit*, Hayek argued that an evolutionary approach to social science was actually pioneered by Adam Smith and Adam Ferguson in the 18th century, well before Charles Darwin used it in biology. (See “Against Tribal Instincts,” Spring 2018.)

Cultural entrepreneurs add to the menu of beliefs, values, and preferences among which individuals can choose. Mokyr devotes a chapter to each of two major cultural entrepreneurs who spread the ideas that would lead to the Enlightenment and the Industrial Revolution: philosopher Francis Bacon and scientist Isaac Newton. Bacon and Newton both emphasized observation and empirical verification as opposed to the mere exegesis of ancient texts. “Bacon’s heritage,” Mokyr writes, “was nothing less than the cultural acceptance of the growth of useful knowledge as a critical ingredient of economic growth.”

Useful knowledge is a crucial concept in *A Culture of Growth*. Exemplified by the French *Encyclopédie* and numerous technical textbooks published all over Europe, useful knowledge is scientific knowledge applied to production. It is related to the Enlightenment idea that “the human lot can be continuously improved by bettering our understanding of natural phenomena.” Newton thought that science could only

explain how things work—as opposed to their metaphysical nature—which implies that it could produce useful knowledge.

**Why culture changed?** It is not totally clear what were the causal factors, as opposed to favorable circumstances, that led to the new cultural belief in progress. Perhaps the point is that the different factors co-evolved (in an evolutionary sense) to produce cultural change.

Mokyr seems to propose four major factors:

First, there are the cultural entrepreneurs such as Bacon and Newton, as well as many others who walked in their steps. They contributed to changing not only the scientific culture, but also the political culture. Perhaps Mokyr could have given more attention to the political evolution toward individual rights, the rule of law, and the division of power in the state.

A second factor is the shock of new knowledge. In the late 16th and the 17th centuries, countless scientific theories of the Ancients—from Antiquity to the Middle Ages, from Aristotle to Aquinas—were disproved by new observations with the help of instruments such as the telescope and microscope. Ptolemy’s vision of the universe yielded to the new observations and theories of Nicolaus Copernicus and Johannes Kepler. Long-distance voyages and geographic discoveries also changed the image of the world.

Third, governments were unable to stop the spread of new knowledge. As David Hume noted, the political fragmentation of Europe prevented governments from suppressing the new ideas they deemed destabilizing and dangerous. “In the political environment of a politically fragmented world,” Mokyr observes, “progress cannot be blocked by the coercion of a few reactionary powers.” Not only was Europe fractured among multiple states, but even monasteries and universities were “quasi-autonomous self-governing bodies.” “Members of the ‘creative classes’ ... moved all over the Continent.”

Tyranny thus suffered a “coordination failure.”

**Republic of Letters** / A fourth factor—a major one—was the “Republic of Letters,” which emerged in the 16th and 17th centuries and stimulated the creation and spread of new ideas. As Mokyr puts it, the “unique combination of political fragmentation with the pan-European institution of the Republic of Letters holds the key to the dramatic intellectual changes after 1500.”

The Republic of Letters was perhaps the most extraordinary spontaneous development in Europe. It was an informal and transnational society of scholars—philosophers, scientists, and other intellectuals—who criticized, developed, and discussed ideas through correspondence and publications. Their correspondence, made publicly available, amounted to an ongoing peer-reviewed journal. The “citizens” of the Republic of Letters followed strict rules such as replying to all letters, giving due credit to the originators of ideas, and putting all knowledge in the public domain. They privately produced the public good of new knowledge.

The small elite constituting the Republic of Letters formed the backbone of a free market in ideas. This market was both competitive and cooperative, Mokyr notes:

There is no contradiction between the coexistence of such harmonious and competitive forces, as an analysis of any market demonstrates. Economists have understood since Adam Smith that the glory of the market system is this unique combination.

The Republic of Letters included most of the great scholars of the time: men such as Erasmus, Bacon, Voltaire, Hume, Smith, Newton, Descartes, Condorcet, and Spinoza, along with numerous lesser-known figures. It covered many European countries, including Great Britain, France, Italy, the Low Countries, Germany, and Spain. Its transnational character was essential: “At least in theory,” Mokyr observes, “a citizen of the Republic of Letters was supposed to be a person without a fatherland.”

The Republic of Letters was critical and antidoctrinaire. According to Mokyr, “The liberal ideas of religious tolerance,

free entry into the market for ideas, and belief in the transnational character of the intellectual community were essential to Enlightenment thought.”

It is true that many if not most scholars depended on the patronage of kings and nobles. But the Republic of Letters served as an informal accrediting process, assuring that the subsidized scholars were not impostors or puppets. The selfish competition between patrons for the best scholars contributed to freedom of thought and speech, which was basically established by the end of the 17th century.

The market for ideas remained largely private. The printing press, invented in the 15th century, played a big role. Printing houses spread all over Europe. Besides producing periodicals and books, they “were ‘international houses’ where dissident foreigners could find shelter and a meeting place.” Mokyr notes that “in Europe, by and large, encyclopedias and reference books were the product of private enterprise, sometimes published very much against the will of authorities powerless to stop them.”

The Republic of Letters “turned out eventually to be an institution unique in human history and a key to understanding where the long road that led to modern economic growth began.” Ideas matter. Free markets too.

**Reactionary forces** / Reactionary forces were represented by such figures as Thomas Hobbes and Jean-Jacques Rousseau, but they were more and more isolated as modern times rolled on. Here again, the reader would have appreciated a reference to Hayek—in this case, the latter’s distinction between “true” and “false” individualism and between British and continental liberalism.

Many of Hayek’s false individualists were associated with the Enlightenment and thus

with Mokyr’s culture of growth. To what extent did both “true” and “false” individualism play a role in creating the modern economy? Did these two strands of individualism have more in common than Hayek led us to believe?

The “battle of the books,” or *querelle des Anciens et des Modernes*, that agitated Europe was emblematic of the clash between old and new ideas. By the end of the 17th century, the moderns had won. The cultural change that had brought scientific contestability, useful knowledge, human progress, and Lockean rights bloomed in the 18th-century Enlightenment and the Industrial Revolution that started toward the end of that century. The entanglement of the Enlightenment and the Industrial Revolution is a major thread in *A Culture of Growth*.

The book ties together many components of our understanding of modernity. For example, the victory of the moderns would end “the folly of mercantilist notions that placed the state (and not the individual) as the ultimate object of society.” Today’s reader cannot but reflect that Enlightenment values are now under siege.

**Why not in China?** / Mokyr raises the peren-

nial question of why the Enlightenment and the Industrial Revolution happened in Europe but not in Asia, particularly in China. He takes much care not to assign the blame for this to an inferior Asian culture compared to Europe. Is this partly a reflection of the political correctness that seems required today when discussing such issues, or is it just scholarly prudence? In any event, we should not forget that the citizens of the Republic of Letters were skeptical of conventional wisdom and were not very politically correct in their own times.

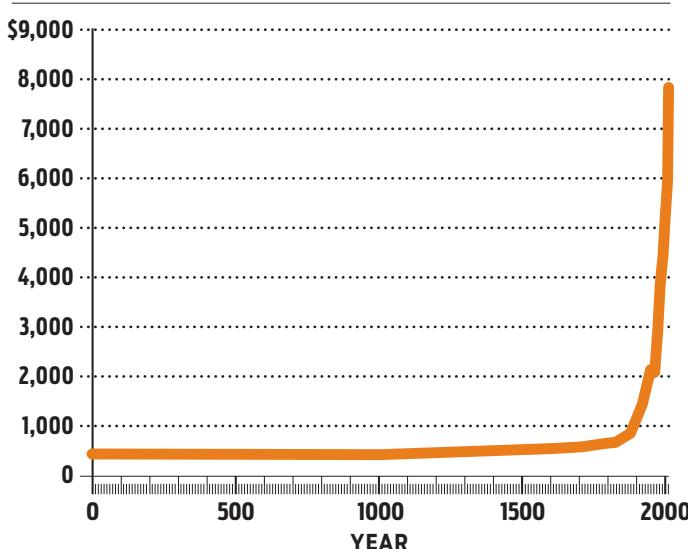
The Industrial Revolution that happened in Europe, Mokyr argues, was a rare and unexpected event. Like evolutionary surprises, it could have not happened, or it could have happened elsewhere. “The advantage of models of cultural evolution,” he writes, “is that they are contingent and concern *ex ante* probabilities rather than deterministic causal models.” An industrial revolution required progress that—instead of fizzling out as had happened in previous examples, including in the East—would start a “positive-feedback self-reinforcing explosive technological trajectory.”

“What was missing in China,” Mokyr explains, “was a high level of competitiveness, both in the market for ideas and at the level of political power.” Despite a vibrant intellectual life and many technological discoveries (including in shipbuilding and clock-making), China’s centralized government and its conservative bureaucracy—maintained by a stifling examination system—choked progress. Barriers to entry in the market for ideas were high. Another scholar quoted by Mokyr, Eric Baark of the Hong Kong University of Science and Technology, observed that scientific knowledge was hampered by “political correctness.”

Because it did not have the necessary culture and institutions, China missed both an industrial revolution and an

FIGURE 1

REAL WORLD GDP PER CAPITA, YEAR 1 TO 2010  
(in 1990 dollars)



Sources: Angus Maddison, *Contours of the World Economy, 1–2030AD: Essays in Macro-Economic History* (Oxford: Oxford University Press, 2007), and the Maddison Project, <http://www.ggdc.net/maddison/maddison-project/home.htm> (accessed March 11, 2018). Note: Data have been linearly interpolated by the author for the years data points are missing.

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enlightenment à la European:

The importance of the Enlightenment for Europe's subsequent economic development goes beyond its impact on the exploitation of useful knowledge for material progress, the essence of the Industrial Enlightenment. It also codified and formalized the kind of institutions any society needed to maintain its technological momentum: the rule of law, checks and balances on the executive, and severe sanctions on more blatant and harmful forms of rent-seeking. ... The historical irony is that prosperity as it was experienced after 1750 required creative destruction, the very opposite of social and economic stability.

After it discovered China, the West eagerly borrowed Eastern ideas and imported goods. For example, "chinaware" was exotic and much in demand, and did not disguise its foreign origins. On their side, the Chinese elite were not interested in "cultural appropriation" from the West, so the country remained insular and mired in the past. It was soon lagging far behind the West in economic growth.

Culture in Mokyr's sense includes philosophical beliefs. *A Culture of Growth* shows that philosophical beliefs in China, despite some diversity, lacked several ingredients of Western philosophy. Perhaps we can go further and say that China lacked the individualistic philosophy that was necessary for intellectual enlightenment and economic progress. (See "Confucius, Autonomy, and Capitalism," Winter 2017–2018.)

If one values individual flourishing, all this looks to me like saying that Chinese culture and institutions were inferior to European culture, even if Mokyr does not cross that bridge. It might be worth crossing if we want to draw lessons for our times. The death of Mao Zedong in 1976 was followed by an explosion of economic and cultural entrepreneurship in China. Economic competition soared. Production and the standard of living there started growing somewhat like in 19th-century Europe.

After three decades of this regime, many observers thought that a Chinese Enlight-

enment and Industrial Revolution were under way, although serious analysts like Ronald Coase and Ning Wang realized that this movement would soon require a liberation of the market for ideas. (See "Getting Rich Is Glorious," Winter 2012–2013.) As the Chinese government has veered back toward authoritarianism, the prospects for continuing growth have dimmed considerably, even if this does not yet show in economic statistics. Those who, often for invalid protectionist reasons, fear the economic growth of China can relax.

**Role of freedom** / Mokyr paraphrases the late science historian Reijer Hoekstra in saying that, at the time of the Republic of Letters, "commercial and industrial cities were intellectually dynamic, far more so than university towns." The coevolution of ideas, commerce, and industry up to the explosion of economic growth in the 18th and 19th centuries reminds us of how intellectual freedom, economic free-

dom, wealth, and individual autonomy are interrelated.

A related fact is how "in the North American colonies and the United States, the odd mixture of Puritan values with elements of the French and Scottish Enlightenment were decisive in setting the culture of the young republic in the 1780s." Thomas Jefferson and Benjamin Franklin were two emblematic figures of the Enlightenment.

If cultural change explains the Enlightenment and Industrial Revolution, has cultural change really been explained? Or have we once again credited the black box? I am not sure. But this complex and rich book certainly provides many keys to the answer. It strongly suggests that limits on government and a free market in ideas created the conditions necessary for the Enlightenment, the Industrial Revolution, and the Great Enrichment. After reading this book, chances are that you won't look at the economic, social, and political world in quite the same way as before. R

## Grim Tales of Small-Town America

REVIEW BY DWIGHT R. LEE

Robert Wuthnow, a sociologist and the Gerhard R. Andlinger '52 Professor of Social Sciences at Princeton University, along with his team of research assistants, has "conducted well over a thousand in-depth qualitative interviews" in hundreds of small communities. He outlines his findings in *The Left Behind*, describing "what people in these communities think—what their lives are like, what they value, and how they arrive at their opinions about political candidates and government."

