

IN REVIEW

Challenging Our Grim Biases

◆ REVIEW BY PHIL R. MURRAY

Factfulness is a family effort. Hans Rosling, who passed away in 2017, was a physician, “a global health professor,” a statistician, a dynamic lecturer, and—a crowd-pleasing element of his lectures—a sword swallower. Ola Rosling is his son; Anna Rosling Rönnlund is Hans’s daughter-in-law. The trio founded Gapminder,

a Swedish foundation that they describe as “a fact tank, not a think tank,” intended to fight “devastating misconceptions about global development.” When Hans’s death left the book unfinished; Ola and Anna stepped in, writing in Hans’s voice.

By “factfulness,” the authors mean “a set of thinking tools.” Likewise, *Factfulness* “is about the world and how to understand it.”

Gap instinct / How much do you know about the world? The Roslings offer a quiz to test your knowledge. Consider one of their questions:

In all low-income countries across the world today, how many girls finish primary school?

- a. 20%
- b. 40%
- c. 60%

The answer is (c), yet the Roslings found that on average just 7% of respondents picked that answer. Note that if people randomly selected an answer, 33% would choose the correct one. The results are similar on other questions. The Roslings summarize: “Everyone seems to get the world devastatingly wrong. Not only devastatingly wrong, but *systematically* wrong.”

The typical Gapminder survey asks 12 such questions, each accompanied by three possible answers. (Test yourself: www.gapminder.org/test/2017.) Again, if answering randomly, the average test-taker should get four of the 12 questions right. The Roslings quizzed thousands of people, who achieved

a mean score of 2.2 correct answers. Because 2.2 is statistically significantly below the expected value from guessing, we must conclude that people are not just uninformed, but biased. The Roslings call this bias an “overdramatic worldview” and recommend a “fact-based worldview.”

They argue that the overdramatic worldview is based on 10 pitfalls in the way we think. Take the “gap instinct,” which they describe as “that irresistible temptation we have to divide all kinds of things into two distinct and often conflicting groups, with an imagined gap—a huge chasm of injustice—in between.” We think in terms of rich versus poor. “When people say ‘developing’ and ‘developed,’” they explain, “what they are probably thinking is ‘poor countries’ and ‘rich countries.’” Other divisions include “West/rest [of the world],” “north/south,” and “low-income/high-income.”

In their terminology, there are “four income levels.” One billion of the world’s population live at what they designate as Level 1, with no more than \$2 in income per day. Three billion live on Level 2, with between \$2 and \$8 per day. Two billion live on Level 3, with between \$8 and \$32 per day. Finally, 1 billion live on Level 4, with at least \$32 in income per day. Thus, the greatest majority—5 billion of 7 billion, or 71% of the world’s population—live on Levels 2 and 3, receiving between \$2 and \$32 per day. The Roslings claim that recognizing there are four income levels is the “most important part of your new fact-based framework.” Hans persuaded the World Bank to classify countries according to the four income levels, though his campaign took nearly two decades.

Perhaps the reader, who the Roslings guess has an income on Level 4, is unaccustomed to thinking in terms of daily income. Note that the midpoint of Level 4, \$64 per day, amounts to \$23,360 per year. If that seems like a modest income, imagine living on Level 1, with \$2 per day. What we imagine will be skewed. The authors liken imagining what life is like on Levels 1, 2, and 3 from a viewpoint on Level 4 to standing on top of a skyscraper and estimating the heights of objects below. “When you live on Level 4,” they observe, “everyone on Levels 3, 2, and 1 can look equally poor, and the word poor can lose any specific meaning.”

To achieve a proper perspective, they recommend traveling. Owing to the impracticality of travel, Rosling Rönnlund developed the website *Dollar Street* “to teach armchair travelers about the world.” Visitors to www.dollarstreet.org may view pictures of families around the world, their incomes, possessions, and more. “What the photos make clear,” the Roslings say, “is that the main factor that affects how people live is not their religion, their culture, or the country they live in, but their income.” *Dollar Street* helps to overcome the gap instinct.

Getting better / Many people think the state of the world is regressing. Ask Grandma and Grandpa what’s worse about today’s society compared to the past, and don’t be surprised if they say crime. To the contrary, the Roslings show that the absolute number of crimes in the United States has fallen from about 15 million in 1990 to about 10 million in 2016 despite the population increasing by nearly 30%.

Most people around the world do not know that the percentage of the world’s population whose daily income is below \$2 (real) per day is steadily declining. The Roslings show that it has fallen from 85% in 1800 to 9% last year. Most people are wrong about the state of the world because we suffer from “the negativity instinct: our tendency to notice the bad more than the good.”

In reality, many diverse indicators of human flourishing, such as cellphone ownership, availability of clean water, and vaccination, are trending up. And many indicators of human suffering, such as hunger, pollution, and disease, are trending down. “In fact,” the Roslings note, “almost every country has improved by almost every measure.” This does not mean all is well: “things can be both bad and better” than before. This reviewer adds, things continue to get better.

Recall Adam Smith’s observation, “There is much ruin in a nation.” The Roslings’ 21st century twist is, “Expect bad news.” That’s one way of countering the negativity instinct. Setbacks, such as the number of deaths from a given natural disaster, tend to be tragic, noticeable, and reported. For example, the Roslings remind us that an earthquake in Nepal in 2015 killed 9,000 people. Those of us who watch the news saw that. Advances, such as a decline in the number of deaths from natural disasters over time, tend to be slow, unnoticed, and unreported, but they are both real and important. One of the Roslings’ charts shows that the death toll from natural disasters fell from 971,000 in the 1930s to 72,000 in 2010–2016. That decline was probably not in the news, but it certainly is noteworthy. Acquiring a perspective of “factfulness” requires study.

An informed citizen of the world knows that the world population is over 7 billion and rising. He or she may have Malthusian notions about that. That is, the typical citizen expects the world population to continue growing geometrically, and reasons that at some point so many people will cause problems. The error in this view is “the straight-line instinct”: assuming that something increasing will continue to increase at the same rate. Countering

that, the Roslings offer interesting lessons in demographic history and future trends.

They begin by showing a picture of the world population over the very long run that looks similar to the “hockey stick of human prosperity.” (See “From the Republic of Letters to the Great Enrichment,” Summer 2018.) The population was essentially flat for millennia; then it zoomed upward in the 19th century. Demographers now predict that this exponential population growth will stop. In what the Roslings call “the most dramatic” data they present, female fertility plunged from five babies per woman in the 1960s to 2.5 today. Demographers expect that number will fall to about two children in the future. They predict the world’s population will increase from 7 billion today to 11 billion in 2075 “mainly because the children who already exist today are going to grow up,” But then the population will plateau. When parents simply replace themselves with two children, population growth will halt.

The Roslings attribute the decline in the fertility rate to rising incomes. Higher incomes enable more children to survive, reduce the demand for child labor, increase the demand for education, and pay for birth control. The lesson in particular is that the world population will eventually level off; we may someday see doomsday books warning of impending underpopulation. The lesson in general is to expect current trends to change course.

Markets / This reviewer thinks markets work well in general. When a market is malfunctioning, he suspects government intervention is the cause. Remove the intervention and expect the market to work better.

This sort of thinking is what the Roslings call “the single perspective instinct”: a “preference for single causes

and single solutions.” They disapprove of this perspective: “Being always in favor of or always against any particular idea makes you blind to information that doesn’t fit your perspective. This is usually a bad approach if you like to understand reality.”

They put forth the following fact as inconsistent with a free-market proponent’s view of the world: “The United States spends more than twice as much per capita on health care as other capitalist countries on Level 4—around \$9,400 compared to around \$3,600—and for that money its citizens can expect lives that are three years shorter.” If Americans devote more resources to health care, why do they have lower life expectancy? The Roslings think they know the answer:

It is the absence of the basic public health insurance that citizens of most other countries on Level 4 take for granted. Under the current US system, rich, insured patients visit doctors more than they need, running up costs, while poor patients cannot afford even simple, inexpensive treatments and die younger than they should.

Maybe I’m blinded by free-market ideology, but doesn’t exempting health care compensation from taxes induce consumers to choose more health care relative to other goods? Aren’t U.S. government officials spending a significant share of the total spent on health care—and spending it primarily on the poor and elderly? Isn’t health care subject to many government regulations?

Despite the Roslings’ conviction that a larger role of government in health care would produce better results in the United States, they also see problems in the government provision of health care. “The challenge,” they write, “is to find the right balance between regulation and freedom.” They convince this reviewer that they genuinely appreciate freedom.

Readers of *Factfulness* will learn of many reasons to be optimistic about the world. Hans Rosling nevertheless described himself as a “possibilist,” not an optimist. By the former he meant a realist, and he was



Factfulness: Ten Reasons We're Wrong about the World—and Why Things Are Better Than You Think

By Hans Rosling with Ola Rosling and Anna Rosling Rönnlund

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realistic that humanity still faces many challenges.

According to the Roslings, these issues deserve our attention: “global pandemic, financial collapse, world war, climate change, and extreme poverty.” Their recommendations for each are brief. To contain worldwide outbreaks of disease, they recommend widely available medical care and an active World Health Organization. To prevent financial crisis, they wonder whether a “simpler system” would help. They do not describe what that system would look like.

In order to avoid war, “We need Olympic Games, international trade, educational exchange programs, free internet—anything that lets us meet across ethnic groups and country borders.” They do not name the nations they consider at particular risk of conflict, but this line gives us insight into their thinking: “It is a huge diplomatic challenge to prevent the proud and nostalgic nations with a violent track record from attacking others now that they are losing their grip on the world market.”

Global warming, in their estimation,

“poses an enormous threat,” yet they do not explain why global warming is costly, let alone perilous. They trust the United Nations to manage the problem.

To maintain progress in reducing poverty, the authors endorse these “solutions: peace, schooling, universal basic health care, electricity, clean water, toilets, contraceptives, and microcredits to get market forces started.” Despite the implication that the introduction of those “solutions” is sufficient for economic development, the authors realize that development is challenging.

The Roslings do not explicitly mention rational ignorance to explain why we do not know the good news about the world. They allude to it, however. We may infer that we have more to gain by learning the story of human progress than we must expend to learn it. Becoming literate in the field of human progress is becoming as crucial as old-fashioned literacy and numeracy. The Roslings’ story-telling, innovative displays of data, and enlightening lessons are a fine place to start. R

power of today’s agencies is unwarranted.

In *Bureaucracy in America*, political scientist Joseph Postell of the University of Colorado at Colorado Springs pushes back strongly against the idea that our forebears were not concerned about administrative power. In his broad historical overview, he shows that early Americans were in fact deeply concerned about keeping administration within constitutional bounds through electoral accountability, decentralization, nondelegation, separation of powers, and the rule of law. Moreover, as the administrative state began to develop late in the 19th century, arguments were constantly made that agencies such as the Interstate Commerce Commission had to accomplish their legitimate objectives *within our constitutional framework*.

While the progressives eventually won out and, especially under Franklin D. Roosevelt, were able to create administrative agencies that combine legislative, executive, and judicial functions under one politically unaccountable roof, many Americans, including some prominent liberals, remained opposed. Today, constitutional arguments over the proper scope of administrative power still ring out in Congress and the courts, and rightly so.

Constraining the fourth branch / Postell makes it clear that colonial Americans did not generally hold a *laissez faire* view regarding the enforcement of laws and norms, but they insisted that such enforcement be done through officials who were accountable for their actions. In the system they adopted, judicial officers enforced laws enacted by their representatives in the legislature. Crucially, those judicial officers were subject to common law damage suits if they committed wrongs against individuals. Those early Americans would have been aghast at today’s concept of law enforcement by appointed minions who are above the law. As Postell puts it, “Colonial Americans refused to subject themselves to potentially arbitrary authorities that could make, execute, and adjudicate law against individual citizens.”

The Constitution vs. the Bureaucracy

◆ REVIEW BY GEORGE LEEF

One of the most controversial books to come out of the legal academy in many years was Columbia law professor Philip Hamburger’s *Is Administrative Law Unlawful?* (See “The Rise of Prerogative Power,” Summer 2015.) In it, he argues that the vast administrative state—that maze of regulatory agencies that now exerts

so much power over our lives—is simply incompatible with key elements of our constitutional order. Those agencies combine law-making, executive, and judicial functions that the Founders were adamant must be kept separate. The separation of powers was essential to their plan of limiting government and thereby protecting citizens’ liberty and property.

Hamburger’s case rested largely on his account of British history, particularly the battles against royal prerogative. Some scholars have argued that he isn’t always right in his interpretation of those events, leading them to suggest that his whole thesis on the legitimacy of the modern administrative state is mistaken. They purport to find that early Americans were fairly content with administrative authority and therefore conclude that the fuss over the

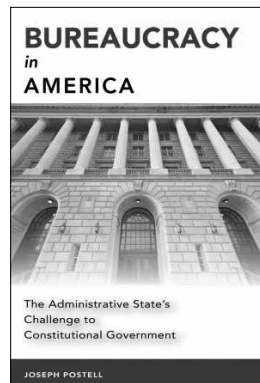
After securing independence from Britain, Americans proceeded to write their views on the proper creation and administration of law into the Constitution. The men who drafted it took pains to ensure that governmental power would only be used for the public good and their belief was that the best way to achieve that would be to maintain an immediate connection between the lawmakers and the people they represent. For that reason, delegation of power to make and enforce the law was forbidden. Defenders of today's administrative state cannot plausibly claim, Postell argues, that there is "a hole in the Constitution" regarding the "fourth branch" of government. The Founders foresaw the troubles that would arise if government authority was not constrained by that immediate connection to the people and crafted the Constitution to prevent them.

As the United States moved into the 19th century, problems not dissimilar to modern ones began to surface, including relief for the poor, the building of infrastructure, public health concerns, regulation of common carriers, and the supposed need to help business and agriculture with subsidies. All of that called for efficient administration, but Americans insisted on the separation of powers and official accountability in doing it. States established, for example, boards of health and sanitation. The administrators who ran them had to follow legislated or common law rules; unlike today's administrators, they were not autonomous.

Pennsylvania's Canal Board is illustrative. Once established, the board was authorized to set tolls on canals, but within a few years the legislature decided to strip that power from it and set tolls by statute. And, Postell writes, "Other regulations regarding how canals were to be built

and repaired were enacted not by the Board itself but by the legislature."

In *Democracy in America*, Alexis de Tocqueville noticed how Americans insisted on dividing government power. Postell quotes him: Americans diminish government power "by dividing the use of [society's] forces among several hands.... In partitioning authority in this way, one renders its action less irresistible and less dangerous, but one does not destroy it." In this manner, "authority is great and the official small, so that society would continue to be well regulated and remain free."



Bureaucracy in America: The Administrative State's Challenge to Constitutional Government

By Joseph Postell
403 pp.; University of Missouri Press, 2017

That commitment to constraining administrative authority did not abate during the nation's rapid growth following the Civil War. In the 1880s, two significant bills were enacted that, some claim, sowed the seeds of the modern administrative state: the Pendleton Act of 1883 (creating a civil service system based on competitive examination rather than political favor, as had previously been the case) and the Interstate Commerce Act of 1887 (intended to control perceived abuses by railroads).

Postell rejects that claim, writing, "The Pendleton Act and the ICC Act did *not* reflect a commitment to the idea of an administrative state, nor were they intended to eventuate in the modern administrative state we have today." The former simply represented widespread disgust at the corrupt political patronage system and the latter "was a cautious reform aimed at providing for expertise in investigating abuses, without doing damage to established constitutional principles."

Progressive breakthrough/ It was not until the early decades of the 20th century that advocates of the administrative state began to break down those constitutional principles and create the kinds of agencies that progressives wanted—agencies

staffed with experts who were empowered to scientifically direct society to its optimum. They argued that the Constitution was outmoded and should be scrapped in favor of centralized power necessary to cope with contemporary problems. Their breakthrough, Postell shows, came with the Hepburn Act of 1906, which gave the Interstate Commerce Commission the power to set railroad rates and adjudicate any controversies. Not long afterward did courts begin to retreat from adherence to the Constitution, adopting a posture of deference toward the actions of administrative agencies.

Despite that breakthrough, many Americans, including some famous legal scholars who were sympathetic to progressive aims, worried that the new system was undermining the rule of law. Most notably, Ernst Freund and Roscoe Pound raised concerns about the danger of centralized, unaccountable power. Their arguments, however, fell mostly on deaf ears and by the time FDR assumed the presidency, the table was set for rapid growth of the modern administrative state. During the New Deal, he established a host of agencies combining lawmaking, executive, and judicial power.

Constitutional pushback/ Nevertheless, the old notions about separation of power and nondelegation persisted. In the 1935 *Schechter Poultry* case, which struck down the National Industrial Recovery Act on those grounds, liberal Justice Benjamin Cardozo decried "delegation run riot." Justice Louis Brandeis told a group of FDR's insiders, "I want you to go back and tell the President that we're not going to let this government centralize everything."

The constitutional ideas couldn't be killed.

Dissatisfaction with the administrative state led to bipartisan action in Congress: the 1946 Administrative Procedure Act (APA), meant to rein in the agencies and compel them to abide by fair processes subject to judicial oversight. Rep. Samuel Hobbs of Alabama spoke for many when he said, "It seems to me that the Constitu-

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tion has divided the powers of Government into three coordinate branches, the legislative, executive, and judicial. These have been swallowed up by some administrators and their staffs who apparently believe that they were omnipotent.” Although the APA has had less effect on the bureaucracy than many of its supporters hoped, it did show the widespread dissatisfaction with the despotism of “fourth branch” bureaucrats.

The 1960s and early 1970s saw a profusion of new federal agencies devoted not to economic but rather social regulation, such as the Environmental Protection Agency, Occupational Safety and Health Administration, and Equal Employment Opportunity Commission. When Richard Nixon tried to assert more control over those (and the older) agencies, he was annoyed to discover that key personnel had been drawn into the orbit of their agendas and resisted presidential influence.

About the same time, however, the left took notice of the tendency for administrative agencies to become captured by the interests they were expected to control. That gave them a serious case of, as Postell writes, “buyer’s remorse.” Realizing that the administrative state didn’t necessarily produce the results they had expected, leftists began to demand that courts stop deferring to agency procedures and decisions, but instead vigorously oversee them. According to Postell,

Their remedy was not to return to the earlier, nineteenth-century approach to regulation and administration but, rather, to use procedural requirements and new standing doctrines to democratize the administrative agencies, preventing them from being captured and turning from the public interest.

Conservatives, on the other hand, did an about-face of their own, calling for the courts to show more deference to the agencies. That’s the origin of the much-debated “*Chevron* deference” doctrine.

Conclusion / Postell has written a deeply researched, provocative book on the history of administrative power in America.

After it, the argument that the administrative state was somehow implicit in our governmental arrangements all along simply won’t hold water. The administrative state emphatically *does* run contrary to our constitutional principles. Just as important, the book suggests that modern Americans shouldn’t accept our administrative state as inevitable and permanent.

The Bitter Angels of Our Nature

◆ REVIEW BY DWIGHT R. LEE

The first six chapters of Yale law professor Amy Chua’s new book *Political Tribes* focus on the failure of American foreign policy to consider political tribes when trying to spread political democracy and economic prosperity. This discussion, which makes up more than half of the book, will find support among most on the American political left and many on the right, especially the libertarian right.

Capitalism and democracy are mentioned in broad generic terms. Chua sees them as desirable complements, but she faults American foreign policy for considering them in terms of

ideological battles—Capitalism versus Communism, Democracy versus Authoritarianism, the “Free World” versus “the Axis of Evil”—[that blind us to] more primal group identities, which for billions are the most powerful and meaningful, and which drive political upheaval all over the world.

To illustrate, she quotes President George W. Bush’s comment that “freedom and democracy will always and everywhere have greater appeal than the slogans of hatred.” Remaining bipartisan, she also quotes President Barack Obama’s “unyielding belief”

Why couldn’t Congress stop delegating, and itself take responsibility for writing whatever laws might be necessary? It used to. Why can’t administrative officials be held responsible for wrongful conduct? They used to be. The progressive sea change in our political structure *could be* reversed and *Bureaucracy in America* is a good foundation for such a project. R

that all people yearn for certain things: the ability to speak your own mind and have a say in how you are governed; confidence in the rule of law and the equal administration of justice; government that is transparent and doesn’t steal from the people; the freedom to live as you choose. Those are not just American ideas, they are human rights, and that is why we will support them everywhere.

Chua’s fundamental argument is that the “great Enlightenment principals of ... liberalism, secularism, rationality, equality, free markets—do not provide the type of tribal group identity that human beings crave and have always craved.”

After applying her views on the emotional appeal of tribal identities internationally, she focuses on the influence of tribalism in American politics in her last three chapters, including her epilogue. For example, without completely dismissing the influence of Occupy Wall Street, she sees it as a failure because it “attracted so few members from the many disadvantaged groups it purported to be fighting for.” Instead, “the participants of Occupy

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were not the hungry or exploited, but rather relatively privileged self-identified activists ... [and] Occupy offered a meaningful tribe to such people.”

Among other interesting, and often frightening, implications of political tribalism in America that she considers, some of the most troubling deal with identity politics. For example, after quoting the *New Yorker* that the Woman’s March of January 21, 2017 was “so radiant with love and dissent, that’ the ‘coming together’ of all marginalized groups ‘seemed possible,’” she adds some realism by pointing out that “below the surface, however, political-tribe tensions plagued the march.” She explains the tensions (and insults) the “radiant love” motivated between black and

white women, as well as other provocations between other tribes, shouldn’t be surprising given negative-sum competition motivated by identity politics.

The book focuses on politics rather than economics, but public choice economists will connect Chua’s discussion to related insights. To me her book indicates why a sound economic argument that economists routinely make to criticize government policies is commonly unper-
suasive.

Ethnically oblivious / In her opening chapter on “American Exceptionalism,” Chua chronicles America’s deficiencies in matters of race. She makes the paradoxical argument that “what’s so peculiar about America [is that] we have been both exceptionally racist and exceptionally inclusive.” She quotes President Woodrow Wilson’s statement that “*you cannot become thorough Americans if you think of yourself in groups. America does not consist of groups*” (Chua’s emphasis). She recognizes that Wilson was a hard-core racist and sees his statement as “remarkable not only because of how false it was, but also because of

how much truth it holds, at least for certain major segments of the population.” “Even today,” she admits “the aftereffects of slavery still haunt America in the form of systemic inequality and injustice.” Yet she sees in a “seemingly contradictory way ... [that] through the alchemy of markets, democracy, intermarriage, and individualism, ... America has been uniquely successful in attracting and assimilating diverse populations.”

It seems natural for Americans to ask, if “immigrant communities from all sorts of background have become ‘Americans’; why wouldn’t Sunnis, and Shias, Arabs, and Kurds all similarly become ‘Iraqis’”? Our ability to overlook tribal differences is rooted in some of America’s “noblest ideals: tolerance, equality, individualism, the power of reason to triumph over irrational hatred, and the conviction that all men are united by their common humanity and love of liberty.” Unfortunately, it also “predisposes us to ignore ethnic, sectarian, and tribal divisions in the countries where we intervene.”

Chua closes out this chapter by highlighting one “successful” intervention that soon became a disaster that U.S. State Department officials wanted to forget. In the glow of “success” after toppling Libyan strongman Muammar Gaddafi by a U.S.-led coalition in 2011, President Obama declared, “One thing is clear—the future of Libya is now in the hands of the Libyan people.... It will be the Libyans who will build their new nation.”

Market-dominant minorities / Chua’s first detailed discussion of the failure of U.S. foreign policy concerns the Vietnam War. People still debate how America, with the most powerful military on the planet, managed to “lose to what Lyndon B. Johnson called ‘a piddling pissant little country.’” Chua’s answer is “millennia-old

ethnic conflict” and “political tribalism.”