Wuthnow emphasizes that he tried to keep his personal views out of the narrative, just as he and his assistants tried to do in the interviews. From my reading, he

is credible when he writes, "We've tried as best we could to set aside our disagreements with some of the things we heard, seeking instead to listen and understand."

It is not until his epilogue that he clearly acknowledges, "I'm part of the liberal elite, ... and ... opposed nearly everything about the Reagan and Bush administrations, favored much of President Obama's efforts and voted for Hillary Clinton." Despite his political views, he conveys a genuine respect for those he and his team interviewed. That said, he is not entirely successful at keeping

DWIGHT R. LEE is a senior fellow in the William J. O'Neil Center for Global Markets and Freedom, Cox School of Business, Southern Methodist University. He is a co-author 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.

his political views out of the narrative, as will become clear in this review.

**Moral communities** / Wuthnow states early in the book that “understanding rural America requires seeing the places in which its residents live as *moral communities*” (his emphasis). I found his use of this term interesting because James Buchanan employed the same term in his 1981 monograph “Moral Community, Moral Order, or Moral Anarchy” to describe a situation in which a set of individuals identify “with a collective unit, a community, rather than conceive themselves to be independent, isolated individuals.” Buchanan recognized that people will “identify simultaneously and with various degrees of loyalty with several [such] communities.”

Wuthnow doesn’t cite Buchanan but sees a moral community in much the same way. He, along with Buchanan, doesn’t make any claims as to whether moral communities are good or bad. According to Wuthnow, such a

community draws our attention to the fact that people interact with one another and form loyalties to one another....

Understanding communities this way differs from the notion that people are independent individuals who form opinions based strictly on their economic interests and their psychological needs.

Both Buchanan and Wuthnow recognize that the loyalties within moral communities can generate hostility between communities. Wuthnow sees

a darker side to the togetherness townspeople experience, [with there being] a strong sense of “us” and “them.” The result “ranges from negative stereotypes to overt discrimination.

While he points out that not all small-

town residents engage in such exclusionary behavior, he follows up with:

It was one of the ways the subjects I interviewed maintained their sense of identity. They probably revealed more than they realized when they said the people they knew were all the same.

Another similarity in Buchanan’s and Wuthnow’s understanding of moral communities is that those communities are not confined to geographically small areas. Buchanan is clear on this when he extends such communities from those of nuclear families to the nation state, with ethnic, racial, and religious groupings included, with each of us generally being in several moral communities at the same time, along with people outside our small geographic area.

Given Wuthnow’s focus on small, rural towns, it would be easy to assume he limits his understanding of moral communities to geographically small communities. But

much of what he sees as characteristics of these communities—such as shared views and ideologies that create common understanding and a sense of “us vs. them”—don’t depend on physical proximity. Consider his comment on a moral community and those who share such a community:

They know the norms of the community well enough to abide by them without having to give them much thought. A common identity is publicly affirmed in the stories they tell.... [The community includes] people who rarely [interact] with [each other].... The norms they espouse pertain to a large share of the population.... [This moral code] is enabling in terms of the expectations its members reliably take for granted and at the same time is constraining in terms of the beliefs and activities it encourages and the ones it discourages.

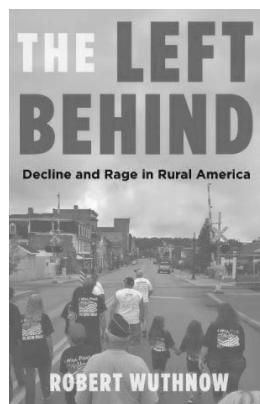
I believe he agrees with Buchanan that we can identify with, and be influenced by, the views of widely dispersed people in several moral communities, including those pertaining to political ideology.

**Does voting reflect morality?** / Wuthnow does not include voting in his index. Yet much, though not all, of what he discusses influences the voting decisions of people in rural settings.

The book opens with six paragraphs discussing the role of the rural vote in Donald Trump’s 2016 election as president. This discussion includes such topics as racism and misogyny, grievance and resentment at Washington and being left behind economically, and “backward” voters whose conservative ideological beliefs ostensibly motivated them to vote against their interests as Wuthnow interprets them. These voters were also affected by the view that morality in American is declining, a perception that is discussed in Chapters 5 and 6.

Wuthnow notes that both rural and urban voters see the votes of the other as clear evidence of their moral deficiency. He is cautious about making moral judgments about rural voters. But his urge to do so, at least subtly, is there, as I discuss below. In his defense, it is a common urge.

Many of us are far too quick to see those who vote differently than we do as morally flawed, if not evil. In fact, research indicates that people’s voting decisions are not very good indicators of their moral behavior. Voting decisions are overwhelmingly influenced by emotional attachment to particular issues and political ideology, which are generally more the accident of people’s backgrounds than thoughtful moral deliberation. We are identifying with members of our moral political community when we vote the way we know they are voting. We’ve all heard some updated version of the Pauline Kael tale where a Blue State voter says, “I can’t believe Trump won; I don’t know anyone who voted for him.” That voter may be mythical, but her political moral community probably includes millions of Americans. If Wuthnow had interviewed her, he could have written that



**The Left Behind:  
Decline and Rage in  
Rural America**

By Robert Wuthnow  
200 pp.; Princeton  
University Press, 2018

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she probably revealed more than she realized with that statement.

With the growing emphasis on identity politics, how people's votes are seen to reflect their views of others has taken on increased moral significance. When voting for policies to allegedly help a group suffering from discrimination, the measure of a voter's morality is his intentions, which for many are automatically considered good if he votes for the policy and bad if he votes against it. Good intentions are not irrelevant to moral decisions, of course, but they are hardly the whole story.

This is not to deny that members of some groups have been deprived of the basic freedoms and legal opportunities available to others (African Americans, Native Americans and homosexuals come to mind), and that the moral thing to do is give them those freedoms and opportunities. A policy doing this would generate positive-sum benefits, leaving us all better off materially as well as morally.

Unfortunately, the policies motivated by identity politics often exempt the mistreated from the responsibilities that have historically been associated with the successful instead of providing them with more freedom and opportunity. Furthermore, identity politics has created a political dynamic in which increasing numbers of groups have benefited from claiming that they have been treated unjustly. The result is an increasing number of people identified as members of unjustly treated groups are being pitted against each other in a negative-sum process of political transfers in which they compete over who is suffering most from social injustice. This is hardly an effective way to bring us together by promoting social justice or harmony.

It is hard to believe that a rural voter who votes against such a policy because she believes it is socially divisive and harms the people it is supposed to help is less moral, or more bigoted, than a city voter who votes for it because he believes the opposite. Wuthnow almost seems sympathetic to this view, at least momentarily, when he writes, "Most people living in rural America are probably no more prone toward

bigotry than many people living in suburbs and cities." But in the very next paragraph he states that the

anger that prompts rural Americans to lash out at Washington is a source of bigotry as well. It can be a thin line from arguing that Washington is broken to saying that President Obama was illegal, stupid and untrustworthy because he was African American.

No one can deny that there are bigots in rural America, just as there are in urban America and everywhere else where humans live. We are instinctively and emotionally a tribal species. And when expressing ourselves through voting or political speech, we sometimes embrace ideas that we would never consciously

*Our tribal instincts make expressing our moral anger at opposing voters far easier than considering the possibility that those voters are decent people.*

espouse or exhibit—or even tolerate—in other contexts. The line between how we vote and how we act is not thin; indeed, it is quite thick.

Unfortunately, politicians are very effective at harnessing these tribal passions by demonizing political opponents and those opponent's voters in order to get their own voters to the polls. Hate is more effective politically, and divisive socially, when voting is depicted as having that same moral significance for good or evil as decisive actions. Our tribal instincts make expressing our moral anger at opposing voters far easier than considering the possibility that voters who disagree with us are decent people doing what we are doing: expressing their emotional attachment to what they genuinely believe is good for America. Yet doing the latter would be far more conducive to social harmony than judging the morality of others by whether they vote like us or against us. The former is far

too strong and evidence that too many of our differences have become politicized.

**Getting to know you** / The most effective way to moderate our "us vs. them" impulse is by interacting with "them" as individuals, as Wuthnow recognizes. He states, "Research on prejudice toward people unlike yourself shows that knowing someone personally usually has a significant effect in reducing prejudice." He follows up with some examples of this happening in small communities.

Before talking about prejudice, he emphasizes that "the limited opportunity for social interaction in small places force people to mingle on an equal footing" and he gives examples of people interacting socially across class lines. It doesn't eliminate the "us vs. them" impulse, as he makes clear, but it surely helps reduce it more than identity politics. Wuthnow seems to accept, at least cautiously, the view of the small-town people

he interviews when they say that "when you live in a large place, ... you can isolate yourself from people unlike yourself if you want to, but in rural communities you can't."

He cites Harvard political scientist Robert Putman on the importance of social interaction within communities. Putman's 2000 book *Bowling Alone* worries that Americans' involvement in their communities (e.g., visiting neighbors, being members of civic organizations, doing volunteer work) has declined to troubling levels. According to Wuthnow, Putman observes that this disassociation has not been the case in small towns and rural areas. Wuthnow provides support for this notion by referring to a survey he did in the late 1990s in which he found "that residents of small towns or rural areas were significantly more likely than residents of cities or suburbs to feel they can count on the neighbors for help if someone in their family became seriously ill."

The observed politeness of people in

small towns relative to that of people in cities is, at least in part, a result of the greater social mingling in the former than in the latter. Wuthnow doesn't emphasize the politeness of small-town folks, if he mentions it at all, yet it is clearly reflected in the pattern of helping others that he does discuss in some detail as a strength of small towns. Yet, toward the end of his book, he reveals his bias by indicating that people's good acts do not reflect their moral status if those people do not vote the "right" way.

**Do good intentions trump decisive action? /**

In addition to the greater social interaction between different social groupings in small towns than in cities, Wuthnow recognizes that religion "plays an important role in holding the community together [and] ... supports the family values that people hold dear and tells them that they should care for their neighbors." Yet he sees a contradiction in the clergy's and lay members' caring for neighbors. What they "usually missed seeing," according to Wuthnow, "was that how they voted also affected provisions for the needy." They voted for conservative Republicans who "opposed welfare spending, favored regressive tax policies."

Wuthnow sees this as a moral "blind spot" based on the "small-town view that local charity and volunteering were better than government programs." He doesn't consider the possibility that individuals taking decisive action with their own money to help the poor are engaged in an act that is both more moral and effective than is expressing good intentions with an indecisive vote that costs the individual voter effectively nothing for the purpose of having the government force everyone to contribute the same way. And speaking of blind spots, he doesn't consider how much more likely the small-town contributor is to follow up on his contribution to see if it is used effectively than is the voter to follow up on his vote to determine how much the policy he voted for (if enacted) benefits the poor after being processed through state or federal legislatures and bureaucracies.

**Conclusion /** I give Wuthnow credit for describing the concerns, resilience, virtues, and flaws found in small-town America. My biggest concern with his book is its tendency, in most cases implicit, to attribute too much moral significance to how people vote.

I recognize this tendency is not limited to him or to those embracing the same political views he does. He was more

explicit in describing how people in small American towns lived and interacted with each other as friends and neighbors. From those accounts I got the strong impression that Wuthnow would give small-town American higher marks for how they acted outside the voting booth than for how they voted in it. And he might agree with me that the former is a better measure of their decency than the latter. R

## Manipulating the Levers of the Regulatory State?

◆ **REVIEW BY SAM BATKINS**

**D**oes America have its current regulatory state because we're an industrious, wealthy society that decided we could afford more regulation? Or are we a productive, wealthy economy because of the regulatory state? Naturally, libertarians and progressives will have different answers to those questions.

In *Pricing Lives*, Vanderbilt law and economics professor Kip Viscusi doesn't directly answer either question, but he does hint that the current regulatory environment—and by some association, our tort system—is a result of America's willingness to pay for more environmental and workforce safety protections. Just as workers are willing to pay to reduce risk and gravitate toward higher paying, low-risk jobs, regulators are employing ever-higher figures for the Value of a Statistical Life (VSL) to justify more stringent regulations. In a sense, American prosperity has given regulators ample evidence to justify a myriad of new rules.

The crux of *Pricing Lives* rests on the belief that society, and corporate America specifically, should confront the tradeoffs of risk and think systematically about safety, striking a balance between it and possible profits. With a title like *Pricing Lives*, there is a robust discussion of VSL and its cousin in the regulatory world, the Value of a Statistical Life Year (VSLY). Pro-

gressives and some conservatives strongly denounce VSL and its corollaries as placing a monetary value on a human being, a task that they say is impossible and that they would not do directly with their children or loved ones.

In fact, Viscusi and other proponents of cost-benefit analysis note, we frequently place a value on lives, only in an indirect manner. We purchase life insurance with certain monetary values. We typically drive safe cars but not impregnable tanks that would lower the risk of a fatality to near-zero. Courts and juries have monetized the value of a life for centuries.

Lives are monetized frequently. The only question is whether government or corporations are rigorous in their methodology when doing this and transparent about their process. Viscusi devotes a great deal of the book to the auto industry, from the troublesome General Motors ignition switches that resulted in several recalls in 2014 to the infamous gas tank design of the 1970s Ford Pinto. The industry has had several other public gaffes that have resulted in hundreds of fatalities. Yet the

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book isn't a Naderesque screed against corporate America, but rather a plea for its wider adoption of cost-benefit analysis.

Surprisingly, corporate risk analysis was arguably more advanced decades ago than it was in the recent ignition switch fiasco. As Viscusi recounts, Ford engaged in a detailed risk analysis of the Pinto's design, but that analysis was flawed in a number of ways. Most notably, it valued lives based on the level of tort liability damages in wrongful death cases. That resulted in a value of just \$200,000 for each burn death. According to Ford's math, the cost of a design change to prevent ignition of the rear-mounted gas tank was triple the VSL for potential victims. When jurors learned that the cost to fix each car was just \$11, the way Ford undervalued each life was laid bare to the public. Eventually, it cost Ford \$3.1 million in compensatory damages for one victim, in addition to \$3.5 million in punitive damages. Despite the automaker's attempt to measure and monetize risk properly, Ford made the wrong decision, from which future businesses would learn. Viscusi argues this is to the detriment of both cost-benefit analysis and public health.

**Transparency** / Imagine if the U.S. Environmental Protection Agency instituted a \$20 billion regulation but, instead of releasing a detailed explanation of its cost-benefit analysis of the rule, it just said that Congress and the public should trust its decision. Assuming the regulation survived Office of Information and Regulatory Affairs (OIRA) scrutiny, which is unlikely, a court would probably strike it down in short order. During the regulatory process, industry expects high standards from agencies, at least for regulators in executive branch agencies whose work is subject to OIRA review. However, after the Pinto fiasco, corporations have been

more secretive in their risk analysis than government is.

With regulators, the public generally knows the estimate on potential lives saved and how government monetizes this figure for an apples-to-apples comparison with monetized costs. Contrary to progressive critics, VSL does not directly place a dollar value on a human life. Instead, VSL is, in the words of Viscusi, "a reflection of the monetary risk preferences of a particular population and the tradeoffs exhibited during an economic era."

For example, suppose you're a 45-year-old skier and you buy a \$200 helmet that can reduce your risk of death by 1:50,000. You have implicitly valued your life at \$10 million (i.e.,  $\$200 \times 50,000$ ). In contrast, a young skier fresh out of college, working internships to get by, may buy a \$100 helmet that reduces her risk of death by 1:25,000. This equates to a VSL of \$2.5

million. This doesn't mean her life is worth less than yours, but it does illustrate that the willingness to pay for risk reduction is measurable and quantifiable.

This begs the question about inequality and varying VSLs for different countries. For instance, the U.S. VSL, according to Viscusi, is roughly \$10 million; in Australia it's \$7.1 million. India and Pakistan report VSLs of \$4.9 million and \$12.3 million, respectively. Given what we know about willingness to pay, Viscusi notes these figures are "implausibly high."

It is fear over implausibly high or low VSL figures that has driven much of corporate risk analysis into the ground, or at least into the shadows. Public backlash against Ford's shoddy math has made corporations fearful of these calculations and weary of ever presenting them to a judge or jury.

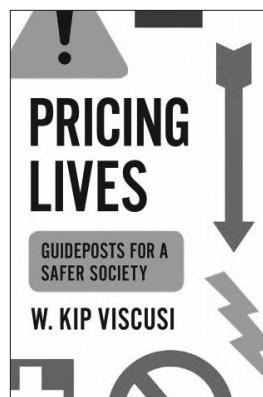
Viscusi argues this is a grave mistake; both corporations and the government should be rigorous in their risk analysis. Speaking directly to progressives weary of

VSL, he notes that a properly vetted cost-benefit analysis can produce more stringent regulatory outcomes. A good analysis can generate more protective regulatory standards even if there is a dollar value placed on each life at the outset. This may sound like music to the ears of some trial lawyers and progressive regulatory activists, even if they detest cost-benefit analysis.

**Moving the regulatory levers** / For libertarians, there are several notes of caution. As many have noted, the VSL has been crawling upward for several years. Now at roughly \$9–\$10 million across the federal government (although not uniform across all agencies), it was just \$3 million in 2005 according to a Department of Transportation final rule. Moreover, since 1995 there have been only 105 final rules that have cited a VSL, including 33 from the DOT and 21 from the EPA. This raises a series of questions: For regulators suddenly willing to embrace statistics and economics, can they manipulate the VSL to produce favorable regulatory outcomes? Why has the VSL tripled in roughly 10 years when U.S. household income has not made nearly the same gains?

Viscusi doesn't answer these questions directly and they are not the focus of the book. However, just as juries want to know how the sauce is made for corporate cost-benefit analysis, the public has every right to know if the VSL is used as a backdoor tool to justify additional regulatory standards. Rarely is the VSL challenged in court when confronting landmark regulations, and perhaps that should change. For corporations, the Ford Pinto disaster gave birth to a practice libertarians and progressives should both detest: fear of rigorous and transparent risk analysis.

GM's ignition switch controversy is an example of a company running from cost-benefit analysis. Mindful of the Pinto experience, GM apparently decided not to undertake a quantitative analysis of the risk it faced versus the cost of recalling the affected cars. The automaker even avoided the use of qualitative terms that described the real safety risk. The result was 124 lives



**Pricing Lives:**  
Guideposts for a  
Safer Society  
By W. Kip Viscusi  
280 pp.; Princeton  
University Press, 2018

lost, resulting in part from a corporate culture fearful of quantifying the value of saving lives. Instead of showing the government and potential juries their work on an appropriate VSL and the risk of fatalities, the public learned of “judgment words” banned from corporate communications. These included: “you’re toast,” “powder keg,” “potentially disfiguring,” and “rolling sarcophagus.”

There should be general agreement across the ideological spectrum that GM’s time would have been better spent hiring economists and mathematicians to evaluate the tradeoffs of a potential recall. Courts, the public, and regulators rightly savaged the automaker for its decisions. Perhaps the silver lining to the catastrophe is that corporate America will begin to embrace cost-benefit analysis as a tool for better decision making and to guard against such brand-damaging episodes.

Viscusi does offer one idea that may provide a path for corporations interested in risk analysis but weary of formally publishing a VSL. He suggests the government grant “safe harbor” in legislation for VSL calculations. In other words, plaintiffs would not be permitted to introduce evidence on corporate risk analysis. Companies would, however, be allowed to introduce evidence of reasonable estimates of VSL and VSLY. This may be a practical solution for the wider adoption of cost-benefit analysis, but the trial bar would likely stand in the way of such a provision.

In conclusion, most rational followers of the regulatory state will cheer for more widespread use of risk analysis. If greater corporate adoption of the practice leads to fewer lives lost—and somehow, fewer lawsuits—all the better. However, there is a real fear that regulators and trial lawyers could wield an expanding VSL to push for their preferred regulatory standards, higher tort damages, and the aim of reducing inequality through regulation. American ingenuity has produced a great deal in the last 150 years, including one of the highest VSLs on the planet. Let’s hope regulators don’t wield the VSL to impede further progress.

# Shaping Markets

REVIEW BY PHIL R. MURRAY

**A**lvin Roth is the Craig and Susan McCaw Professor of Economics at Stanford University and co-winner of the 2012 Nobel Prize in Economics. In January of this year, at the close of his term as president of the American Economic Association, he offered his presidential address, “Marketplaces, Markets, and Market Design,”

which followed up on his 2016 book, *Who Gets What—And Why*. His address interested me enough to pick up the book and write this review.

In it, he proclaims, “The new economics of *market design* brings science to matching-making, and to markets generally. That’s what this book is about” (Roth’s emphasis). “My hope,” he tells readers, “is that this book will help you see markets in new ways.”

If there is a shortage in the market for a commodity, economists predict that buyers will bid higher prices and sellers will accept the higher prices in return for increasing the quantity supplied. In this case, it doesn’t matter what commodity is being traded. “The price does all the work,” he explains, “bringing [buyer and seller] together at the price at which supply equals demand.”

However, in some cases, what is being traded does matter. For instance, consider a “matching market” such as a market for donor organs. In such a market, buyers must choose sellers and sellers must choose buyers in order for the exchange to be mutually beneficial. Roth puts it this way: “A market involves matching whenever price isn’t the only determinant of who gets what.” Or who gets whom, for that matter.

**Market necessities** / Some economists try to make the world a better place by recommending better public policy. Roth makes the world better by designing markets so that they work better. “Market design” is the set of rules according to which buyers

and sellers interact; it is also the making of those rules.

A market works well, in the jargon of market design, when it is “thick,” “uncongested,” and “safe.” A market is thick if there are many buyers and sellers. It is uncongested if buyers and sellers have enough time to evaluate offers. In general, if buyers and sellers feel comfortable participating, a market is safe. A matching market in particular is safe if buyers and sellers honestly share who they want to deal with. For example, school choice requires that parents “list their true preferences” for schools, which may differ from what they think they might get based on the school board’s assignment criteria.

A market “fails” or “unravels” when it becomes thin, congested, or unsafe. Roth strives to repair those problems.

**Thickening markets** / Kidney exchange illustrates the features of a matching market as well as the benefits of market design. Roth first pondered kidney exchange in the early 1980s. He reports that in 2014, the shortage of kidneys exceeded 100,000. Given that shortage and the National Organ Transplant Act of 1984, which bans the sale of kidneys, market designers aimed to thicken the market by increasing the number of donors. After that, the author says, “making the market thick involved assembling databases of patient-donor pairs.” These pairs must match based on blood type and immune system. Roth and his colleagues devised an algorithm to determine matches.

To shed light on the possibilities, consider how a database enables “trading

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cycles." Suppose Mr. Jones needs a kidney and Mrs. Jones is willing to donate one of hers, but they are incompatible. Likewise, Mrs. Smith needs a kidney and Mr. Smith is willing to donate one of his, but they too are incompatible. Roth's algorithm determines that Mr. Jones and Mr. Smith are compatible, and Mrs. Jones and Mrs. Smith are compatible. Doctors perform one transplant from Mr. Smith to Mr. Jones and another from Mrs. Jones to Mrs. Smith. This "two-way cycle" saves two lives. Likewise, a "three-way cycle" saves three lives. Last year, doctors at Yale-New Haven Hospital performed a nine-way cycle.

Trading "chains" make the market thicker yet. In contrast to a trading cycle in which a donor expects a loved one to receive a kidney, a "non-directed donor" initiates a chain that will include "some patient-donor pairs, and end with a donation to someone on the waiting list." Another significant benefit of a chain is that transplants may occur non-simultaneously. Note that Mr. Smith would hesitate to donate his kidney to Mr. Jones if he could not expect Mrs. Jones to give up hers at the same time and place to Mrs. Smith. Doctors perform the transplants in a kidney trading cycle simultaneously in order to prevent the possibility that a directed donor cannot or will not give up a kidney after his or her loved one has already received one.

The problem with simultaneous operations is that they bump into resource constraints because of the limited availability of doctors, nurses, and facilities. A non-directed donor relaxes those constraints; he or she donates to Mr. Jones, and even if Mrs. Jones fails for some reason to reciprocate, no one has donated without a loved one receiving a kidney. To paraphrase Roth, Mr. Smith may remain in the kidney exchange as a donor to benefit his wife at some point in time. The author shares the

story of a non-directed donor who initiated a chain that involved 16 operations over a period of years. More recently, since publication of this book, Roth described a chain involving 60 donors and recipients.

The aforementioned resource constraints that hindered simultaneous transplant operations congested the market for kidneys. Trading chains not only thicken the market; the non-simultaneous operations they make possible also decongest the market by relieving those resource constraints.

#### **Decongesting markets /**

Another factor impedes trading. "Keep in mind," Roth writes, "that hospitals earn revenue on their transplants; they're commercial enterprises as well as caregivers." Thus hospitals have an incentive to keep their "easy-to-match" pairs off the market and refer the "hard-to-match" pairs to the market. The problem is that "when transplant centers withhold easy-to-match pairs and transplant them internally, it reduces the number of people who can

be matched nationwide, because it's easier to find matches for hard-to-match pairs if they don't always have to be matched with other hard-to-match pairs."

Roth and a colleague imagine that the problem can be fixed by rewarding hospitals with more matches based on the number of easy matches they refer to the market. Their idea is unlikely to be implemented, Roth laments, because health care providers refuse to admit that "hospitals are strategic players in competition with one another." More lives are likely to be saved by integrating regional markets for kidneys into a national market and relying on trading chains.

At the time he was writing, Roth anticipated kidney exchange would go global. Since publication, that has become a reality. Transplants cost less than dialysis;

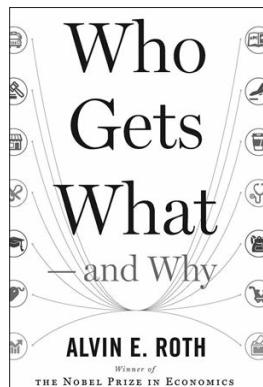
the cost savings finance travel, transplant operations, and other health care for patients and donors from poor countries to rich countries in what one of Roth's medical colleagues calls "reverse-transplant tourism."