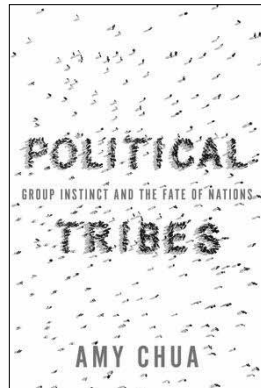
Without attempting a detailed account of her discussion of each American foreign-policy blunder in the book, it is useful to describe a common condition in developing countries, the ignorance of which helps explain many of those blunders. The condition is “market dominant minorities,” a term Chua coined in 2003. The term describes a situation in which

an ethnic minority tends, under market conditions, to dominate economically, often to a startling extent, the poor “indigenous” majority around them, generating enormous resentment among the majority, who see themselves as the rightful owners of the land under threat from “greedy” exploitative outsiders.

Market-dominant minorities “include Chinese throughout Southeast Asia, Indians in East Africa and parts of the Caribbean, Lebanese in West Africa and parts of the Caribbean, ... whites in South Africa, whites in Zimbabwe, whites in Namibia, Croats in the former Yugoslavia, Jews in post-Communist Russia, ... —[and] the list goes on.” In these and other examples, “intense ethnic resentment is almost invariable, leading frequently to confiscation of the minority’s assets, rioting, violence, and, all too often, ethnic cleansing. In these conditions, the pursuit of unfettered free-market policies makes things worse.”

If those conducting American foreign policy during the Vietnam War were aware of these “ethnic realities,” there’s no evidence of it. The portion of the \$100 billion-plus the United States spent on the war that reached the local population “ended up wildly disproportionately in the pockets of the ethnic Chinese,” the market dominant minority of Vietnam.

The blunders created by the U.S. invasions of Afghanistan and Iraq are also illuminated by the ethnic realities in those two countries that were largely ignored, at least initially. Chua provides an interesting explanation of the success of the 2007 surge in Iraq as “a concrete example



**Political Tribes:
Group Instinct and
the Fate of Nations**

By Amy Chua

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of what a more effective, tribal-politics-conscious U.S. foreign policy might look like.” She doesn’t explicitly mention market dominant minorities in her chapters on Afghanistan and Iraq, or in her following chapter on terrorism, but it is implicit in her emphasis in these chapters on the tribal satisfaction humans receive from dehumanizing outsiders and engaging in savagery that few of us would consider when acting alone.

A market dominant minority plays a clear role in Chua’s chapter on Venezuela and the political success of Hugo Chavez. The chapter begins with an interesting discussion of feminine beauty, which arguably is Venezuela’s most prominent industry after oil. Featured is Irene Saez, a Miss Venezuela who went on to win the Miss Universe title. Like all Miss Venezuelas up to that point, she was “light skinned with European features, bearing little resemblance to Venezuela’s darker skinned masses ... [which make up] the vast majority of the country’s population.” In 1998, the year Chavez was elected, “it was inconceivable [both in Venezuela and the U.S. State Department] that a person with Chavez’s complexion and ‘African’ features could become Miss Venezuela or the country’s president.”

Why did Chavez win? Because it was an election between “Venezuela’s dominant ‘white’ minority and its long-degraded, poorer, less educated, darker-skinned, indigenous- and African-blooded masses. Even today, partisan finger pointers in the United States have little understanding of the origins of the autocratic havoc now engulfing the country.” Maybe those finger pointers didn’t realize that Chavez’s opponent when he won the presidency in 1998 was the former Miss Universe, Irene Saez.

An important issue that Chua does not consider when discussing market dominant minorities is whether the poor are made better off by government policies that harm those minorities by imposing government restrictions on markets for the stated purpose of helping the poor. In Venezuela, for example, the rich were

creating wealth for the most part through market activity. Though that wealth was distributed far less equally than in the United States, it still provided more benefits to the poor than the economically destructive policies of Chavez (and now his hand-picked successor, Nicolás Maduro) even when considering the short-run benefits the poor received from government transfers. Yet it is surely true that many of the poor still have strong tribal affection for Chavez because of his resentment and ridicule of the market-dominant minorities they felt had stripped them of their wealth and dignity.

The bitter angels of our nature / In her last three chapters, Chua turns her attention to tribalism in America. The message is that it doesn’t take social gaps as large and rigid as those existing in many poor and developing countries to spawn political tribes. And those tribes can motivate emotions that render politically irrelevant the question of whether harming the wealthy helps the poor or hurts them.

In some respects, Chua’s argument in Chapter 7, “Inequality and the Tribal Chasm in America,” is puzzling. First, she states that

inequality is fracturing our nation. But just as America’s foreign policy establishment repeatedly fails to understand the group realities that matter most to people abroad, America’s elites have been blind to—or dismissive of—the group identities that matter most to ordinary Americans. If we want to understand our current political turmoil, we need to open our eyes to the vastly different group identities of America’s rich and poor.

Are there really many Americas who haven’t heard about income inequality in America? Obama did his part to “open our eyes” by claiming “the defining challenge of our time” is growing income inequality and a lack of upward mobility. Few issues have been more effectively used in recent years to justify identity politics. The result has been more people being treated as

members of victimized groups, with “social justice” requiring government programs and regulations directing attention and benefits on such groups, supposedly at the expense of the privileged. The problem Chua sees is “that the groups America’s have-nots belong to are often ones that elites view as antisocial, irrational, or even contemptible, if they even know about them at all.” Unfortunately, identity politics is more likely to tear us apart than to bring us together in ways that Charles Murray recommends in his 2013 book *Coming Apart*.

So is it inequality that is “fracturing our nation” as Chua indicates, or is it the political response to inequality that rewards the formation of tribes in ways that foment resentments and scorn between them? No doubt, both have worked together to explain the “tribalism in America [that] propelled Donald Trump to the White House.” She obviously understands the problems with tribalism, yet believes we have “to acknowledge the impact of inequality and the wedge it has driven between America’s whites.”

Whatever one blames for tribalism, no one can deny it exists and is motivating additional tribalism. According to Chua:

The Left believes that right-wing tribalization—bigotry, racism—is tearing the country apart. The Right believes that left-wing tribalization—identity politics, political correctness—is tearing the country apart. They are both right.

Yet, she doesn’t believe the “United States is in ... immediate danger of actually breaking up.” Hopefully she is correct. There is always an element of anger and contempt reflected in political debate, and American politics is no exception. But few would deny that the anger and contempt in political discourse has increased along with the growth in identity politics. Chua recognizes that identity politics is a product of both the Left and the Right, and the result is increased hostility between groups fighting for political advantage with complete confidence in the righteousness of their demands.

Unfortunately, those who see themselves fighting for righteous causes invariably also see themselves as facing evil enemies, with justice requiring harming those enemies even at the expense of harming themselves. As Chua points out,

In recent years, whether because of growing strength or growing frustration with the lack of progress, the Left has upped the ante. A shift in tone, rhetoric, and logic has moved identity politics away from inclusion—which had always been the Left’s watchword—toward exclusion and division.

Exclusion and division harm everyone, including those promoting exclusion and division. She contrasts this with Martin Luther King’s ideals, “the ideals that captured the imagination and hearts of the public and led to real change—transcended group divides and called for an America in which skin color didn’t matter.” The heartland supporters who propelled “Trump to the White House” were reacting against the “Coastal elites” whom the heartlanders see as “a kind of market dominant minority” who rig the economy against them and dismiss them as deplorable. The result is a level of resentment that justifies harming the elites even if it means also harming the heartlanders with trade restrictions.

There is nothing new about “cutting off one’s nose to spite one’s face,” and people are quite capable of such self-inflicted harm when acting out of anger and resentment as individuals. But there can be no doubt that tribal anger and resentment are particularly dangerous when people act politically. Political action greatly reduces the sense of individual responsibility and cost of going along with a crowd to harm others even if it means harming one’s self.

Political action makes it more likely that we will yield to the urging of *the bitter angels of our nature*, who tempt us more than we like to admit. Those angels, I suspect, explain why economists have been less persuasive than we wish when emphasizing the negative-sum consequences of government policies. R

Getting Government *More* Involved in Banking?

◆ REVIEW BY VERN MCKINLEY

In banking policy circles, there are issues that are argued over and over for decades on end. The fight over Glass-Steagall restrictions is one such example. The act was passed during the early 1930s, slowly reduced in scope during the 1970s and 1980s, and finally most of its restrictions were repealed with the Gramm-Leach-Bliley

Act of 1999 (GLBA). The financial crisis less than a decade later reanimated the conversation on banking activities, with many fingering the changes up to and including the GLBA as one of the causes of the financial crisis.

Another issue with a similarly long shelf life is the argument over allowing the post office to provide banking services. University of Georgia law professor Mehrsa Baradaran is one of the most high-profile advocates for a modernized version of a postal bank and she lays out her vision in *How the Other Half Banks*. Previously, she wrote *The Color of Money: Black Banking and the Racial Wealth Gap*.

Baradaran refers throughout *How the Other Half Banks* to a “social contract with the banks.” This contract has evolved over time, but its history shows that “banking policy has always been deeply intertwined with politics.” As an example, she points to the financial safety net for banks, which includes federal deposit insurance, the ability to borrow from the Federal Reserve, and government bailouts. Those interventions, she argues, justify policies to help the unbanked: “Many describe modern banks as private enterprises but this is illusory.... To be sure, individual banks are private companies, but each of these private banks sits atop a foundation of state support.” The implication is that financial institutions cannot survive without some form of government backstop.

Emotional appeal/ The title of the book is a clever twist on *How the Other Half Lives*, Jacob Riis’ 1890 photojournalism exposé of abysmal living conditions in New York City during the Gilded Age. The book was a classic example of muckraking journalism intended to appeal to people’s emotions to bring about social change. Similarly, Baradaran’s goal is to present the dire situation that the unbanked and underbanked face in order to trigger changes in the way policymakers approach banking policy.

She presents data that the average unbanked family has an annual income of \$25,500. Nearly 10% of that income is spent on fees related to financial transactions. For many of these families that translates to more than they spend on food. Many of these expenses are incurred through non-bank outlets that specialize in check cashing, money orders, remittances, payday lending, and pawn brokering.

Banks with a soul/ To delve deeply into why the unbanked and underbanked have very few options in the formalized banking system, Baradaran traces the history of financial institutions that were intended to address the needs of the entire population, not just cater to those at the top. For example, originally “credit unions cut out the owners and the profits in order to serve the poor. Their motto was ‘Banks of the people, by the people, and for the people.’” These “banks with a soul” included savings and loans, Freedman’s Savings Banks, building and loans, Morris Banks, and industrial loan companies. But in

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each case they either ceased operation or no longer serve the masses as they used to.

In the case of credit unions, the industry boomed in the postwar decades, growing from 3,372 credit unions serving 640,000 members in 1935 to over 16,000 credit unions serving 8.1 million members in 1955. But Baradaran argues that over time credit unions' focus on the poor eroded and "the nature of the movement had changed greatly ... and developed more of a middle-income orientation than one devoted to lower-income groups." Large and profitable credit unions became much more common in the 1970s and 1980s. Today, credit unions are much like mainstream banks. Her conclusion from this recitation of business models of old is:

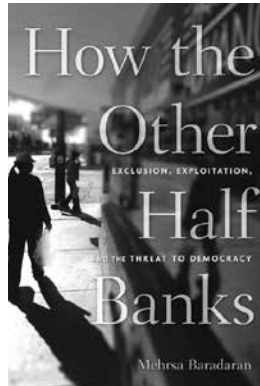
The movements that succeeded in serving the poor received heavy support from the federal government. And they only succeeded in achieving their mission insofar as they remained committed to a public purpose and explicitly rejected a purely profit-oriented model.