Recall that the National Organ Transplant Act prohibits the buying and selling of organs. Why? Roth's term for it is *repugnance*. "Let's call a transaction *repugnant*," he suggests, "if some people want to engage in it and other people don't want them to."

He begins his chapter on repugnance by noting that even though there would be willing producers and consumers of horsemeat, a majority of voters in California banned the market. What offends third parties, as they observe other people buying and selling, varies over time and from place to place. Roth gives several examples. Money lending used to be repugnant in the West; it remains so in Islamic society. On the other hand, indentured servitude was not repugnant in early America, but eventually became so. The French and the Germans continue to dine on horsemeat.

If anyone can think of a way to enable the buying and selling of kidneys without arousing repugnance, the gains from trade—in terms of lives saved—would be large. Roth presents a few ideas. Some people object to buyers compensating sellers because they expect the former to have high incomes and the latter to have low incomes. The objection fails to see that by allowing donors to be paid, the increase in the quantity supplied of kidneys will benefit low-income patients by reducing the time they spend on waiting lists. There is nevertheless a way to avoid this objection based on income inequality. Roth points out that the government could raise taxes and buy kidneys, which would then be assigned to patients on waiting lists based on criteria other than income.

Another objection is that allowing donor compensation could lead to undue influence. For example, creditors might pressure debtors into paying off their obligations by selling a kidney. To counter this objection, the author recommends donors



**Who Gets What—and Why: The New Economics of Matchmaking and Market Design**  
By Alvin E. Roth  
261 pp.; Mariner, 2016

undergo a “cooling-off period” so that they are sure they are making the right decision.

At the time he was writing, Roth admitted that he was pessimistic about overturning repugnance in the buying and selling of kidneys. He refuses to give up, however. His latest tack advances a question put forth by Philip Cook and Kimberly Krawiec of Duke University: If society finds it acceptable for professional football players to put their health at risk for compensation, why not kidney donors? (“If We Pay Football Players, Why Not Kidney Donors?” Spring 2018.)

Although kidney exchange teaches many lessons about a matching market and market design, the book offers much more. Roth explains the intricacies of matching law students with judges, medical students with residencies, and students with schools. He describes the latest ideas of market designers who are trying to solve problems that arise when stock traders compete down to a fraction of a millisecond, or Federal Communication Commission officials auction “a package of licenses” to businesses that use a portion of the radio spectrum.

The book has an offbeat element reminiscent of *Freakonomics*, the 2005 bestseller from economist Steven Levitt and journalist Stephen Dubner. For example, Roth writes of his and colleague Xiaolin Xing’s discussion of an amazing case of early trading in which a polygynous Aboriginal Australian tribe matched newborn boys with the *future daughters* of newborn girls. Other colleagues discovered that delivering “virtual ‘roses’” on a dating website was as effective in generating mutual interest as good looks and a good job. The reader will encounter market maladies such as “sniping” (offering to buy just before the market closes) and “exploding offers” (those that expire rapidly). Sometimes market designers solve or attenuate these problems, sometimes not.

Readers of *Regulation* may be interested in how Roth handles this question: “How do we square market design with the notion of the ‘free market’ that so many people hold dear?” To him, a free market is “a mar-

ket with well-designed rules that make it work well.” Those who design the rules may be buyers and sellers in the market as well as government officials imposing mandatory regulations. Both the private actors and the government regulators, he lets us know, are capable of making mistakes.

He thinks of “economists as engineers.” Readers might balk at that because it sounds like dreaded social engineering. But

Roth points out that markets are “human artifacts” just like agriculture and the medical profession. Just as farmers tweak seeds and doctors prescribe medicine, economists may recommend modifications that help markets work better. Let’s hope that economists who think of themselves as engineers use persuasion in the marketplace of ideas and refrain from advocating coercive government intervention. R

## Corruption and Government

REVIEW BY GEORGE LEEF

**W**hat motivated the American colonists to rebel against the British crown? The reasons that immediately come to mind include unwanted taxes, trade interference, and disrespect for the colonists’ property rights. In his latest book, George Mason University law professor F.H. Buckley argues that we should add corruption to this list. The patriots saw the monarchy and its officials as wallowing in corruption as they lived high on graft and doled out favors to friends and cronies at public expense.

While tensions grew in the 1770s, few Brits understood the fuss. “But what they missed,” Buckley writes, “was the colonists’ ire over corruption in the British government—the King’s Friends in Parliament, the showering of gifts on royal favorites, the patronage machines of prime ministers and of royal governors in the colonies.”

The patriots did not just want to throw off the yoke of King George III; they wanted to create a government that would be virtuous. They wanted a government run for the good of the people at large rather than for a few with money and influence. They wanted to prevent corrupt bargains and self-dealing.

**Constitution vs. corruption** / Once independence was won and the new nation’s leaders got together in Philadelphia to deal with the evident flaws of the Articles of Confederation, the need to keep cor-

would accept the reality of our ordinary vices, but would make it harder for them to infect the body politic. By dividing powers and asking one branch to check another, the Framers sought to restrain those who would use the means of government to serve wasteful private ends.

From that goal sprang many of the Constitution’s features. The president would not be popularly elected but rather chosen by the Electoral College, which would presumably consist mostly of wise and virtuous men. Furthermore, the Electoral College would meet in the separate states rather than the nation’s capital, a provision meant to prevent unsavory deals among the electors.

The president would be subject to impeachment and it was originally proposed that only a majority vote in the Senate was needed to remove him. (Buckley notes that the change to a two-thirds vote was made late in the convention by a committee and never debated.) To keep the president from squandering money on his

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friends as English kings were wont to do, the Appropriations Clause stated that no money could be withdrawn from the Treasury except upon a vote of Congress. Nor could the president confer any title of nobility or accept any foreign emoluments. He could make appointments, but only with the advice and consent of the Senate. Those and other provisions were intended as barriers against corruption.

Buckley, who has studied the Constitutional Convention carefully, notes that Ben Franklin even suggested making the presidency an unpaid office to further reduce its attractiveness to grasping men. That idea, however, was too much for the rest of the assembly and his suggestion died quietly.

Turning to the legislative branch, each state's senators would be chosen by the state legislature rather than elected directly. (The 17th Amendment would change that.) Members of Congress were forbidden to hold any other federal office at the same time. The powers of Congress were carefully enumerated and did not include any authority to engage in what James Madison called "factionalism," meaning the promotion of legislation intended to benefit individuals or interest groups rather than advance the general good.

**Slipping the constraints** / The Framers put a great deal of effort into devising a governmental structure that would ward off corruption. Alas, it has failed. The government today is riddled with the kind of influence peddling and hidden deals that drove the patriots to take up arms in 1775. Buckley writes,

From TARP, to the Export-Import Bank, to the tariff protections offered to favored industries, there is a growing concern that the federal government has become a necessary business partner, and that the (imagined but not necessarily imaginary) free market capitalism of the past has been transformed into a wasteful crony capitalism that favors well-connected special interests.

He provides a convincing analysis of the Constitution's inability to maintain

the envisioned "republic of virtue." The separation of powers proved no match for presidents who were determined to act as they wanted. He observes:

The president has slipped off many of the constraints that were meant to curb his authority. He makes laws by regulatory fiat and executive order, and unmakes them by refusing to enforce properly enacted legislation. He can reward friends and punish enemies in ways the Framers would not have imagined.

That's perfectly true, although Buckley doesn't mention that the presidents who were eager to slip those constitutional restraints were able to do so only with the complicity of Congress and the Supreme Court. The Framers' design worked for a while, but their words on paper could not prevent corruption once the ruling elite decided that limited government was too old-fashioned.

And so we live with a level of corruption that makes that of King George's time seem quaint. Much of today's policymaking appears to have nothing to do with the merits of the proposed legislation, the political appointee, or the legal arguments, but instead is driven by money and connections.

**Judicial corruption** / Consider, for instance, the way justice often depends on where a case is tried. Trial lawyers have worked out brazenly corrupt methods of shaking down out-of-state litigants in venues where they pretty much own the judges.

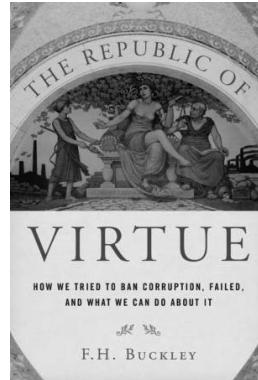
Buckley recounts an infamous Mississippi case involving a contract dispute between a Mississippi firm and one from Canada. The proceedings reeked of favoritism toward the former and hatred directed at the latter, even playing the

"race card" with the black jury. The judge, elected with plenty of support from the trial bar, allowed the plaintiff's legal team to get away with outrageous conduct (he was later given an appointment to the Fifth Circuit by President Barack Obama) and the resulting damage award against the Canadian firm was staggering: \$100 million in compensatory damages (including \$75 million for "emotional distress") and \$400 million in punitive damages. Moreover, the defendant was not allowed to appeal under Mississippi rules unless it first posted a bond of \$625 million. The unfortunate Canadians finally settled the case, paying \$130 million over a dubious breach of contract.

There is a clear solution to the problem of state judicial corruption. Congress need only adopt the proposed Fairness in Interstate Litigation Act, amending the law

providing that in cases involving diversity of citizenship, federal and not state courts have jurisdiction. That is apparently what the First Congress had in mind when lawmakers passed the Judiciary Act of 1789, which provides for removal of "diversity" cases to federal court.

The problem is that in an 1806 case, Chief Justice John Marshall read the statute to mean *complete diversity*, so that if the plaintiff and at least one defendant were from the same state, the case must remain in state court. Ever since, lawyers have taken advantage of that decision, which Marshall later admitted was a mistake. They find some in-state company to plead in as co-defendant, which is why one small drugstore in Mississippi has been sued hundreds of times, to provide the in-state connection that defeats federal jurisdiction. If Congress would pass the proposed amendment, that would wipe out a great deal of judicial corruption. That's the book's most efficacious idea.



**The Republic of Virtue: How We Tried to Ban Corruption, Failed, and What We Can Do about It**

By F.H. Buckley  
246 pp.; Encounter Books, 2017

**Campaigns and corruption** / But what about the big “money in politics” problem? Going back to the 1970s, America has had a fixation on trying to “clean up” politics through contribution limits and disclosure requirements. Buckley argues that it has all been futile. Such constraints do nothing to keep people and groups with money from finding ways to influence who gets elected and appointed, and what bills and regulations are adopted or defeated. All they accomplish is to create traps for the unwary that can be exploited by partisans who want to use the law as a sword to harm their opponents.

Buckley gives several jarring examples of that, including the prosecution, imprisonment, and mandatory psychiatric evaluation of conservative writer Dinesh D’Souza and the SWAT raid of the homes of Wisconsin Club for Growth members for having supposedly violated campaign finance laws in supporting Gov. Scott Walker. Zealots can and will hunt for petty violations of these complicated laws to take down people on the other side. Instead of making politics cleaner, they make it dirtier and more vicious.

We would be better off, Buckley argues, if we repealed the current campaign finance laws and put in their place three rules: that all political contributions be made anonymously, that we legislate specifically against “pay for play” operations, and that we stop the revolving door between government jobs and lobbying firms.

Regarding the first, Buckley argues, “There’s bound to be less corruption attached to the money when the gift is anonymous.” Moreover, a rule of anonymity would prevent the “outing” of donors like former Mozilla president Brendan Eich, who was forced to resign after left-wing political forces discovered his contribution to the campaign in California against same-sex marriage. (See “Should Campaign Donors Be Identified?” Summer 2001; “Answering Ayres,” Winter 2001.)

Regarding the second rule, what Buckley has in mind is a ban on political contributions from government contractors and municipal bond dealers. Both groups

have a strong temptation to engage in rent-extraction by supporting candidates who will channel business their way.

Concerning the third rule, he points out that “on leaving elective office, many congressmen and senior staffers become lobbyists and cash in on the contacts they have made. The Center for Responsive Politics reported in 2011 that at least 285 of an estimated 1,000 former members of Congress were registered as lobbyists, and another 85 provided ‘strategic advice’ for clients.” Because of this well-lubricated revolving door between legislating and lobbying, we probably have a lot of laws and regulations that wouldn’t otherwise come into existence.

In my view, those reforms have merit, but they would only make a small dent in

America’s political corruption problem. We have corruption because, like the British monarchy, today’s government has too much power to tax, spend, and regulate—powers that inevitably attract the dishonest and seduce the once-honest. So long as that power remains, we will have corruption.