Exploitation and paternalism / So what options do the unbanked and underbanked have as they struggle with executing financial transactions on a day-to-day basis? Baradaran begins with a lengthy history of usury, the practice of lending money at unreasonably high interest rates. This leads to the inevitable focus on payday loans, where "the borrower must have a regular paycheck against which she borrows, usually up to \$500, with a typical term of anywhere from a week to a month." Ideally, borrowers would pay the loans back and that would be the end of them, but typically such loans are rolled over or otherwise extended. According to Baradaran, a borrower supports the loan with "either a postdated check or permission for direct withdrawal." The annual

percentage rate comes in at about 400%.

Some states have reflexively and paternalistically banned such loans because they consider them usurious. Baradaran makes clear that the borrowers desperately need these loans and an outright ban is extremely harmful:

These are real people who live and work in cities and towns, poor neighborhoods and wealthy ones.... They borrow to pay for things that are widely considered essential. They borrow with forethought and with care.... And fringe lenders are the only ones meeting this large market demand because banks, credit unions, and other mainstream lenders have chosen not to.



How the Other Half Banks: Exclusion, Exploitation, and the Threat to Democracy
By Mehrsa Baradaran
336 pp.; Harvard University Press, 2018 (reprint edition)

She rails against "paternalistic financial advice against debt, which is based on the assumption that if people only *realized* how bad debt was, they would not take out loans." She lectures that "it is especially unfair to morally oppose the use of fringe lending when there are no meaningful options."

Why not banks? / Baradaran claims that commercial banks largely ignore the unbanked, citing studies that the annual administrative cost of a checking account is \$250 to \$300. But she also criticizes the profit motive for the high overdraft and other fees charged:

Several barriers keep mainstream banks from serving the poor—the most important is simple math. Banks can make much higher profits elsewhere. The poor may need banks, but banks most definitely do not need the poor. Banks' transaction and overhead costs are much the same whether they lend \$500 or \$500,000, but, of course, the larger loan yields a much higher profit.

Where banks do offer services, she fur-

ther claims that high fees related to bank accounts somehow manage to give banks a twofor: "These fees are used both as a way to repel and punish low-balances and as a significant source of revenue."

The postal option / So we are left with 70 million Americans without a bank account or access to traditional financial services. The climax that every reader knows is coming at the end of the book is the introduction of postal banking as the answer to the struggles of the underbanked and unbanked.

The idea is not unprecedented in the United States. President Ulysses S. Grant's postmaster general, John A.J. Creswell, proposed a postal bank in 1871. After four decades of back and forth in Washington, it finally became law under President William Howard Taft in 1910. (Democrats resisted.) The United States Postal Savings System (USPSS) was born. The USPSS was popular everywhere, especially among immigrants who apparently had a great deal of confidence in the government because of postal banking's European roots. But after World War II, the deposits flowed out of the USPSS and into the commercial banks, which could pay higher interest rates. The USPSS was abolished in the late 1960s.

In her final chapter, Baradaran argues that it is time to revive "a public option in banking," as it is consistent with the centuries-long social contract between banks and the government. She claims that "the post offices could offer these services at a much lower cost than the banks and the fringe industry."

In a final section, she anticipates critiques of her plan. Amazingly, she cites Fannie Mae and Freddie Mac as good examples of how government involvement in financial markets can achieve social policy.

Notwithstanding the fact that Baradaran recognizes the role of politics in banking policy, a gaping hole in her defense is that she ignores how a postal bank would politicize credit allocation even more than it already is. The combination of a postal bank along with an economic recession

would surely lead to political intervention on many fronts. There would likely be demands for forbearance in addressing past-due loans and calls for greater lending to juice the economy. Private market solutions, such as expanded powers for Walmart and others to compete and mobile and peer-to-peer banking options, which she mentions briefly, would be much better alternatives. Equality banks, which facilitate cost-sharing among small banks in order to help them provide short-term, small-dollar loans, also hold some promise but she does not mention them.

The past 100 years have seen the government get progressively more involved in the banking industry. During that same time and by many measures, we have more instability in our financial system and greater disparities between banking services for the haves and the have-nots. If readers truly believe that more government is the answer, they will find Baradaran's prescriptions to their liking. Everyone else should still find of interest her history of the provision of credit to the underbanked and unbanked and her analysis of banning payday lending. R

argued in the late 20th century that encryption was a tool to protect individual liberty. In 1976, Stanford cryptographers created the concept of "public-private key cryptography" to address the need for secure key distributions. In 1978, MIT cryptographers created an algorithm to securely broadcast private keys using prime factorization. With Bitcoin, participants must solve a mathematical puzzle using a solution that meets the system's protocol. This "consensus algorithm" is security against fake transactions or altered records emerging in Bitcoin's blockchain. The blockchain uses economic incentives: Bitcoin miners receive a Block reward" (piece of Bitcoin) each time they create a legitimate hash.

The Blockchain Revolution

◆ REVIEW BY GREG KAZA

Imagine an electronic spider web. It's built around a spreadsheet—regularly updated to facilitate commerce—and spread across a computer network. The network becomes active when someone requests a transaction. It adds the transaction to the existing network once it is verified.

The preceding is a simple explanation of Blockchain, a developing technology that some associate with cryptocurrencies and others with supply chains. The process is novel and not without critics.

Blockchain technology is often associated with Bitcoin, a decentralized digital currency that emerged a decade ago. Yet blockchains are more than electronic skeletons for cryptocurrencies such as Bitcoin or the faster Ethereum. They are commercial systems used by public companies.

Unfortunately, in their new book *Blockchain and the Law*, Primavera De Filippi and Aaron Wright do not chronicle this recent commercial history. Rather, they focus on the technology, organization, and potential regulation at the heart of this innovation.

How it works/ The authors' description of blockchain-based "smart contracts" is the highlight of the book. They describe the technology in detail. Bitcoins are transac-

tion bundles of electronic data grouped into "blocks" that are linked together to form "a sequential, timestamped chain" of information. Each block contains a database "header," the components of "a unique fingerprint (or a hash) of all transactions ... along with a timestamp and—importantly—a hash of the previous block."

Hashes are generated using cryptographic functions invented by the National Security Agency that bundle transactions "in a block as a string of characters and numbers ... uniquely associated with that block's transactions." Ultimately, cryptocurrencies are "just a series of bits stored in the memory of one or more machines."

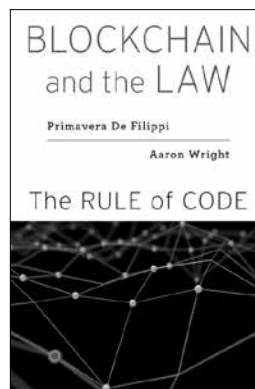
Blockchain relies on cryptography. Cypherpunks

Depository free from regulators/ There are private (permissioned) and public (permissionless) blockchains. The authors focus on the latter, arguing their "pseudonymous nature" cause concern when "deployed in heavily regulated areas" such as banking. They contend blockchains suffer from "one important drawback: trust is fickle." Pseudonymity "may embolden parties" to buy drugs, launder money, or commit tax evasion.

Blockchain's "tamper-resistant" nature creates "complications" for regulators. Yet blockchains "handle basic economic

transactions at lower costs, with higher degrees of reliability and potentially greater speeds." They "store data, messages, votes, and other" information in digital format, creating "a shared depository of information" that could "crack open the flow of information, powering new peer-to-peer file-sharing applications, decentralized communication platforms, and social networks." They "could affect governance itself," supporting organizational structures that "promote more democratic and participatory decision making."

Blockchains are "particu-



Blockchain and the Law: The Rule of Code

By Primavera De Filippi and Aaron Wright

312 pp.; Harvard University Press, 2018

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larly potent” as algorithmic systems integrating storage and computation layers. They can store other information, including computer programs known as smart contracts that allow parties to “enter into a binding commercial relationship” using code and software “to manage contractual performance.” The authors envision a future where existing bureaucratic systems would be replaced by technocratic systems relying on “code-based rules that ultimately constrain human behavior and discretionary choice.”

Ethereum was the first blockchain to enable smart contracts, while eBay and Craigslist use them “to support and coordinate the sale of goods.” Blockchains increase the transparency of over-the-counter derivatives markets. Financial firms “memorialized the economic terms of credit default swaps using a blockchain-based system to provide parties with insight into trade details, counterparty risk metrics, and potential financial exposure.”

More ambitious projects could emerge in the future. A smart contract has controlled a drone’s trajectory “without the need for a centralized middleman to manage the device.” Robust blockchain property rights systems could manage and control devices on the “Internet of Things”—the internet connection of such devices as home appliances—supporting “autonomous and self-sufficient” objects. Blockchain may lead to “autonomous machines that do not rely on any central operator,” resulting in “emancipated, AI-driven machines, which could be used for either positive or dangerous ends.”

Blockchain and government / Smart contracts can also be used to create alegal systems. Yet regulation creates its own unique challenges. Regulating “too soon” would provide markets’ guidance but “stamp out potential benefits.” By contrast, waiting “too late” may allow “socially objectionable aspects ... to emerge.”

The authors attempt a risk-reward balance, arguing blockchains “exhibit dual, competing characteristics.” Risks include digital currencies that “have gained a foot-

hold with those seeking to evade existing laws and regulations” and reduced privacy if governments censor commercial or political activity. This issue is “exacerbated by the fact that, once data has been stored on a blockchain, it can no longer be unilaterally modified or deleted.” The internet “could become progressively more unruly” in a blockchain-dominated world. Commercial banks could suffer if digital currencies shrink balance sheets, “depriving them of needed revenue.”

Rewards include blockchain’s appeal to entrepreneurs in nations without stable currencies, businesses seeking efficiencies, and shareholders interested in facilitating consensus. They also appeal to government units, protecting against cybersecurity attacks, managing Illinois’s land registry and Estonia’s birth and marriage records system. Tax collection could be “streamlined.”

De Filippi and Wright acknowledge all “regulatory approaches discussed here are

incomplete solutions.” They cite Harvard law professor Lawrence Lessig’s “pathetic dot theory”: individual actions can be “controlled or affected” via laws, social norms, market forces, or architecture. Potential laws include “blockchain neutrality” and “extensive regulatory constraints on software development.” Governments could shape social norms within a blockchain community. The authors cite the end-to-end principle: networks should be as simple and general as possible, leaving intelligence at the network’s “edges.” Regulators could respect the principle or “adopt a more restrictive regulatory regime.”

De Filippi and Wright conclude that the best way to regulate a code-based system “is through code itself.” They worry that Blockchain liberation could cause us to live “under the yoke of the tyranny of code,” yet they leave unanswered the crucial question of whether regulators have the knowledge to write code, let alone balance the myriad issues raised in this book. R

A Bridge to Collectivism

◆ REVIEW BY PIERRE LEMIEUX

Yoram Hazony’s *The Virtue of Nationalism* is a well-written and challenging book. While today’s Trump supporters would likely agree with its main theses and conclusions, classical liberals, small-government conservatives (perhaps), and libertarians will be troubled or disagree.

The author is a philosopher and president of the Herzl Institute in Jerusalem. According to its website, the institute’s mission is “to contribute to a revitalization of the Jewish people, the State of Israel, and the family of nations through a renewed encounter with the foundational ideas of Judaism.” As we will see, this is congruent with the ideas expressed in *The Virtue of Nationalism*.

Hazony warns us at the outset that he will not “waste time trying to make nation-

alism prettier by calling it ‘patriotism’” because they are the same. Fair point. He defines the nation as an association of tribes “with a common language or religion, and a past history of acting as a body for the common defense and other large-scale enterprises.” As opposed to primitive tribes—the “tribes of Israel” that we meet in the Bible, for example—it is not always clear what today’s tribes are, although we can imagine many. Nationalism stands for “a principled standpoint that regards the world as governed best when nations are able to chart their own independent course, cultivating their own traditions

PIERRE LEMIEUX’s latest book is the just-published *What’s Wrong with Protectionism? Answering Common Objections to Free Trade* (Rowman & Littlefield, 2018).

and pursuing their own interests without interference.”

The book’s argument can be summarized as follows: The choice of an international political order is between national states on the one hand and imperial or world government on the other. This choice parallels the distinction between nationalism and liberalism: nationalism claims that each nation should be independent in order to pursue its own interests, aspirations, and purposes; liberalism “assumes that there is only one principle of legitimate political order: individual freedom,” and that this universal principle can be imposed on all nations. Contrary to rationalist liberalism, nationalism is consistent with man’s natural loyalty to his own kind, from the family, the clan, and the tribe, up to the nation. The nation can better ensure external security than tribal anarchy can, and better elicit the loyalty of its citizens than other sorts of states. Independent national states promote diversity and experimentation, contrary to empty universal principles and homogenizing empire. A national state is also the only formula capable of nurturing and protecting free institutions.

Each of these claims is doubtful at best.

Underestimating liberalism / The national state and world government do not exhaust the possibilities for the world order. On the axis of political power, there are many alternatives between ideal anarchy with zero political power and an ideal world-state with potentially total power. For example, there are non-world imperial states, and everything that is not a pure national state is not an empire. The European Union, we are told, “is a German imperial state in all but name,” but it’s a strange imperial state if a national state can legally secede with a two-year withdrawal notice!

Liberalism is much more cautious toward a world state than Hazony assumes. (He generally takes “liberalism” to mean classical liberalism.) Some liberals did favor a world state: one was Ludwig von Mises, as Hazony notes. Others were continental liberals and Enlightenment thinkers that Nobel economics prizewinner Friedrich Hayek blamed for their constructive rationalism and their false individualism. (See his “Individualism: True and False,” 1945.)

Hayek himself, whom Hazony calls “the most important theoretician of liberalism of the last century,” defended a theory of “the Great Society,” an abstract order guided only by the impersonal rule of general laws. On the basis of a 1939 article, Hazony blames Hayek for proposing a world government to establish this order. In his 1960 “Why I Am Not a Conservative,” a postscript

to *The Constitution of Liberty*, Hayek was prudent. He did argue that nationalism “provides the bridge from conservatism to collectivism.” But, he wrote rather wishfully, “until the protection of individual freedom is much more firmly secured than it is now, the creation of a world state probably would be a greater danger to the future of civilization than even war.” Most liberals in the Anglo-American wing of liberalism did not and do not favor a world state.

Hazony must be troubled by Hayek’s liberalism, which is based on the same Anglo-American tradition of empirical historicism that *The Virtue of Nationalism* claims to represent. Hayek proposed a liberalism that is both respectful of evolved traditions and against the morals of the tribe.

Tribe vs. Great Society / Hazony does not only provide a bridge to future collectivism, he also has deep roots in past collectivism, in the loyalty of tribe members.

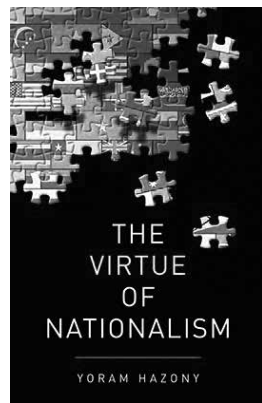
They recognize “the aims of the collective” as their own. The nation gains its cohesion from a similar loyalty.

The collectivism that Hayek blamed conservatives for sharing with the socialists is quite visible in *The Virtue of Nationalism*. Speaking about “clan, tribe, and nation,” Hazony states that “these collectives are of the same kind as the family, albeit on a greater scale.” The nation is presented as an organism with its “own interests,” its “aspirations,” and “its own unique purposes.” Nations can even “develop attachments to other nations.” He explains, a bit laboriously, that these are not only metaphors.

In reality, social organisms don’t exist. And collectives can only be understood with methodological individualism—that is, by starting from the individual to understand social phenomena. Methodological individualism is what separates Hayek’s historical empiricism from the Hazony variety.

Collective preferences don’t exist, unless everybody in the collective has similar preferences. Nobel laureate Kenneth Arrow demonstrated that if all individual preferences are admitted, there is no way to build consistent collective preferences on the basis of individual preferences. (See his *Social Choice and Individual Values*, 1951.) There will always be some individuals whose preferences are not taken into account. In other words, collective choices are authoritarian. *The Virtue of Nationalism* shows no trace of this line of research.

The tribal psychology underlying Hazony’s political theory is the exact opposite of Hayek’s Great Society, where abstract and mostly impersonal relations allow each individual to pursue his own goals. (See “Against Tribal Instincts,” Spring 2018.) Individual choices can incorporate the welfare of family or friends, but they are not coercively subordinated to the goals of other individuals. The abstract order of the market, in which we cooperate with unknown persons with different goals, is one dimension of the Great Society; so is the rule of law. Only such abstract order can allow the production of wealth typical of liberal societies since the 19th century.



The Virtue of Nationalism

By Yoram Hazony
304 pp.; Basic Books,
2018

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Hazony's psychology is incompatible with modern society. Individuals are as disobedient as they are social. Loyalty to the national state is largely a product of state propaganda. The flags, symbols, and pomp of the nation-state are designed to elicit tribal loyalty. I submit that there is not much virtue in that.

Rousseau in disguise? / With the Enlightenment, a new concept of individual liberty emerged, as opposed to collective liberty—or “collective self-determination,” as Hazony would say. He cleverly avoids the concept of sovereignty, but defends it with other words. The author of *The Virtue of Nationalism* remains a believer in ancient liberty. National states are the locus of collective liberty. On the contrary, we should not renounce the virtues of the Enlightenment, including individual liberty. (See “From the Republic of Letters to the Great Enrichment,” Spring 2018.)

One can imagine a world where collective liberty would work flawlessly. Imagine that the world is divided into sets of identical individuals (with the same preferences and values), each of these sets contained in a contiguous territory. Each set forms a national state. Any collective choice in a national state would, by construction, represent the unanimous choice of all its citizens. (I disregard the possibility that different circumstances could lead an individual to wish he could make a different choice: “I would love to participate in our war, but my wife just delivered our baby.”) Each individual would literally feel the pains and pleasures of the state as his own, like Hazony imagines.

Such a world is romantic and unrealistic. The national state is not a big family. However much Hazony blames Jean-Jacques Rousseau's rationalism, the tribal Rousseau makes a return in *The Virtue of Nationalism*. Hayek wrote about “the Rousseauesque nostalgia for a society guided, not by learned moral rules which can be justified only by a rational insight into the principles on which this order is based, but by the ‘natural’ emotions deeply grounded on millennia of life in the

small horde” (*Law, Legislation and Liberty*, Vol. 2, 1976).

Rousseau may hide elsewhere in *The Virtue of Nationalism*, where “the freedom of the individual is seen to depend ... on the freedom and self-determination of the collective to which he is loyal.” But what if an individual is persecuted by his free collective? This seems impossible in Hazony's theory. Would we say that an individual persecuted by his own tribe or nation is free or, as Rousseau wrote in *On the Social Contract* (1762), that he is “forced to be free”?

Politics with romance / The rest of Hazony's argument—on security, diversity, and free institutions—mostly rests on an idyllic view of the democratic state.

James Buchanan, another Nobel prizewinning economist, described the approach of politics by public choice theory as “politics without romance.” This school of economic and political analysis takes individuals as they are, as self-interested in the public sphere as they in the private sphere. By contrast, Hazony does politics with romance. He ignores how the state works in practice, with rationally ignorant voters, and interest groups and state bureaucracy grabbing a large share of state power. He underestimates the constant danger of Leviathan.

Consider the argument that the national state is the best protector of security. It ignores the possible exploitation of citizens by their own national states—especially, but not only, if they are a minority of a different nationality. The national state may reduce the risks of outside attacks; in many ways, though, it increases the security risk from inside because it combines the power of the state with nationalist emotions. Haven't we observed that often?

Another weakness in the security argument is that the national state is a natural way toward empire, as Nazi Germany illustrated. Hazony underestimates that risk, seeing in the national state only the “national.”

Bertrand de Jouvenel's argument in *On Power* (1947) is very relevant to national

states, which have made wars more devastating. Helped by the power of nationalist propaganda and emotions, the state has claimed jurisdiction on all the “national resources,” including conscripted men. Noncombatants have been brought into the ambit of war. The summit was reached with the bombing of civilian populations in World War II. Isn't an enemy state “the nation as a whole” (an expression used by Hazony many times)? Let's bomb the nation as a whole!

Diversity and liberty / Hazony argues that independent national states promote diversity and experimentation, as opposed to homogenizing empire. This is probably true globally, but not within each country. Most national states undermine diversity within their borders. Hazony's argument for diversity is incomplete: it does not consider the need for constraining state power.

Similarly, most national states crush free institutions instead of nurturing them. By “free institutions,” Hazony means the institutional structure that generates or protect the “rights and freedoms” of the individual, including generally free markets. Even without speaking of immigration (a more difficult topic), national states nearly always restrict free trade in goods and services, a power Hazony supports. He also seems to believe that the state should promote the country's traditional language and religion. Taken seriously, collective liberty can only clash with individual liberty.

Readers of *The Virtue of Nationalism* will sometimes get the impression that the author does not dislike individual liberty, but that he lacks some important analytical tools to understand it. For example, he presents “the World Trade Organization as an authoritative body regulating the economies of nations as a condition of their participation in international trade.” Doesn't he understand that unilateral free trade—that is, letting a country's residents import what they want at the best conditions they can get—would allow any nation or, to speak properly, individuals

in any country to participate in international trade? Does he understand how that works?

The main argument for independent states—not necessarily national states—is a public choice argument related to the danger of an international Leviathan, which would be much more difficult to escape than local tyrants are. This argument is based on the intrinsic danger of the state as a monopoly of force, and on the value of individual dignity and flourishing. Don't forget individuals! The idea that a system of independent states is a less dangerous system than a world empire—at least for those who do not live under the worst tyrants—must not prevent one from dissenting against his own Leviathan. It is not a license to glorify nationalism.

The Virtue of Nationalism is anchored in the Hebrew Bible, that is, the Old Testament, and in the political history of the Jews in biblical times. “I have been a Jewish nationalist, a Zionist, all my life,” the author writes in the book's introduction. We can understand and sympathize with the plight of Jews in history, from the early tribes of Israel and the kingdoms of Israel and Judah, to the diaspora, the constant discrimination against Jews, the Holocaust, and the contemporary refuge that the state of Israel represents for them. We can also admire the millennia-old Jewish traditions (when they are not too stifling), as well as the major contribution of Jewish culture to Western civilization. But that's not a reason to hold the Hebrew Bible as the ultimate book of political philosophy.

Lessons / I think that two qualified lessons can be drawn from *The Virtue of Nationalism*. First, it reminds us of the danger of a world state. A world state would likely have killed the experiments that led to the discovery of individual liberty and classical liberalism. Hazony would not weep for the latter, but perhaps he does not understand it well. Under a world tyrant, islands of liberty would be very difficult to establish and defend. But note how these islands of liberty have also been busy destroying

themselves under national states with growing power.

Second, nationalism does not always turn into national socialism or other monsters. Hazony shows that nationalism can sometimes be useful. We know many Western national states under which individual liberty has flourished in different degrees. Yet, these liberty-bearing societies were probably those whose elites had the most cosmopolitan outlook. Note also how open these countries were historically to trade or immigration. Immigration constantly changed the “tribes” of America.

A more general reflection is that we—we who think that individual liberty is the main political value—must accept both that it is a universal value and that prudence requires not to trust a world state

to impose and protect it. This does not preclude international treaties between national governments. Another way to express the general idea is that we must marry cosmopolitan values with the preservation of separate states, of which some will hopefully become islands of liberty. Incidentally, unilateral free trade is one way to achieve that: it would leave individuals in the unilaterally free-trading country free to import, export, or invest abroad, even if foreign states don't recognize the same liberty for their own subjects. (See “How Is Your Trade War Going?” Summer 2018.)

If there is something that could persuade a cosmopolitan intellectual of the virtue of nationalism, this book would be it. It doesn't succeed, though, because of its collectivism and romantic politics. R

Is the Era of ‘Free to Choose’ Medicine Upon Us?