Buckley knows there’s no silver bullet to kill corruption, but he hopes to offer a bit of relief. He concludes:

Rather than rely upon people’s intrinsic goodness, we should look more modestly for feasible ways to guard against particular kinds of corruption where we find them. That’s what the Framers did in aiming to design an anticorruption covenant, and the best we can do is keep tinkering with the machinery they gave us. R

## A Radical Restructuring and Redistribution of Wealth

• REVIEW BY DAVID R. HENDERSON

**I**n *Radical Markets*, University of Chicago law professor Eric Posner and Microsoft senior researcher Glen Weyl propose a radical restructuring of property rights, immigration policy, and voting, as well as a substantial change in corporate law. Their most radical proposal is to completely overturn property rights so that people would need to continuously “bid” for property they already own. They want to alter immigration policy to allow about 100 million more immigrants into the United States, but change who decides whether or not to allow particular prospective immigrants to enter. They want to switch to “quadratic” voting as opposed to the current one citizen—one vote method. They also want a major change in how investors can hold shares in corporations.

ments. The most compelling one is on voting. The least compelling, and also absolutely horrific, one is on property.

**Worse off?** / Posner and Weyl begin by making the case that the current political and economic situation in the United States is well short of ideal. Who could disagree? But in making their case, they claim that the U.S. economy has been stagnating for many years for most of its residents. They base this strong conclusion on thin evidence.

The closest they come to making their case is to cite a study by Stanford University economist Raj Chetty and co-authors, who found that only 50% of American children born in 1980 had a higher liv-

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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ing standard at age 30 than their parents had at the same age. They don't mention three huge problems with the study, all of which, if corrected for, would undercut that result.

First, as Chetty admits, the study measured income not for the individual, but for the household. Are 30-year-olds' households systematically different today than they were in 1980? Yes. Today, 30-year-olds are less likely to be married and living with a spouse who earns income.

Second and related, today's 30-year-olds are typically not quite as far along in their careers as their parents were in 1980. One reason for this is that many of them were in school longer than their parents were, getting undergraduate and even graduate degrees.

Third, to adjust for inflation so that they could compare incomes over time, Chetty and his co-authors used the U.S. Consumer Price Index. The CPI systematically overstates inflation by about 0.8 percentage points per year. Over a generation of 25 years, that's an overstatement of 22%. Had they taken that into account, they would have found that well over half—I would wager over 60%—of today's 30-year-olds earn more than their parents earned when they were 30.

**Undercutting property rights** / Posner and Weyl's argument for overturning property rights is that private property inherently confers market power. Indeed, the title they choose for their chapter on this topic is "Property Is Monopoly."

They are right in some instances. My home, for example, is the only house on the piece of property that I also own. Because there is no perfect substitute for that piece of property or that house, I have a small amount of market power. But there are close substitutes for my home. And there are even closer substitutes for my stocks, bonds, and car. So "Property Is Monopoly" is a highly exaggerated title.

They go from that idea—I'm skipping their fairly good exposition of 19th century economist Henry George's idea for taxing land—to their proposal for a com-

mon ownership self-assessed tax (COST) on wealth. They would have the federal government impose a stiff 7% annual tax on people's wealth. People would assess their own wealth, estimating, say, the value of their house.

What would prevent people from underestimating the value of their assets? This is where Posner and Weyl's proposal is horrific. Once a homeowner, say, has stated the estimated value publicly, he would have to sell his house to anyone who offers more than that value. So, for example, suppose my aforementioned house is worth about \$900,000 on the open market. If I estimated the value at \$900,000, my annual tax under their proposal would be a whopping \$63,000. If I estimate the value below that, I would risk losing the house to anyone who bids more than my estimate. To be safe, I would probably estimate the value at \$1 million because I like living there. But then I would pay \$70,000 in taxes on my home annually. (Notice that a 7% annual tax on an asset would amount to an implicit tax of over 100% on the income from many assets.)

In short, Posner and Weyl would fundamentally undercut property rights, making them conditional. If you've lived in your home for 32 years, as my wife and I have, and put a lot of sentimental value on the place where you raised your children, then you would have to put a number on that value. And in case you think you can handle that, you must remember that they want to do the same with virtually all of your net worth.

Toward the end of the book, they even toy with having people pay taxes on their human capital. They give an example of a surgeon who announces that she would perform gallbladder surgery for \$2,000 and pay a tax accordingly. She would be

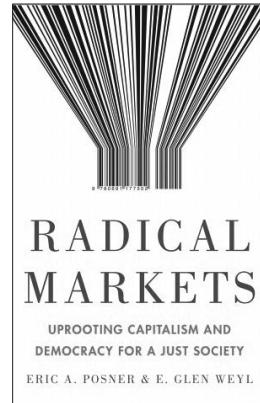
obligated to provide that surgery to anyone willing to pay \$2,000. So if the surgeon was thinking of retiring, forget it. The only satisfactory solution for her would be to estimate the value of her services at a number that really would make her indifferent between working and retiring.

The authors are aware that they're treading on sensitive ground here, writing, "A COST on human capital might be perceived as a kind of slavery." *Might* be? They claim that such a perception is incorrect, but the reasoning behind their claim is weak.

They implicitly admit that their proposal is coercive when they write that it would be a mistake "to think that the current system is not coercive." How is the current system coercive? Here's how: "Those with fewer marketable skills are given a stark choice: undergo harsh labor conditions for low pay, starve, or submit to the many indignities of life on welfare." In short, to Posner and Weyl,

being relatively poor is akin to being coerced. I would bet that a newly freed slave in 1865, though almost certainly poor, would understand the difference between poverty and coercion better than Posner and Weyl seem to.

And let's not forget the huge transfer of wealth that COST would imply, a transfer that they claim is a virtue of their proposal. A family with a net worth of, say, \$2 million would pay \$140,000 a year. They estimate that a COST would raise 20% of GDP annually, half of which would replace "all existing taxes on capital, corporations, property, and inheritance" and wipe out the deficit. The other half would be given to each U.S. resident, which would mean a per capita annual payment of about \$5,300. Elsewhere ("A Philosophical Economist's Case Against a Government-Guaranteed Basic Income," *Independent Review*, Spring 2015), I have



**Radical Markets:  
Uprooting Capitalism  
and Democracy for a  
Just Society**

By Eric A. Posner and  
E. Glen Weyl  
316 pp.; Princeton  
University Press, 2018

described the huge problems with such a universal basic income. In short, Posner and Weyl advocate a huge wealth transfer.

Notice, also, that the biggest revenue sources for the feds—the individual income tax and the payroll tax—would be left in place. This means that Posner and Weyl are calling for a gigantic increase in the size of the federal government.

**Making immigration benefit natives** / Their other major economic proposal is on immigration. They would take away U.S. corporations' power to hire immigrants and would instead give each of 250 million American adults the power to hire one immigrant. Then, the American doing the hiring could employ the immigrant or hire the immigrant out to someone else.

What's the American's incentive? Each would make an offer to an immigrant—they use the number \$12,000 per year for illustrative purposes—that would be attractive to someone from a low-income country, and each native would then pocket the difference between that \$12,000 and the value of what the immigrant produces.

Posner and Weyl estimate that only 100 million Americans would take advantage of this opportunity, but it's hard to imagine 150 million other American adults all leaving thousands of dollars of annual value untapped. Although my first instinct was to find their proposal wacky, after I thought about it I found it more reasonable than I had thought at first.

Their immigration idea does, though, sound *politically* undoable. It's hard to imagine Americans going along with at least 100 million new immigrants entering the country in a short time. I hasten to add that I would love it, even if I didn't take advantage of the system (which I probably would). Posner and Weyl claim that their system is better than the late economist Gary Becker's proposal to auction immigration slots, but it's hard to see why.

An important argument for their proposal is that it would offer the average American a benefit that's much greater than he receives from immigration today. That's true, but Becker's proposal would

also do so if the proceeds from the auction were used to fund an equal grant to each American. They also claim that a pure Becker-type auction would ignore important factors such as the immigrant's cultural fit to local communities or people's willingness to welcome migrants. But a migrant bidding tens of thousands of dollars for the right to immigrate would surely take such factors into account in deciding how much to bid and where to settle.

**Voting and corporate control** / One of Posner and Weyl's most promising ideas is for quadratic voting. The idea is that each voter could save up votes in order to cast more than one vote on a given issue that he or she feels strongly about. But under this proposal a voter who has accumulated, say, 64 votes would, by using up all those votes on one issue, be able to cast only the square root of 64, which is eight votes. They have a fairly good explanation for why they advocate the square root rather than the straight number, but it's too complicated to explain in a short space. Suffice it to say that their proposal would do what the current system doesn't: allow voters to back the intensity of their preferences and constrain voters to make tradeoffs among issues.

The other main issue that the authors discuss is the ownership of corporations. They point to the tension between the interests of stockholders and the interests of high-level corporate managers. Economists who have addressed this issue, they note, believe that a market for takeovers “where another firm or group of investors buys an underperforming firm and fires the CEO” will discipline the management. It's true that many economists believe that; the pioneering scholar in this area was the late law and economics scholar Henry Manne. But Posner and Weyl say nothing about one of the main impediments to a well-functioning market for corporate control: Section 13D of the 1968 Williams Act.

Under Section 13D, when someone acquires more than 5% of the voting shares of a corporation, he must report it within

10 days of the acquisition. The problem is that all the relevant players will suspect that the acquirer wants to purchase even more shares in order to have more control. Many shareholders will hold out for the higher expected price, making the takeover less likely and making it less attractive for firms to attempt to get control of other firms in the first place.

Here's how Duke finance professor Michael Bradley put it to me years ago. Imagine that you make a living hunting for and reselling rare books. In a used-book store, you find an autographed first edition of a rare book, priced at \$2. You know that you can sell it for \$1,000. But what if a well-enforced federal law requires that you inform the seller of the book's value. Then the seller will hold out for much more than \$2. The consequence to you is that you are less able to make a living; the consequence to the rest of society is that fewer people will be out there moving books to higher-valued uses. Similarly, the statement that a firm has newly acquired more than 5% of the voting shares of a corporation is a signal to potential future sellers of shares that their shares are worth more than they had thought, and they will be less likely to sell. The result: a substantially hampered market for corporate control and more running room for top managers to ignore the wishes of shareholders.

Posner and Weyl do make a somewhat persuasive argument on cross-ownership of shares. They argue that when large mutual fund companies such as Vanguard, Fidelity, and BlackRock own a substantial amount of stock in multiple firms in a concentrated industry, the mutual fund companies have an incentive to motivate the firms not to compete against each other as aggressively as they otherwise would. The authors offer evidence that this happens. They propose changing the law to prohibit a given mutual fund from owning a large percentage of shares in more than one company. That way, there would be less incentive for the funds to discourage competition.

Posner and Weyl point out that the funds could still get the advantages of

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diversification because they would have many concentrated industries in which they could own substantial shares of one company. I couldn't find any holes in that argument.

Interestingly, one of the concentrated industries that the authors worry about is U.S. domestic air travel, but they don't mention an obvious solution to counteract monopolistic behavior: changing the law to allow foreign airlines to compete on routes between U.S. cities. Laws keeping out foreign airlines, which are called "cabotage" laws, are the main impediment to foreign competition in the U.S. airline market.

In their chapter on corporations, the authors blame "monopolistic conspiracies" for an industry practice, resale price maintenance (RPM), that has a far more cogent pro-competitive explanation. Suppliers engage in RPM when they require retailers to charge a minimum price on certain items. In a classic article more than 50 years ago, University of Chicago economist Lester Telser pointed out the problem with the monopoly explanation for RPM: suppliers would be facilitating retail monopoly, which would result in fewer items sold, hurting the supplier. A supplier with monopoly power would be better advised to simply charge a high price to retailers. So the monopoly explanation doesn't make sense. Telser proposed an alternate explanation for RPM: encouraging retailers to compete not on price, but on demonstrating and exhibiting the product. This explanation seems to have stood the test of time, and I'm surprised that Posner, a law professor at Telser's school, does not discuss this explanation.

**Conclusion** / I hope that policymakers and others will outright reject—with prejudice, as the lawyers say—Posner and Weyl's drastic proposal for undercutting property rights and substantially redistributing wealth. On the other hand, I hope they implement the quadratic voting proposal and increase individual Americans' ability—while not taking away corporations' ability—to hire immigrants.

# A Captivating, Frustrating 'Grand Bargain'?

REVIEW BY ART CARDEN

Bucknell University economist Marcellus Andrews has written a self-consciously pugnacious book proposing a radical change to the structure of American welfare funded by a radical change to the structure of American capitalism. No matter your ideological persuasion, you will find something in his *Vision of a Real Free Market Society* to inspire you and something in the book to infuriate you. That's quite an achievement for 106 sparsely footnoted pages. Andrews explores the kinds of issues that readers of *Regulation* and its sister publications in the broader classical liberal academic and think tank universe should take very seriously.

Andrews's venture is inspired by Milton Friedman's 1962 book *Capitalism and Freedom*, though Andrews proposes "a better form of capitalism." It really is a *re-imagining* of capitalism, thinking not in terms of piecemeal reforms but in terms of a new structure—and this makes the book at once fascinating, stimulating, and frustrating. As a matter of pure policy, I can't help but wonder if it offers a grand political bargain that would be acceptable to both the right, which would get freer markets, and the left, which would get something akin to a Basic Income Guarantee. Theoretically, *everyone* would get richer faster in the long run. As I tell my students, I would be a very happy economist if I woke up one morning and this change had been made.

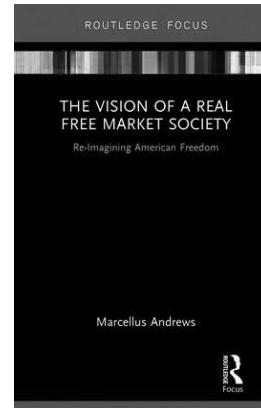
**Better than a dog's breakfast** / Andrews's language is strident in places, but to get lost in this is to misinterpret the kind of

book it is. *The Vision of a Real Free Market Society* isn't the discussion that happens in the seminar room. It's the (usually better and more insightful) discussion during the post-seminar visit to the bar. That makes it a lot more fun to read than most academic books.

Brevity requires him to economize on nuance, but I was still surprised to read his claim that capitalism *obviously* tends toward monopoly, inequality, and crushed hopes and dreams for the poor. He tells us that markets are sources of "unemployment, unnecessary suffering, and environmental degradation." But I think the preponderance of the evidence suggests that unemployment and "unnecessary suffering" are not market phenomena per

se. I think these claims are empirically false and I would suggest that the problem with modern "capitalism" is that there's not enough of it—or, rather, too much of the market is captured by special interests that are able to profit not from innovation, lower prices, and greater output, but from higher prices and lower output made possible by barriers to entry.

The novelty comes from Andrews's realistic approach to policy. While I don't share his skepticism about untrammelled markets, he acknowledges the problems of a lot of government policies on poverty, noting that they come with a whole host of



**The Vision of a Real Free Market Society: Re-Imagining American Freedom**

By Marcellus Andrews  
106 pp.; Routledge, 2017

pathologies, inefficiencies, and failures. Is his proposal what most libertarians would see as an ideal social policy for an anarcho-capitalist paradise? Clearly not. Is it better than the dog's breakfast of "welfare" as it is currently structured? Probably so.

Andrews proposes a novel twist on what we would normally think of as a Basic Income Guarantee or Universal Basic Income. It is, as he puts it, a shot at "exploring how to combine markets with public ownership—but not management—of a large share of the nation's private capital stock, which is the antithesis of socialism as usually understood." He proposes moderate social ownership of some of the means of production but not ownership *with control*. Instead, he proposes that the government own shares in mutual funds that would be privately managed with, presumably, the income from these funds being distributed to the people.

This would have the virtue, I think, of a more equitable distribution of the returns to capital without the distortionary effects of taxes on capital. The requirement that government own shares in privately managed mutual funds also means that the profit-and-loss system is minimally compromised. Given how much money the government spends every year on war, farm subsidies, and so on, it's difficult to claim "We can't afford this!" with a straight face.

But I'm not sure how "minimal" this distortion would remain in the long run. I'm not terribly optimistic about our ability to insulate such funds from political control. First, there is the rent-seeking bonanza that will accompany the struggle to become one of the chosen few firms managing the state's multitrillion-dollar portfolio. Second, I agree with Milton Friedman's critique of "Social Security Socialism," namely that government stock purchases would "threaten our freedom" by encouraging large-scale government ownership of private enterprise, even via shares in mutual funds. I doubt that the current Congress—or any Congress—could be trusted to design rules that would insulate the system from overwhelming political pressure. Consider calls for college endowments, state pensions, and

TIAA-CREF to divest from oil companies and gun manufacturers. The pressure to direct funds away from politically unpopular and toward politically popular causes would be enormous.

That said, there are examples of at least minimally competent government management of resources. Oil in Alaska and Norway comes to mind, and Andrews's proposal is especially interesting in light of economists Damon Jones and Ioana Marinescu's recent finding that distribu-

*It offers a grand political bargain where the right would get freer markets and the left would get something akin to a Basic Income Guarantee.*

tions from Alaskan oil revenues apparently didn't reduce Alaskan labor force participation, but also in light of Finland's recent decision to cancel its Universal Basic Income experiment. As returns on investment in the social trust fund improve, Andrews argues, we can begin phasing out welfare as we know it. I'm less optimistic of this policy change given the enormous stakes some people have in the continued expansion of programs like the Children's Health Insurance Program, and we need to take very seriously the possibility that this would simply become another add-on for a very inefficient system.

**Misfortunes, deserved and undeserved** / Andrews makes an interesting point in his discussion of the ways in which one's choices have downstream consequences, but I think he goes too far. He writes, "A middle-aged adult who is poor, or even destitute, because of bad choices made when they were young is, in a very real sense, a prisoner to another person: their former, frivolous, reckless self." Yes, and I've said before that if I could punch one person in history it would be my teenage self. But I don't think this is a sound justification for redistribution at all. Why, I wonder, should my children and I be held

"prisoner" by your "former, frivolous, reckless self"? Andrews doesn't provide a good answer to this question or acknowledge the ways in which this creates an ultimate problem of concentrated benefits and dispersed costs. Here, the right's criticisms about virtue and incentives and so on need to be taken more seriously.

Andrews does confront two of the knottiest problems facing the left and right in thinking about the structure of the welfare state. For the left, there's the inconvenient

problem that people respond to incentives, and badly structured welfare infrastructure punishes labor and capital accumulation, subsidizes dissipation, and leaves us all worse off in the long run. We're worse off financially in that we can't produce as many goods and services, but we're also worse off morally in that we make poor use of our gifts.

The problem for the right is that people's endowments are largely arbitrary. I have worked hard to get where I am in life, certainly, but I also had the good fortune to be born into a two-parent household where my parents loved my sisters and me, stuck together through thick and thin, and made (mostly) good choices. Less fortunate people experience struggles that I simply cannot identify with or empathize. To pretend that what I have is purely the result of my own merit when a lot of it is the result of my hitting the genetic and geographic lottery is unseemly. Justice seems to demand that others' undeserved misfortunes somehow be corrected.

**Interventions or markets?** / Here's a point, though, on which Deirdre McCloskey, the philosopher David Schmidtz, and I would agree: other people are not poor *because* I am rich. I am not rich *because* they are poor. Only in a zero-sum world is my good fortune causing another's misery. Here, Andrews's claim that the free market *obviously* leads to crushed dreams rings hollow. Moreover, even if we grant his claim about "the free

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market's tendency to lock poor and working people into society's basement," economic growth means that from year to year it becomes a much nicer, well-appointed basement with carpeting, a big screen TV, air conditioning, and other amenities.

It's hardly the case, furthermore, that free markets are guilty of "denying [the unfortunate] access to the keys to survival, mobility, and development: adequate schooling, health care, housing, safety, nutrition, and other vital goods and services." Last I checked, schooling was dominated by government ownership and provision, municipalities are served by government-owned security monopolies (police departments), and government intervention in markets for health care, food, housing, and all sorts of other "keys to survival" is extensive. Perhaps the free market would do a poor job of providing those goods, but it can certainly be argued in many cases that government doesn't do a particularly good job.

I'm also less sanguine about the idea that redistribution will lead to meaningful changes in the dynamics of class and status. Gregory Clark's 2014 book *The Son Also Rises* shows how we see similar patterns of social mobility across institutional types and time periods. (See "Do Good Names Bring Great Riches?" Spring 2015.) There's another problem that F.A. Hayek pointed out: dynastic wealth might be the least-bad way for parents to transfer to their heirs. If we get rid of transmitted privilege via financial inheritance, people will look for other ways to secure power and influence for their kids, perhaps by over-investing in or competing wastefully to get into influential social networks.

In this respect, Andrews's rhetoric sometimes gets the best of him. For instance, he writes, "The sin of the Right, from a left-libertarian point of view, is that the poverty and underdevelopment of some is seen as the necessary price for the wealth and freedom of others." I don't know anyone who actually believes that. "Trickle-down" economics is a caricature. He criticizes textbook models of competitive markets by invoking textbook models of incomplete information, monopoly, and monopsony, and he doesn't grapple with the fact that

in all sorts of markets (like health insurance) people are rebelling against efficiency enhancements on the grounds that insurance companies know *too much* about us.

He writes of the "unavoidable brutality and unfairness of private enterprise economies," but I think there's a lot of evidence to suggest that private enterprise economies are the best solution we've found to the "unavoidable brutality and unfairness" of a fallen world constrained by limited knowledge and bound by scarcity. And yet I say "Amen!" when he writes, "A capitalist road to economic justice is readily available to the Left once we get over our aversion to markets in general, and find a way around the problems with the labor market," and "Private property is ... an essential precondition for the existence of substantive liberty because it provides each person with the means to carry out their plans."

**Conclusion** / This is a captivating and at times frustrating book, hence the embarrassingly long gap between its release and when I submitted this review. It is captivating because it sets aside too-simple ideological narratives. It is frustrating in some of the ways Andrews gets carried away rhetorically. (I've been guilty of that myself and as a result of reading Andrews I've been looking for the planks in my own eyes.)

In broad outline, I'm onboard with a project like this, but I think the constitutional details are crucial. However, the point of the Routledge Focus series, of which this book is a volume, is not to present exhaustive accounts of every nuanced detail, but to summarize and provoke. *The Vision of a Real Free Market Society* does exactly that. As welfare reform proposals go, Andrews's vision of a real free market society deserves a place at the public policy table. R

## Government Fixation Is the Problem

♦ REVIEW BY PIERRE LEMIEUX

It is easy to attack quantitative analysis in general and statistical methods in particular. It is also easy to call "tyranny" anything that appears to have an exaggerated and unfavorable influence.

Such hyperbole is part of Jerry Muller's *The Tyranny of Metrics*. Speaking of finance, the Catholic University of America historian criticizes the idea that "numerical acumen (premised upon probability formulas rather than empirical research) can substitute for practical knowledge about the underlying assets." But how can "probability formulas" be excluded from empirical research? How can portfolios of complex, diversified, and abstract assets be evaluated without numbers and statistical analysis?

Muller's case is not boosted by Oxford historian Niall Ferguson's line that "those whom the gods want to destroy they first

teach math." Mathematics and probability theory are certainly among the tastier fruits of the Tree of Knowledge.

Yet *The Tyranny of Metrics* is not an attack on quantitative methods. Altogether, it is a moderate book. It only criticizes inappropriate use of metrics, metrics being defined as "numerical indicators of comparative performance based upon standardized data." They become problematic only when "the marginal costs of assembling and analyzing the metrics exceed the marginal benefits." Muller reminds us of the continuous importance of local knowledge à la Hayek and individual judgment.

Muller's main argument is that inap-

propriate metrics corrupt the goals of public policy and incite individuals to game the system. He documents many examples of “metric fixation.” For instance, police departments classify serious crimes as minor ones in order to show better numbers on the reports they must submit to federal officials. Schools “teach to the test” in order to increase the student scores on which government largesse depends. Under then-secretary of defense Robert McNamara during the Vietnam War, body count proved largely useless as a metric of performance. Another perverse incentive is “creaming,” an example of which is surgeons declining to operate on difficult cases for fear of reducing their performance scores. And so forth.

An important aspect of Muller’s criticism relates to pay-for-performance systems in schools, hospitals, and even private companies. These systems often do not succeed in improving performance, he argues. Another aspect of metric fixation lies in the publication of such metrics in the name of transparency. The measurement of performance fails when its costs—including the opportunity cost of collecting and tabulating data—are greater than its benefits. Individuals work to increase their scores, not to do the jobs they have been hired to do.

**The market and government** / Muller uses theoretical insights and evidence from several fields, including economics. His command of economics is often surprising for a non-economist.

For example, he shows how the fixation on metrics can be seen as an instance of the principal–agent problem. In case of a listed corporation, the principal—the shareholders—need to make sure that the agents—the executives—maximize profits. One way to align incentives is to tie the executives’ remuneration to the metric of

stock prices. The danger is that the executives will take maximizing short-run stock prices as their goal instead of the firm’s long-run discounted profits. But note how the stock market still tends to reflect the long-term value of the firm, because it is in each investor’s interest to buy a stock only if its price is lower than its expected discounted return. Market prices are not arbitrary metrics.

The problem is very different in the public sector, a difference that Muller tends to overlook. Consider a simple market—say, the market for haircuts. The barber wants to earn as much as he can in order to buy the consumption goods and services he likes. He does this by satisfying his customers. The happier they are, the more he can charge them if he offers a differentiated service, or the more customers he will get. He may—especially if he employs many people or owns a haircut

chain—use metrics to measure his performance, but the real and ultimate measure lies in his profit. Moreover, he may be more entrepreneurial and rely on his intuition. At any rate, his metrics are likely to be of the sort that Muller would find reasonable.

Now consider government. If it supplies only what the market cannot efficiently supply—what economists call “public goods”—then the link between profits and consumer satisfaction is broken. People may be very happy with the national defense they get, but a large number of consumers will not voluntarily pay for it, by the very nature of a public good. Once national defense is provided, everybody can consume it equally. In this case, some metrics are required to (imperfectly) measure if taxpayers get more value than what they are forced to pay in taxes. Moreover, the process through which defense expenditures are determined and allocated must be transparent for the very reason that taxpayers are forced to finance them. Muller’s arguments against metrics and transparency become moot. As far as

public goods are concerned, government inputs and outputs must be measured and transparent.