◆◆ REVIEW BY THOMAS A. HEMPHILL

Over a decade ago, Bart Madden unveiled the genesis of his “Free to Choose Medicine” concept in the pages of *Regulation* (see “Breaking the FDA Monopoly,” Summer 2004). He developed those ideas in the monograph *Free to Choose Medicine*, the third edition of which was released this April. Just a few weeks

later, President Trump signed “Right to Try” legislation giving terminally ill Americans greater access to investigational drug treatments that have undergone Food and Drug Administration Phase I safety and early efficacy testing but have not completed the full FDA testing regimen and are not yet available to the public.

Madden's arguments support policies like “Right to Try,” but there is much more to what he proposes than simply giving terminal patients access to experimental drugs. In this review, I sketch out his proposal and offer some practical suggestions

for increasing the possibility that it will one day become law.

Need for Free to Choose Medicine / On the first page of the first chapter, Madden states the purpose of his Free to Choose Medicine concept:

This book makes the case that we need to be free to make informed decisions about whether to use not-yet-approved therapeutic drugs—that is, new drugs that have successfully passed initial safety trials, generated preliminary efficacy data, and may offer us the opportunity to improve our health or even save our life.

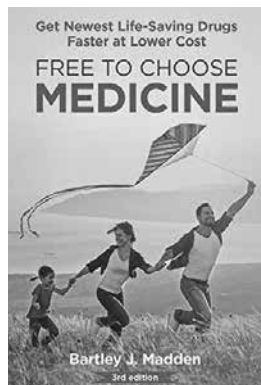
He believes that the result of the 1962

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federal legislation expanding the FDA's monopoly authority to test drugs and judge whether they are "safe and effective" has been ever-increasing prescription drug prices. He argues this is because of the agency's continuing demand for more expensive and time-consuming clinical trials to minimize the likelihood of injury and death (and adverse publicity for the FDA) and expand understanding of the experimental drugs' effects. More importantly, he argues powerfully that these lengthy clinical trials come at a steep cost in the unreported "invisible graveyard" of patients with serious or immediately life-threatening conditions who die while the drug undergoes the extensive testing necessary to be brought to the U.S. market.

He gives four reasons why there has not been a growing grassroots movement demanding reform of the FDA in order to make experimental drugs more readily available. First, it's easier to observe (and the media report on) adverse side effects (including death) from approved drugs as well as new information from extensive trials. People assume that unapproved drugs would be even riskier, which results in political pressure for even stricter regulation. Second, the FDA and its supporters sincerely believe they possess the moral high ground; pharmaceutical companies that would be inclined to question FDA policies are, unsurprisingly, fearful of antagonizing the regulators whose decisions can mean the difference between company failure and success. Third, most Americans are unaware of what economists call the "opportunity costs" of not being free to make an informed choice about the best drug treatment for ourselves. Fourth, only a small percentage of people at any one time realize they are experiencing pain, suffering, and the prospect of death because of denied access to new drugs.



Free to Choose Medicine, 3rd ed.

By Bartley J. Madden
83 pp.; Heartland
Institute, 2018

The drugs-to-patient system / Madden applies a systems theory approach in his analysis, one that elevates the goal of providing more drugs to more patients and that focuses on eliminating questionable constraints on those drugs. He believes his systems approach "produces genuine insights that reveal a path to true reform."

The existing FDA drug approval system consists of two primary stages: the pre-clinical stage and the clinical trials stage. Historically, for every 5,000 substances that drug companies initially investigate, about 250 enter the formal preclinical research and testing stage where there is basic evaluation for patient safety. This stage typically takes three to six years to complete. Only about 10 of those substances exhibit enough promise to induce a pharmaceutical company to file an Investigational New Drug (IND) Application with the FDA to move on to Phase

I testing where they are safety-tested on healthy volunteers. Roughly eight of those substances then enter Phase II safety and efficacy clinical trials where they are tested on volunteers who have the condition the substance is intended to treat. Only about three of those substances move on to Phase III efficacy clinical trials, involving larger testing groups. Finally, only about one drug out of those original 5,000 substances successfully achieves FDA New Drug Application approval.

Madden views the key bottleneck in the drugs-to-patient system as "the FDA and its narrow focus on ever more refined (and expensive) clinical trials." Research shows that in 1980, the typical drug underwent 30 FDA clinical trials involving about 1,500 patients. By the mid-1990s, the typical drug had to undergo more than 60 clinical trials involving almost 5,000 patients. Because the FDA is the monopoly gatekeeper for the American market, it is able to "disregard evidence of its failure and

the pleas of suffering and dying people who are being denied potentially life-saving treatments" in the later clinical phases of the seemingly interminable drug evaluation process.

The FDA's defense / FDA staffers respond to this criticism with a simple question: Do you want citizens to have safe and effective drugs and for public knowledge about drug effects to increase? Since no one would dare not answer this question affirmatively, the FDA requires that new drugs pass an extensive battery of randomized clinical trials (RCTs) in which subjects are randomly assigned to control and test groups, with the former receiving the current standard of care (or a placebo) and the latter the substance under investigation. RCTs are considered the "gold standard" in empirical testing. They also are incredibly costly in time and resources. Thus, FDA staffers successfully lobby for "greater FDA power and a bigger budget to get the job done," even as the drugs move slower and slower through the testing pipeline.

Since no drug is 100% safe, argues Madden, the FDA's goal of "safe and effective drugs" deflects attention from the fundamental tradeoff that the agency faces:

More extensive and hugely expensive testing can reduce the probability of unanticipated adverse side effects from an approved drug. But that same mindset greatly increases drug costs to consumers and, most importantly, causes suffering and premature deaths from delayed access. That's the tradeoff dilemma.

While he agrees that the RCT is a powerful tool in determining if drugs are safe and effective, it is only one tool of many in the growing medical knowledge base. He also notes that many physicians and medical ethicists consider RCTs unethical because they require the participation of ill individuals. In essence, the control group is barred from receiving a potentially superior treatment. Madden makes a case for using observational data versus RCTs. As

evidence, he points out that observational data, or “real-world data,” are contained in physician communications when considering the “pros” and “cons” of off-label use of FDA-approved drugs. Observational data and the associated inferences of cause-and-effect expand the knowledge base through daily life experiences.

What are the costs of the FDA’s reliance on RCTs? It can take up to 12 years, on average, for a new drug to successfully complete the FDA review process. In addition, according to a 2014 Tufts University study, total development costs of a new drug are estimated at \$2.9 billion. Madden believes that the FDA needs competition to eliminate this “critical bottleneck” in the nation’s health care system.

Two tracks/ As a solution, Madden offers a “dual approval track” plan. Under the first track, patients choose to only use drugs that have gained approval through the traditional FDA approval process. Under the second track, the Free to Choose track, the FDA would have “competition,” which I’ll describe below. Madden’s hope is that this competition will provoke the agency to streamline its clinical testing and approval requirements, thus allowing smaller, cash-strapped pharmaceutical companies to bring their drugs to market much sooner.

The Free to Choose track would allow patients (under the care of their physicians) to access not-yet-approved drugs. Specifically, this would provide access to drugs in Phase II of FDA clinical trials after the drug’s completion of one or two trials.

In the drug discovery stage, which precedes the Phase I trials, basic safety of the drug is established. In Phase I of clinical trials, 20–80 healthy volunteers are used to establish a drug’s safety profile; this process usually takes one year. In Phase II of clinical trials, 100–300 patient volunteers with the condition the drug is intended to treat are used to better assess the drug’s safety. Because these trials are randomized, researchers find indications of its efficacy; this phase can take up to two years to complete. Phase III (involving further

testing of 1,000–3,000 volunteers afflicted with the condition) better assesses efficacy and gathers other information about the drug’s effects, and can easily take up to five additional years before the FDA grants final approval. All told, that’s 12 years of evaluation. In contrast, Madden believes the Free to Choose track can reduce the evaluation period to just six years.

As an integral part of the Free to Choose track, physicians would be required to input treatment results anonymously (although including pertinent genetic data and biomarker information) into an internet-based Tradeoff Evaluation Drug Database (TEDD). TEDD would become a valuable database of up-to-date information about the risks and effectiveness of drugs qualified for early access on the Free to Choose track, enabling patients and their physicians to make informed decisions about what is in a patient’s best interests. Madden believes that TEDD would be invaluable for medical researchers, greatly accelerating further pharmaceutical innovation through faster learning and more effective allocation of research and development funds. TEDD would be operated independently of the FDA within a public/private organizational structure.

TEDD would be useful. The question is, would it provide anywhere near the information on drug effects that Phase III RCTs do. The great value of RCTs is that they control for unobserved differences in test subjects that cannot be controlled for in observational studies. The resulting information is important, and there have been many cases where it has been outright revelatory.

To attain it, the current FDA system uses coercion—people can’t obtain an experimental drug unless they participate in a trial, and then they still may be assigned to a control group. The Cato Institute’s Michael Cannon has proposed that, instead of coercion, test administrators pay subjects to participate in RCTs (and maybe receive the experimental drug). With the Free to Choose track, Madden risks losing a significant chunk

of this information, though TEDD may provide some of it and the traditional track may ultimately provide all of it (if enough desperate patients don’t select the Free to Choose track). In essence, he makes a values choice to increase access at the risk of less information—but then, Congress and the FDA made a values choice to increase information at the loss of some access, and Cannon makes a values choice to increase information and access at a public financial cost.

Drug developers would have the choice to use either track, or both, to bring their drugs to market. To institute the Free to Choose track, Madden argues that new federal legislation would be needed to provide drug developers sufficient immunity from strict product liability laws to ensure their active participation in this track. There is also a strong assumption that health insurance companies would respond favorably to a drug that has a low price and shows safety and effectiveness under the Free to Choose track, and that these drugs would likely receive insurance reimbursement. As to patient safety, Madden notes that technological advances make preclinical testing by drug developers, as well as the FDA’s Phase I safety trials, far superior to the testing used during the 1960s when the thalidomide disaster took place in the United Kingdom.

Traversing the public policy gauntlet /

When evaluating Madden’s proposal, it is important to begin the process with clear parameters on what the author is not proposing. First, he is not calling for the elimination of the FDA; instead, he wants to reform the agency. The FDA status quo is, in fact, a complement to his proposal because the agency’s drug approval process would remain in place. Second, to reinforce the first point, RCTs would be an integral part of the Free to Choose proposal up through the early part of Phase II. This includes through all of the basic safety protocols and initial testing for effectiveness of the drug on the affected population. Third, Madden’s proposal does not eliminate mandatory

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reporting of the affected population after initial Phase II testing. TEDD requires physicians to report to a designated third party on the effects of Free to Choose-track pharmaceuticals on their patients.

Yet reforming the FDA (a laudable and challenging undertaking) and getting the “newest life-saving drugs faster at lower cost” to Americans vulnerable and in need would require confronting and ameliorating formidable public policy challenges involving a myriad of stakeholders. Toward that end, here’s a five-point strategy:

■ **Define the target population.** While Madden relates deeply moving examples of people with life-threatening diseases who are not able to access experimental drugs, his Free to Choose track leaves the decision on patient eligibility entirely up to the patients (in consultation with their physicians). This is a position entirely in line with a libertarian philosophy supporting the broadest freedom of individual choice; however, from a public policy perspective, acceptable eligibility limitation is essential to successfully enacting this federal legislation.

For example, FDA Commissioner Scott Gottlieb recommended to Congress that Right to Try legislation define the term “terminal illness” as “a stage of disease in which there is a reasonable likelihood that death will occur within a matter of months.” Similarly, since his proposal is especially intended to help alleviate suffering from “life-threatening” diseases, federal legislation should emphasize developing a workable definition of such diseases—that is, one that includes reasonable and politically justifiable qualifications for patient eligibility.