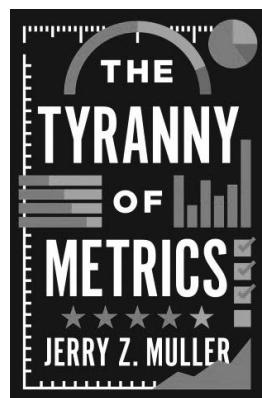
Perhaps one underlying problem in Muller’s economics is that he does not seem to believe in, or understand, consumer sovereignty. He blames “the ideology of consumer choice,” stating that “in some domains choice is particularly fraught.” But how can we assume that politicians and bureaucrats choose better? Will they have to use imperfect metrics to do this?

**Government metrics** / The problem is that government supplies or subsidizes a lot of services that are not public goods or, at least, not pure public goods. Instead, governments spend on education and health care, not to mention electricity, public transportation, and garbage collection. In fact, the largest part of government expenditures goes to redistribution. But the taxpayers are still forced to pay for all of this.

It is easy to understand that those taxpayers want at least to know what is spent and what the spending achieves. In these conditions, the proliferation of metrics is not surprising because it is a direct function of the extent of government intervention. This, and not metrics per se, is the problem. Shouldn’t these considerations influence Muller’s conclusions?

A related problem involves government agents, who—as James Madison noted in Federalist 51—are not angels. They will be tempted to loot the public treasury, legally or not. Even virtuous motivations are dangerous in the case of government agents because they may impose on people their own conception of the good. Government bureaucrats and politicians are paid with, and redistribute, taxpayers’ money, so they should indeed be submitted to performance metrics. Their activities should be as transparent as feasible, and they should be held accountable for what they do.

In brief, it can be argued that governments should be subject to metrics, transparency constraints, and accountability standards—and the more of them, the better—while people should be free to run their private activities as they want. It is



**The Tyranny of Metrics**

By Jerry Z. Muller

240 pp.; Princeton University Press, 2018

## IN REVIEW

true, as Muller conclusively demonstrates, that government-devised metrics tend to be especially inefficient, but this is in direct proportion to what the government should not be doing. He provides us with some keys to these conclusions.

**Mounting regulation and metrics** / There is yet another problem of government activities outside the field of public goods: mounting regulations carry benefits for some individuals and impose costs on others. One can argue that an attempt to measure these costs and benefits must be made, however difficult it is both in theory and practice. (See “The War on Consumer Surplus,” Spring 2017.) Voters must have at least the possibility of evaluating what their agents are doing. To the extent that a tyranny of metrics does exist, it is mainly caused by government interventionism, which brings us back to the real meaning of “tyranny.”

Last decade’s recession provides a good example of regulation and metrics gone wild, but Muller does not see this clearly. He blames the financial crisis on the quantification and abstraction of finance, strangely ignoring the role of government.

Mortgage-based securities were pioneered in 1970 by Ginnie Mae, a federal government agency, in order to encourage the sale of residential mortgages. The Community Reinvestment Act of 1977, reinforced in the 1990s, established ratings to force banks into offering more loans and mortgages to the poor. Before the recession, financial institutions were probably the most metric-regulated businesses in America. The recession was in large part, if not ultimately, a consequence of these government-imposed requirements and metrics. (See my book *Somebody in Charge: A Solution to Recessions?* Palgrave Macmillan, 2011.)

Muller criticizes “short-termism” in business management, suggesting that it is partly the result of the use of performance measures in quarterly reports. But the Securities Exchange Act of 1934 forces listed companies to produce those reports. The criminalization of insider trading (using one’s private information to trade on exchanges) further encourages the use of public and transparent metrics. Government promotes short-termism in business decisions.

**Nothing’s perfect, but...** / Nothing is perfect of course, but government dirigisme

is certainly not the least imperfect phenomenon under the sun. Muller’s case studies include the production of culture and the transmission of knowledge, from K-12 schools to colleges and universities. He rightly notes that “it is an impoverished conception of college education that regards it purely in terms of its ability to enhance earnings.”

He observes how government-imposed performance metrics damage education: “Among the stronghold of metrics in the United States has been the Department of Education, under a succession of presidents, Republican and Democratic.” Such observations should raise alerts about government’s subsidization and regulation of education.

*The Tyranny of Metrics* could have better analyzed the role of unbridled government in what the author calls “metrics fixation.” The problem is not metrics per se, but the fact that they are imposed by governments that should not be doing what they are doing. Government fixation is the problem. Yet Muller’s book remains an interesting one: short, unpretentious, scholarly, and full of insights. And it provokes the reader into asking further questions. R

## Working Papers BY PETER VAN DOREN AND IKE BRANNON

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

## Conservation Easements

“Charitable Contributions of Conservation Easements,” by Adam Looney. *Economic Studies at Brookings*, May 2017.

In Michael Lewis’s 1998 book *Losers* about the 1996 Republican presidential primary, he remarks that upon hearing candidate and orator par excellence Alan Keyes speak for the first time, he was torn between being outraged by Keyes’ message and feeling compelled by Keyes’ arguments to quit his job and work for Keyes’ campaign.

Likewise, the treatise on conservation tax easements by Adam Looney—a fellow at the Brookings Institution and a former economist for the Council of Economic Advisers—filled me in equal measures with anger over the existence of a costly and unproductive

tax break and visions of exploiting the break to bilk the Treasury and make millions for my family.

A conservation tax easement essentially awards property owners a tax benefit in exchange for the owners permanently extinguishing the right to develop a property. The intent of the deduction is to provide an incentive for landholders to preserve pristine land that they might acquire. For instance, the hills surrounding the childhood home and presidential library of Calvin Coolidge in rural Vermont all have conservation easements applied to them, precluding future development and maintaining the area just as it was in the late 19th century.

However, an easement can also be granted to a golf course or a backyard, which illustrates the rub with this tax provision: most of the time it is used to stop development in places where development was unlikely to ever occur.

For instance, many homes in Georgetown have been granted a

type of conservation easement that precludes owners from altering or removing the façades of their houses. The easement affords the owner a charitable deduction—ostensibly worth the reduced value of the home that results from the easement—of as much as \$100,000, which represents a substantial savings for the homeowner.

Of course, the notion that someone who owns a stately townhome in this wealthy enclave could ever get the local Area Neighborhood Council, city government, housing commission, and pitchfork mobs to allow any sort of change to its façade is laughable. It's unlikely that a single façade was "preserved" by this conservation easement. I suppose it can be argued that the easement is just compensation for all these political bodies usurping the development right, but most if not all affected property owners were aware that the development

right was lost long before they purchased their properties.

In the case of the conservation easement Looney describes, the property owner must donate the right to develop the land to a nonprofit. Many of these properties are small: backyards instead of open land.

The conservation easement is not terribly common: only about 2,000 taxpayers claimed it in 2016, Looney determined. But it is becoming increasingly costly: the Treasury lost \$5–\$7 billion to it in 2016.

Looney reached the latter estimate by going through Internal Revenue Service forms 8283 and 990, although the latter documents—a standard for all nonprofits—were not terribly useful for this purpose. Of the top 21 organizations in terms of the amount of easements received, only six actually bothered to report them on their 990s. He suggests that this omission may obscure the fact that some of these charities are not, in fact, charities in any real sense of the word but instead act more or less as private foundations, and that closer scrutiny by the IRS would force them to conclude as much. This is now among the IRS's most litigated tax issues, despite the low number of taxpayers who claim the deduction.

This lack of transparency may persist indefinitely, Looney laments. An entity called Partners for Conservation lobbies to prevent any sort of mandated disclosure of such transactions. A provision that would prevent such reporting was included in a draft of an appropriations bill in 2016.

Greater transparency on such transactions is important because the tax revenue losses from conservation easements have been accelerating over the last few years. What's more, such easements occur most often in a few select geographic areas, most notably Georgia. Looney attributes this mainly to the fact that a small legal community there has figured out how to game the system, rather than any surfeit of land in need of conservation in the Peach State. In contrast, the states we commonly think of as being leaders in acres conserved—Wyoming, New Mexico, Maine,

Montana, New Hampshire, Washington, and Arizona—have virtually no conservation tax easements.

These benefits from the easement are also highly concentrated. The top 2% of all transactions amounted to 43% of the cost of all easement tax breaks, and the top 10% amounted to fully 70% of the cost. The valuation of the land in these easements ranged from \$10,000 an acre to over \$100,000. Prospectuses published by lawyers hoping to earn fees for creating new easements suggest an investor can obtain \$6–\$9 of tax deductions for every \$1 invested in an easement.

Our tax code has many such dubious tax breaks ostensibly designed to promote conservation of some sort that accomplishes little in this regard. For instance, a great number of summer lake homes in Wisconsin come attached to relatively large

lots, the preponderance of which are just over 17 acres. This is because 17 acres once was the minimum size for a property to be considered a tree farm in the state. Being a "tree farmer" was a great tax dodge because tree farmers had to show a profit from the activity only once every 17 years, instead of every three years for other businesses. The thousands of "tree farmers" in the state could deduct a variety of expenses related to the upkeep of their cabins, and every so often they would have someone harvest a few trees that paid them enough to show a profit for the year.

Wisconsin now has a Managed Forest Law that was crafted to avoid the abuses of the tree farm law. The new law greatly reduces the property tax on land that's at least 40 acres, available for recreation, and undeveloped. But, unsurprisingly, there are easy ways to still put a house on the land, deny access to hunters and hikers, and get the low tax rate just the same.

Many people still have a perception that giving a tax break to induce behavior is somehow inherently different and less expensive than a government expenditure. However, the distinction is meaningless, and when most of a tax break fails to affect any salutary behavior at all while costing the public fisc billions a year, it is an abomination. We should all be outraged by the results of Looney's research.

—Ike Brannon

## Investment Advice

"The Misguided Beliefs of Financial Advisors," by Juhani T. Linnainmaa, Brian T. Melzer, and Alessandro Previtero. December 2017. SSRN #3101426.

In 1934 Congress created the Securities and Exchange Commission, which regulated brokers who bought and sold stocks and bonds for investors. In 1940 Congress enacted the Investment Advisers Act, which implemented different legal standards for those who provided financial advice for a fee but do not sell finan-

## IN REVIEW

cial products. Interestingly, the 1940 law holds financial advisers to a stricter fiduciary standard, requiring them to recommend the “best” financial product to clients, while brokers under the 1934 law are only required to recommend “suitable” financial products if their advice is “solely incidental” to their service as a broker.

This has produced a legal and political wrestling match over the different regulatory treatment of brokers and financial advisers. The perception is that brokers operating under the looser standard have incentives to steer clients to purchase investments that yield fees and commissions for the brokers rather than investments whose net returns to the brokers’ customers would be higher, and that regulation is required to eliminate those incentives and the resulting financial malpractice.

After the 2008 financial crisis, the original Senate version of financial reform legislation authored by Sen. Chris Dodd would have eliminated the broker exemption from the fiduciary standard. But as enacted, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 only requires the SEC to study the issue and report to Congress on the problems created by the differential regulatory treatment of financial advisers and brokers.

Given congressional inaction, President Barack Obama

*The investment advisers traded more, had less diversified portfolios, and paid more in fees for their own accounts relative to their clients’ accounts.*

instructed the Department of Labor to impose the stricter fiduciary rule on Individual Retirement Account advisers using the DOL’s regulatory authority over company-provided retirement plans under the Employee Retirement Income Security Act of 1974 (better known as ERISA). The DOL did so in 2016, but advisers have not had to comply with this requirement thanks in part to the Trump administration pushing back the compliance deadline to July 1, 2019. This past March, the Fifth Circuit Court of Appeals vacated the Fiduciary Rule, stating that the DOL had overstepped its statutory authority.

The authors of this paper argue that the “conflict-of-interest” view of financial advice that is the rationale for the fiduciary rule is not consistent with the data studied in the paper. The authors had access to trading and portfolio information on more than 4,000 advisers and almost 500,000 clients between 1999 and 2013 provided by two large Canadian financial institutions. These advisers were not subject to fiduciary duty under Canadian law. A comparison of advisers’ trades for their own accounts and their clients would reveal any systematic differences. If the conflict-of-interest theory is right, advisers’ personal accounts would hold lower-cost, more diversified investments.

The authors conclude that misguided beliefs are the problem

rather than conflicts of interest. The advisers trade more, have less diversified portfolios, and pay more in fees for their own accounts relative to their clients’ accounts. And both have net returns that are about 3% less than the market.

The authors present four additional types of evidence to support their argument. First, advisers continue to trade similarly after they quit the industry. Second, the correlation between their behavior and their clients’ increases with the size of the advisers’ personal portfolios. Third, advisers would have been better off had they held exact copies of their clients’ portfolios. Finally, advisers’ trading behavior is stable over their career.

—Peter Van Doren

## Environmental Regulation

*“Is Pollution Value-Maximizing? The DuPont Case,”* by Roy Shapira and Luigi Zingales. September 2017. NBER #23866.