An example of such a disease would be ALS, better known as Lou Gehrig’s Disease, a “life-threatening” neuromuscular disease with no known cure. The overwhelming majority of people diagnosed with ALS die from respiratory failure within three to five years of diagnosis. In contrast, many chronic

diseases can be “life-threatening” yet medically managed through existing treatments, e.g., diabetes. Therefore, a proposed rubric useful for “defining a life-threatening” disease may be “reasonable likelihood” of death within 10 years of diagnosis with no known treatment available to successfully manage the disease and prevent death. This would coincide with potential patient benefits accruing from the Free to Choose track, which is expected to reduce the length of time required for drug approval by six years.

■ **Tort liability reform.** Pharmaceutical manufacturers are held to strict product liability for adverse effects on patients under U.S. tort law (with the exception of in Michigan, where citizens do not have the right to sue pharmaceutical companies unless the drug maker withheld or misrepresented information to the FDA that would have led to non-approval, or bribery was involved). Strict liability is the imposition of liability on a party without finding of fault, such as negligence or tortious intent. In other words, the aggrieved party—i.e., the patient—need only prove that the tort occurred and the drug company was responsible. Madden correctly argues that the trial bar would lobby intensely against a patient waiving liability by explicitly consenting to engage in what can be reasonably construed as “a risky activity.”

Establishing a written waiver of “consent” releasing the pharmaceutical company from any liability—short of gross negligence or willful misconduct—would require the establishment of a legislative tort liability “safe harbor” for participating pharmaceutical companies. Realistically, to create this safe harbor would require that Free to Choose drugs be made available only to patients having serious, life-threatening diseases without a known cure. Expanding the definition of patient eligibility would require widening the

safe harbor, potentially nullifying the legal protection of strict liability and thus making it exponentially more difficult to acquire congressional support for legislative passage.

■ **Physician liability.** Physicians whose patients want to use Free to Choose medicines may worry that they could still be held liable for negligence under “duty of care” obligations. Since physician licensure is regulated at the state level, a state authority could declare physician complicity contrary to ethical standards (“physician do no harm”) for medical practice, thus placing a physician’s licensure in jeopardy. Physicians would need a clear legal standing regarding their personal liability. While establishing a similar safe harbor (through model state legislation) allowing for a defense of willful consent by the patient may eliminate civil negligence liability, the question of ethical conduct is one that could play out differently among 50 state licensing boards.

■ **Combat FDA resistance.** “We’re going to be cutting regulations at a level that nobody’s ever seen before,” President Trump vowed in a meeting with pharmaceutical industry executives in January 2017. So would Commissioner Gottlieb support a decision contrary to the existing agency philosophy for a drug made available to a non-FDA participating trial patient before extensive testing for efficacy (in Phase III trials)? If he is not supportive, and if Free to Choose legislation were enacted over FDA protest, would pharmaceutical companies be willing participants in making access available to patients? The agency could, after all, sanction participating drug makers by slowing approval of drugs the makers have submitted to the traditional process. Perhaps such risk was behind PhRMA, the major drug industry association, saying it was “neutral” on Madden’s Free to Choose idea.

In addition, would health care insurers be as open to patient eligibility (and thus financial remuneration) of such pharmaceuticals (after one or two Phase II trials) knowing that many of the drugs will ultimately prove to be ineffective and some may have adverse effects? Furthermore, could an adverse effect from an investigative drug potentially leave a patient without health insurance coverage, resulting in unpaid medical bills?

■ **Promote and continue to improve the Expanded Access Program.** The FDA has a lengthy history of supporting patient access to investigational new treatments through the agency's Expanded Access Program. (The seminal regulations for the program were issued in 1987.) In 2009, after enactment of amendments to the Federal Food, Drug, and Cosmetics Act, the FDA revised its regulations to consolidate the provisions concerning the use of investigational drugs and biologics for expanded patient access where no existing FDA approved alternatives exist. The FDA reports that, in recent years, the agency has received over 1,000 applications annually for expanded access to treat patients with these investigational drugs and biologics, and subsequently authorized 99% of the requests. In addition, the agency makes "meaningful changes" in approximately 10% of these cases to enhance patient safety.

Yet program critics note that, in the past, physicians were required to file full investigational new drug (IND) applications with the FDA, as if they were company sponsors undertaking clinical trials. The FDA reported that it took an estimated 100 hours to complete this paperwork, a daunting task for physicians who are time-strapped. (Because of this, we should qualify the 99% authorization statistic; many potential applicants likely were discouraged by the onerous paperwork demands.)

Obviously, the small number of actual applicants—as well as anecdotal stories of Americans traveling abroad to acquire unapproved drugs—offer support for this criticism.

However, the FDA recently announced revisions to the Expanded Access Program, as required in the FDA Reauthorization Act of 2017 and the 21st Century Cures Act. Such revisions will ostensibly allow the prescribing physician to submit a "single patient IND," which the FDA claims will take as little as 45 minutes to complete, and the subsequent agency review will usually be completed within 24 hours of submission. The FDA's performance on this will need close monitoring by Congress, health

care interest groups, and the executive branch.

Unlike the Right to Try legislation, which was characterized as "toothless" by many critics (as pharmaceutical companies have little incentive to provide access to experimental drugs that have not been approved by the FDA), Free to Choose Medicine could be "game changing" for eligible patients. In this well-written monograph, Madden advocates convincingly for his approach. Yet Free to Choose Medicine has many hurdles to vault before it becomes a viable regulatory solution to alleged FDA government failure. Many vulnerable patients must hope that Madden and other Free to Choose advocates "get it right" on both the policy and the politics. R

Did FDR Default on U.S. Debt?

◆ REVIEW BY GARY RICHARDSON

The risk-free rate of return on investments is often considered to be the yield on U.S. government debt. "The risk-free rate is hypothetical," *Investopedia* states, "as every investment has some type of risk associated with it. However, T-bills [U.S. Treasury debt obligations with a maturity of 52 weeks or less] are the closest investment possible to being risk-free." One of the reasons for this is "the U.S. government has never defaulted on its debt obligations, even in times of severe economic stress." Similar statements appear in *Wikipedia's* entry on the risk-free interest rate as well as in scores of economics and finance textbooks used around the world.

University of California, Los Angeles economist Sebastián Edwards's new book, *American Default: The Untold Story of FDR, the Supreme Court, and the Battle over Gold*, challenges this assertion. Edwards argues that the United States defaulted on federal debt during the 1930s when it withdrew

monetary gold from circulation and abrogated the gold clause in both public and private contracts.

Overview / Before I delve into the details of Edwards's insightful study, I want to give you an overall assessment of the book: It is fascinating, well-written, and thoroughly researched. It provides new perspective on an important era of American history. It discusses the ideas, personalities, politics, economics, and finance underlying the principal policies by which the Franklin D. Roosevelt administration resuscitated the U.S. economy after the catastrophic contraction of 1929–1933. An academic press published the book, but the clarity of its prose and vividness of its narrative make it

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accessible to a general audience. The book should and will be read widely. It's worth pondering and debating, and I will debate some aspects of it later in this review.

Edwards's book asks provocative questions about fundamental features of the U.S. and international financial systems. The author lists these questions at two points in the book: the end of the introduction and the beginning of the conclusion. The lists contain 15 total queries, which I condense into five:

- Did the United States default on federal government debt in 1934 when it abrogated the gold clause for government bonds (particularly the fourth Liberty Bond)?
- Why did the federal government abrogate the gold clause? Was this action necessary?
- Who made the key decisions during this episode and how did they justify their actions?
- What were the consequences for investors and the economy as a whole, both in the United States and abroad?
- Could this happen again?

Edwards answers these questions over the course of 17 chapters plus an introduction, an appendix, a timeline, and a list describing the people around whom the story revolves. The introduction lays out the issues of interest. Chapters 1 through 15 narrate the story. The narrative revolves around such policymakers as Roosevelt, Sen. Carter Glass, and members of the Supreme Court, as well as the people who advised them. Among those advisers were Roosevelt's Brain Trust, whose initial members included Raymond Moley, a law professor from Columbia University, Rexford Tugwell, an economics professor at Columbia, and Adolf Berle, another law professor from Columbia. The narrative describes the decisions that these men made (or had to make), their rationales for those decisions, and the state of knowledge and state of the world at the times those decisions were made.

Fearing devaluation/The narrative starts in

March 1932, during the economic downturn now known as the Great Depression. A few pages describe the poverty and desperation imposed upon people from all walks of life. Nearly a quarter of the labor force experienced unemployment. Commodity prices declined by more than half. These declines proved particularly hard on people running small businesses, such as family farmers who made up a quarter of the U.S. population. Declining farm prices accentuated farmers' debt burden because the nominal value of debts remained fixed, forcing farmers who wanted to pay their mortgages and crop loans to double production (which was often impossible) or cut consumption (particularly of durable goods like cars, radios, and clothing). Some farmers (and eventually almost all farmers) stopped paying their debts, defaulted on their loans, and faced bankruptcy, which often resulted in the loss of lands and livelihoods.

Chapters 1 through 4 cover Roosevelt's campaign platform and policies and the economic turmoil from November 1932 through February 1933. During those last five months of the Herbert Hoover administration, a nationwide panic drained funds from the banking system and gold from the vaults of the Federal Reserve. The public feared for the safety of deposits and rushed to convert their claims against banks into coins and cash. The public (particularly foreign investors) also feared for the value of the dollar because they anticipated that the Roosevelt administration would lower the gold content of U.S. currency or leave the gold standard altogether, as had Britain and numerous other nations.

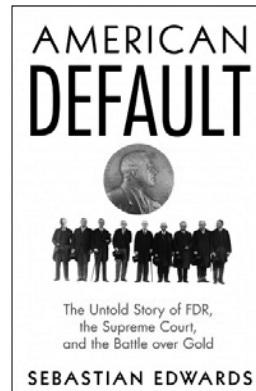
In March, gold outflows forced the Federal Reserve Bank of New York below its gold reserve requirement. To prevent the New York Fed from shutting its doors,

the newly inaugurated President Roosevelt declared a national banking holiday. This segment of the story ends by describing the policies that the Roosevelt administration implemented as it resuscitated the financial system and sparked economic recovery.

This review will not go into detail about the policy decisions and the logic underlying them. For that information, you should read the book, which presents the materials cogently and clearly. Other recent readable treatments on the topic include Jonathan Alter's *The Defining Moment*, Anthony Badger's *FDR: The First Hundred Days*, Adam Cohen's *Nothing to Fear*, and David Kennedy's *Freedom from Fear*. All of these cover similar material and reach similar conclusions. I also recommend the memoirs of Herbert Hoover and Roosevelt's principal advisers; see Edwards's bibliography for a list. To it, I recommend adding *Fifty Billion Dollars: My Thirteen Years with the RFC*, the memoir of Jesse Jones, who headed the Reconstruction Finance Corporation.

Monetary expansion/ Chapters 5 through 10 describe the Roosevelt administration's efforts from the spring of 1933 through the winter of 1934 to help the economy recover. The administration believed a key cause of the contraction was the devaluation of the dollar and decline in prices—particularly of farm commodities—that occurred during the 1920s and early 1930s. Prices of wholesale goods fell an average of 25% between 1926 and 1933. Consumer prices fell by the same amount. The average price of farm crops fell more than 66%.

Declining prices made it difficult for farmers and other producers to earn sufficient profits to pay their debts, which were fixed in nominal terms. As a result, families and firms cut consumption and



American Default: The Untold Story of FDR, the Supreme Court, and the Battle over Gold

By Sebastián Edwards
288 pp.: Princeton University Press, 2018

investment in order to avoid bankruptcy, or else defaulted on their debts, which was often worse for them and put banks out of business. That, in turn, restricted the availability of credit, triggered banking panics, and resulted in further economic contraction. The Roosevelt administration sought to alleviate this cycle of debt-deflation by convincing (or forcing) individuals and firms to redeposit funds in banks, encouraging banks to lend, and refilling the Federal Reserve's vaults with gold. All of these actions would expand the money supply and eventually raise prices.