Gary Becker introduced the economic conception of crime deterrence in 1968. According to Becker, prospective criminals compare the expected costs and benefits of crime. That is, they compare the benefits of the criminal conduct to the probability of being caught multiplied by the monetized cost of conviction. If the expected costs of the crime are greater than the benefits, then the crime is deterred. If the expected costs are less than the expected benefits, then the crime occurs.

This paper explores rational deterrence in the context of environmental law. DuPont emitted C8, a precursor to Teflon, into the environment even though it knew as early as 1984 that the substance is toxic. DuPont had the option to incinerate the C8 and thus avoid the emissions, but the firm chose not to. In fact, production doubled after 1984.

The option of abating C8 was relatively cheap and could have prevented the health damages as well as the legal (\$617 million in 2017) and reputational damages paid by DuPont. Why did the company choose the option that seems worse for the company and certainly worse for society?

By comparing the present value of DuPont’s actual legal liabilities with the present value of the abatement costs, the authors estimate that it was value-maximizing to pollute if the probability of getting caught was less than 19%. According to the authors:

For decades only DuPont and other chemical companies knew the adverse effects of C8 emissions. Yet, DuPont had powerful incentives to hide that information, or selectively release parts of it to the outside world. By controlling information, DuPont was able to co-opt regulators, delay enforcement, and limit the ability of academics or journalists to chime in.

Because DuPont controlled the information that would have increased the expected costs of pollution, it was reasonable for DuPont’s executives to take the risk. In other words, the decision to pollute was ex-ante optimal for DuPont’s shareholders. —P.V.D.

## Market Power

"Is Aggregate Market Power Increasing? Production Trends Using Financial Statements," by James Traina. February 2018. SSRN #3120849.

**C**oncerns about corporate power and antitrust policy remedies are once again in the news and the pages of *Regulation*. (See "Debunking the 'Network Effects' Bogeyman," Winter 2017–2018, "The Return of Antitrust?" Spring 2018.) This paper examines the specific question of whether business markups above the marginal costs of production are also increasing over time.

Traina argues that in 1950 markups were about 15% over marginal cost. Over the next 30 years, they decreased approximately linearly, falling to just under 10% over marginal cost at the beginning of the 1980s. From then until today, however, they have increased approximately linearly, returning to the 1950 level.

His estimates of this markup differ from others because of two methodological differences. First, public firms make up only about a third of U.S. sales and employment. Because these firms are often larger than private firms, markup estimates using only public-firm data bias an aggregate estimate upward. Second, neglecting indirect costs of production such as marketing and management, which are an increasing share of variable costs for firms, overstates both the level and growth in markups. As a share of variable costs for firms, these components have increased from roughly 12% in 1950 to 22% today. A significant part of the incorrect markup estimation is misattribution of selling and general administrative expenses to markups rather than variable costs, and this omission has increased over time.

—P.V.D.

## Employer Credit Checks

"The Unintended Consequences of Employer Credit Check Bans on Labor and Credit Markets," by Kristle Cortes, Andrew Glover, and Murat Tasci. January 2018. SSRN #3103294.

**R**egulations are often enacted with the best of intentions, but they sometimes produce counterintuitive results.

In my Fall 2016 Working Papers column, I described laws that "ban the box," prohibiting employers from asking about criminal history on initial job applications. The intent of such policies is to increase employment among black males, who have disproportionately more criminal convictions than other applicant groups. Most black men, however, do not have criminal convictions. Under ban-the-box policies, they are not allowed to signal that fact to employers. As a result, they lose work opportunities because employers, deprived of the crimi-

nal history information, become less likely to hire black men.

Something similar appears to be happening with credit history information. In the aftermath of the Great Recession, many people lost their jobs and fell behind on their debts. When these people subsequently applied for jobs, some were denied employment when prospective employers became aware of the applicants' low credit scores. Legislators responded by describing this situation as a "poverty trap" because the applicants need employment in order to repair their credit scores, but they need better credit scores in order to gain employment. In response, 11 states banned employer credit checks as of January 2018.

This paper compares employment vacancy creation in states that enacted bans relative to states that did not and relative to exempt occupations in which credit score checks were still allowed (e.g., jobs involving handling cash or access to payroll and Social Security information). When a state bans employer credit checks, the average county experiences a 12% reduction in vacancy creation relative to trend. This decline in job creation is likely caused by the bans because vacancies are unaffected in occupations in which credit checks are still allowed.

—P.V.D.

## Disability Insurance

"Intergenerational Spillovers in Disability Insurance," by Gordon B. Dahl and Anne C. Gielen. February 2018. NBER #24296.

**U**niversity of California, San Diego economist Gordon Dahl has devoted much of his career to examining the efficiency and distributional effects of social welfare policies. In my Summer 2014 Working Papers column, I summarized his analysis of expansion of maternal leave benefits in Norway. Dahl and his co-authors concluded that the program had no effect on a wide variety of desired outcomes and instead redistributed income to the affluent.

This paper evaluates the long-term effects of reductions in disability benefits in the Netherlands between 1993 and 1996. The reductions applied to younger cohorts, while older cohorts were exempted from the new rules. Younger workers who were pushed out of disability insurance or had their benefits reduced are now, a generation later, 11% less likely to receive disability benefits than their parents' generation (with no increased use of other government safety net programs). Further, they earn 2% more in the labor market as adults.

The combination of reduced government transfers and increased tax revenue from lower use of disability benefits resulted in a fiscal gain of €5,900 per treated parent from child spillovers by 2014. Moreover, children of treated parents complete an extra 0.12 years of schooling on average, an investment consistent with an anticipated future with less reliance on disability insurance. Ignoring the beneficial parent-to-child spillovers understates the long-run benefits of the Dutch reform by 21%–40% in present discounted value terms.

—P.V.D. R

## FINAL WORD ➞ BY TIM ROWLAND

## Siding with the Nerds

Like millions of other Americans this spring, I received a notification that a “friend” had logged into Facebook using an app that funneled data to Cambridge Analytica, a digital Rumpelstiltskin that managed to spin gold from the bottomless chum bucket of social media.

Facebook, bless its heart, recommended that I go into “settings” and perform a series of occult maneuvers that would ensure, I guess, that Russian hackers could never access my account and discover that I have two exceedingly handsome dogs named Addie and Pete.

I didn’t do it. Instead, I treated the notice the same way I treat the message that my computer is likely to go all nuclear-fission because I didn’t eject my flash drive properly.

Not so congressional Luddites who, feeding off American outrage as if it were ketchup on a well-done steak, hauled poor Facebook chief Mark Zuckerberg into the Capitol’s hallowed halls to grill him over matters involving what they called “the Facebook.”

Predictably, grizzled lawmakers who wouldn’t know a hard drive from a hard-boiled egg embarrassed themselves by stumbling over the words “device” and “tablet” and by asking how Facebook makes money if it doesn’t charge its customers—which is like asking how CBS makes money on March Madness if it doesn’t charge the players.

For the first time in my life I sided with a computer nerd. Zuckerberg took the “mistakes were made” approach,

but I wish he hadn’t even done that. I wish he’d looked them right in the eye and said: “Newsflash: Facebook is social media. Not the *Encyclopedia Britannica*, social media. It’s a commercial entertainment site that people visit voluntarily, and of course it’s going to be used for manipulation, just like Febreze uses television to suggest you need its product even if you don’t smell anything, because you’ve obviously gone ‘nose blind.’”

Two issues, rivaling each other for silliness, are being tossed about in the Great Facebook Debacle of ’18. One is that the Russians used social media to drive our malleable, child-like public into electing Donald Trump. The second is that Facebook has compromised our God-given right to privacy.

As to the first, who knows the truth? Maybe Russian memes did push that last handful of people in that last handful of states into voting for Trump. Or, more likely, maybe the messages just further ginned up already virulently anti-Hillary

voters. But even if a few more people did pull the lever for Trump because of Facebook, so what? Sometimes an umpire’s bad call affects the game. But the outcome is a lot more complex than one bang-bang play at the plate. In the final analysis, anyone with an imagination vivid enough to believe that immigrants are harvesting the organs of school children for use in satanic rituals is probably not going to vote for someone as technocratically boring as Hillary Clinton in the first place.

Far more worrisome is the possibility that our voting machines could be physically hacked. Naturally, that is the part of the equation that virtually everyone dismisses.

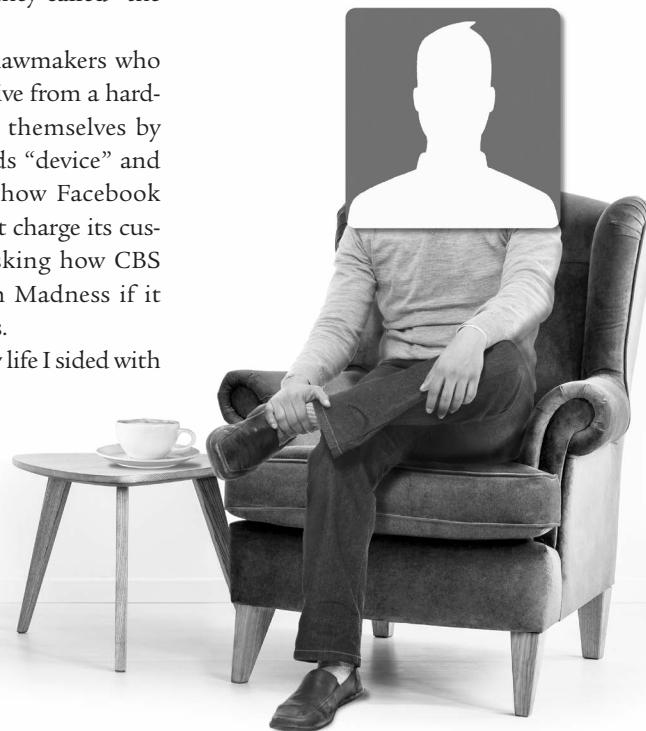
Privacy, meanwhile, is the imaginary life preserver that people like to fall back on when they are doing things they ought not. The right to privacy is not explicitly guaranteed by the Constitution, though a lot of the important things we want covered by it are: speech, assembly, religion, and protection from willy-nilly government searches, wiretaps, and the like. But we hardly need to plumb the depths of the Ninth and Tenth Amendments to remember that the Constitution is about restraining government, not something a nerd whipped up in his dorm room.

And what, exactly, about Facebook can be considered intrusive? Social media is a guest we have invited into our homes. So what part of “social” do federal lawmakers have trouble understanding? It’s like we’re caught doing something embarrassing on the subway and we get angry that people noticed.

Anytime electrons are flying through the air, we should simply assume that they are subject to being netted by someone for whom they are not necessarily intended. And conversely, we must assume that what we see incoming on our screens is not always going to be as it appears.

We expect a bank to take ample precautions against playing fast and loose with our data. But Facebook? Please. On social media, we have no guaranteed right of privacy. But we do—or we should in this increasingly digital age—have the right not to be stupid.

**TIM ROWLAND** is a columnist for the (Hagerstown, MD) *Herald-Mail* newspaper and author of the books *Strange and Obscure Stories of Washington, DC* and *Strange and Obscure Stories of New York City*.



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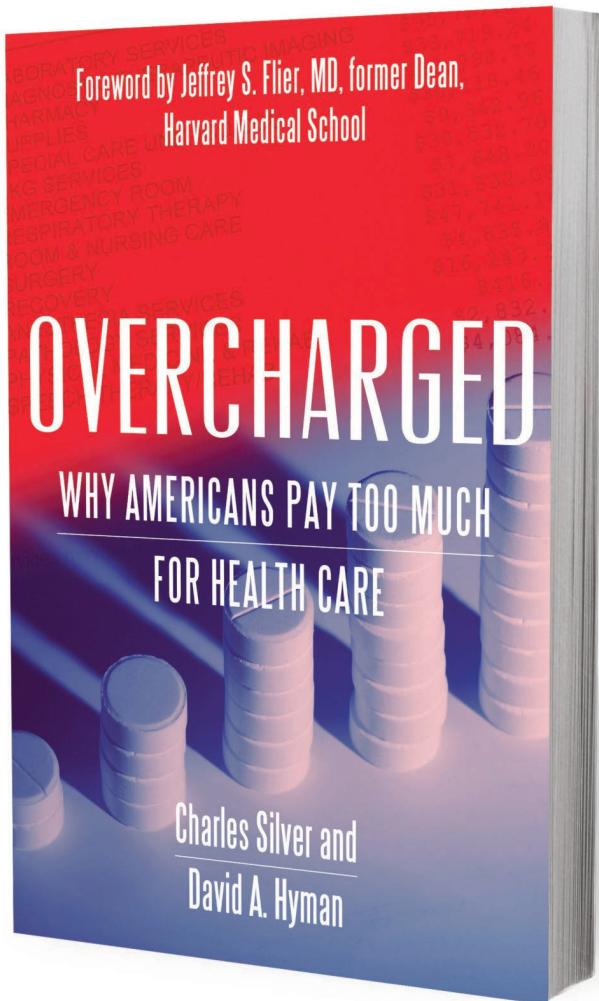
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