The administration also sought to speed the process along by directly influencing commodity prices, particularly those traded on international markets. Those commodities had fallen substantially because of foreign governments' decisions to devalue their own currencies, usually by abandoning the gold standard and allowing the price of their currencies to be determined by market forces. The quickest way to raise commodity prices and alter the exchange rate was to change the dollar price of gold. The federal government had lowered and raised gold's dollar price in the past; the Constitution provided Congress with the power to do so. Congress authorized the president to raise the dollar price of gold by up to 100% (or synonymously cut the gold content of dollar coins by as much as 50%) in the Thomas Amendment to the Agricultural Adjustment Act in May 1933. The Roosevelt administration used these powers to the utmost, periodically and persistently raising gold's dollar price from the spring of 1933 through the winter of 1934. Roosevelt's gold program concluded in January 1934 with the passage of the Gold Reserve Act, which set gold's official price at \$35 per troy ounce.

Gold clauses in contracts impeded this policy. An example was printed on Liberty Bonds: "The principal and interest hereof are payable in United States gold coin of the present standard of value." Clauses like this were common in public and private contracts. Their intent was to protect creditors from declines in the value of currency

or inflation, which is the same phenomenon but stated as an increase in the average price of goods. Gold clauses ensured lenders that they would be repaid with currency or gold coins with the same real value (in terms of the goods and services that they could purchase) as the funds that they had lent.

Gold clauses had a pernicious effect, however, when deflations and devaluation decisions of foreign governments reduced prices and economic activity. Then, gold clauses prevented governments from quickly and effectively remedying the situation by altering the money supply, interest rates, exchange rates, and prices to push the economy back toward equilibrium. In Chapter 16, Edwards admits monetary expansion was the optimal policy to pursue. He "strongly" believes it was the "main force behind the recovery." He indicates, correctly, that this is the consensus of scholars who have studied the issue (and he offers no alternative explanation). The Roosevelt administration understood this problem and on May 29, 1933 convinced Congress to void gold clauses in all contracts retroactively and in the future.

Chapters 5 through 10 do a good job of conveying this material and describing the thought process of the Roosevelt administration as it struggled to make difficult decisions in real time with limited information. The chapters reflect the conventional wisdom found in canonical accounts of this period, including Milton Friedman and Anna Schwartz's *Monetary History of the United States*, Peter Temin's *Lessons from the Great Depression*, and Barry Eichengreen's *Golden Fetters*. The chapters also do a good job of describing concerns and criticisms of Roosevelt's recovery plans. Perhaps as a narrative device, the chapters do not tell you who was right. That material appears 100 pages later, in Chapter 16.

Breach and default? / Chapters 11 to 15 contain the novel part of the narrative. They describe investors' reactions to Roosevelt's gold policies and the abrogation of the gold clause. Investors quickly sued in state and federal courts, demanding that

borrowers repay debts with gold coin as required by gold clauses, rather than currency as determined by Congress. Courts consistently ruled against the plaintiffs, usually indicating that the Constitution gave Congress the power "to coin money and regulate the value thereof" and to determine what was legal tender for the discharge of public and private debts. Plaintiffs appealed these decisions and the cases quickly reached the Supreme Court.

American Default's coverage of these court cases is seminal and stimulating. I know the literature on this topic well. As the official historian of the Federal Reserve System, I co-wrote essays on "Roosevelt's Gold Program" and the "Gold Reserve Act of 1934" for the Federal Reserve's *Federal Reserve History* website (www.federalreservehistory.org). I have read much of what scholars have published on this topic. I know of no comparable source for information on these court cases, the arguments presented by the plaintiffs and defendants, and the rationale underlying the Supreme Court's confusing decision that Congress's abrogation of the gold clause in private contracts was constitutional while Congress's abrogation of the gold clause for government bonds—particularly the Liberty Bonds—was constitutional in some ways but unconstitutional in others, did not harm the plaintiffs, and therefore would not be overturned by the courts.

Now we get to one point on which I disagree with the author. Edwards clearly believes the U.S. federal government defaulted on its debts. The Supreme Court equivocated but generally seemed to think that the United States did not default. I agree with the Supreme Court. Here's why:

The *Merriam-Webster Dictionary* defines a default as either (1) a failure to do something required by duty or law, or (2) a failure to pay financial debts. The U.S. Supreme Court decision in the gold cases indicated that the federal government defaulted in the first sense by not fulfilling a promise printed on the bonds, which was to literally repay bond holders with U.S. gold coins at the standard of value that

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prevailed when the bonds were issued in 1918. At that time, the basic gold coin was the Eagle. It was worth \$10 and contained 0.48375 troy ounces of gold and 0.05375 troy ounces of copper. So, a Liberty Bond with a face value of \$100 promised upon maturity payment of 10 gold Eagles containing a total of 4.8375 troy ounces of gold and 0.5375 troy ounces of copper. When the Liberty Bonds matured in 1938, however, the government gave bondholders neither the Eagles nor the metals that they contained.

However, the Supreme Court ruled that the federal government did not default in the second sense: it fully paid its financial debts. The latter conclusion requires explanation, particularly because the book emphasizes the “American Default” aspect of the Court’s decision. The Court justified this conclusion using two arguments originally advanced by the federal government. The first began with the fact that in 1933, the federal government had withdrawn all monetary gold from circulation and paid in return paper currency at the standard of value that had prevailed since 1900. This meant that an individual holding 10 Eagle coins had to give them to the government and accept \$100 in paper currency in return. The government argued that Liberty bond holders could and should be treated the same way as everyone else in the United States. In a hypothetical scenario, when the bonds matured, the government would pay bondholders the gold coins as promised, but then would immediately confiscate the coins and compensate the former bondholders with currency at the same rate that everyone else had been compensated a few years before. This hypothetical sequence of transactions was legal. The U.S. Constitution enumerated Congress’s power to determine the standards of coinage and legal tender. These enumerated powers enabled Congress to convert gold coins to paper currency and/or redefine the standards of value and objects accepted as payment for public and private debts. If the government executed this hypothetical sequence of transactions when the bonds matured in 1938, an individual who had

purchased a \$100 Liberty Bond in 1918 would in the end receive \$100 in currency. The Supreme Court ruled that it was acceptable for the government to give that currency directly to the bondholders upon maturity, rather than go to the hassle of giving them gold coins, taking them back, and then paying the currency for them.

To understand the second argument that abrogating the gold clause did not involve a financial default, it may help to step back from the legal technicalities and think of the repayment in an economic sense. The purpose of the gold clause was to protect bond holders from a fall in the value of American currency, a phenomenon known as inflation. The clause promised that individuals who invested in the United States would be repaid with dollars whose real value in terms of goods and services was equivalent to the real value of the dollars with which the individuals purchased the bonds. Did the U.S. government do this? The answer is yes. The purchasing power of the dollar rose 4% between 1918, when the fourth Liberty Bond was issued, and 1938, when the fourth Liberty Bond matured. So, an American citizen who in 1918 purchased a \$100 Liberty Bond received in 1938 funds sufficient to purchase goods and services that would have cost \$104 in 1918. The government also paid 4.5% interest each year along the way. So the government did honor its pledge to maintain the purchasing power of the funds entrusted to it by purchasers of Liberty Bonds and return that to the purchasers plus interest.

What about foreigners? They owned many U.S. bonds. The largest group of foreign investors were English. Their position is worth considering. In October 1918, when the Liberty Bonds were issued, the dollar–pound exchange rate was 4.77. An English investor could exchange £1 for \$4.77 and purchase a \$100 Liberty Bond for £20.96. In October 1938, when the Liberty Bonds matured, the dollar–pound exchange rate was 4.77. An English investor who redeemed his bond for \$100 in U.S. currency could convert that into £20.96, exactly what he had paid for it.

And with those funds he could buy goods that would have been valued at £46.69 in 1918 because the purchasing power of the pound had risen substantially since that time. So English investors, like many others overseas, made large profits from investing in Liberty Bonds.

Plaintiffs in the gold clause cases before the Supreme Court hoped that their suit would allow them to reap even higher returns. They argued that the government should be required to pay them with old gold coins, like the Eagle, at the 1918 standard of value, and then they should be able to convert the Eagles to dollars at the price established by the Gold Reserve Act of 1934 (\$35 per troy ounce of gold). The government countered that this was infeasible: there was not enough gold in the United States to pay all the Liberty Bond holders. The plan was also illegal; the law no longer allowed the public to own, save, or spend monetary gold. In that case, the plaintiffs argued, they should receive the amount that would result from a hypothetical sequence of transactions where the government gave them gold coins at the 1918 standard of value (as stated on the bonds) and then immediately converted that gold to currency at the 1934 standard of value. This sequence would pay \$166.67 on a \$100 Liberty Bond upon maturity in 1938, a sum sufficient to purchase goods and services that would have cost \$174.19 in 1918. The majority of the Supreme Court rejected this claim and referred to it as unjust enrichment.

No evidence of distress / Chapter 16 discusses the consequences of the abrogation of the gold clause. At the time, opponents of the policy contended that its effects could be catastrophic. Contracts would not be trusted. Creditors would no longer want to extend loans. Interest rates would rise. Investment would fall. The economy would stagnate.

Edwards looks for evidence of these ailments in data on investment, borrowing, bonds, stocks, prices, interest rates, and output. He finds none. After abrogation, the government actually found it easier

to borrow, rather than harder. Edwards concludes that there is

no evidence of distress or dislocation in the period immediately following the abrogation, or the Court ruling. ... It is possible that if the gold clause had not been abrogated, output and investment would have recovered faster than they did, and that the costs of borrowing would have declined even more. Those outcomes are possible, but in my view, highly unlikely.

The reason abrogation had no detectable effect, Edwards concludes, was that it was an excusable default. Excusable defaults occur under circumstances “when the market understands that a debt restructuring is, indeed, warranted, and beneficial for (almost) everyone involved in the marketplace” when the restructuring is done according to existing legal rules, and when the default is largely a domestic matter with few foreigners involved. Excusable defaults do not stigmatize sovereigns because they do not change borrowers’ expectations of sovereigns’ probability of repaying future debts.

I agree with Edwards that the abrogation of the gold clause fits these circumstances and I argued, in the preceding paragraphs, that the abrogation fit another classic characteristic of an excusable default: bondholders received payment equal to (or better than) what they expected when the debt was issued. Since past holders of Liberty Bonds received the repayments that they expected when they purchased the bonds on origination in 1918, despite the tremendous shocks to the United States and world economies between then and maturity in 1938, future bondholders had no reason to doubt that their expectations would not be met.

A future default? / Could it happen again? The author asks that question at the beginning and end of the book (and in the title to Chapter 17) because, he says, “among all questions, [it was] the one that kept coming back again and again.” In emerging economies, Edwards indicates, “situations

that mirror what happened in the United States during 1933–1935 have occurred recently in a number of ... countries, and it is almost certain that they will continue to arise in the future.” Examples from the recent past include Argentina, Mexico, Turkey, Russia, Indonesia, and Chile.

Advanced economies are not immune from these economic forces. In 2008, Iceland faced “a gigantic external crisis with a massive devaluation and a complete collapse of the banking sector. It took almost ten years for Iceland to recover.” Greece continues to struggle with a similar situation, as do other European nations such as Portugal, Italy, and Spain. These nations may be tempted to leave the eurozone, reintroduce independent currencies, and devalue their exchange rate in order to speed economic recovery. But any nation that tries (or is forced) to do this will struggle with contracts, all of which are written requiring payment in euros. If these are rewritten to permit repayment in new currencies of lesser value, the issue is sure to end up in domestic and foreign courts as well as the World Bank’s tribunal for international investment disputes.

While the rest of the world may be in danger of experiencing events similar to the U.S. abrogation crisis of the 1930s, Edwards argues that “it is almost impossible that something similar will happen again in the United States.” The main reasons are the change in the monetary system and the exchange rate regime. The United States’ exchange rates are now determined by market forces. Gold no longer underlies the monetary system. Most contracts are denominated in lawful currency, not gold, commodities, or foreign currency.

Even if a repeat is extremely unlikely, the chance of the United States restructuring its debt, Edwards argues, is not zero. The federal debt outstanding is now nearly equal to gross domestic product. A tenth of the debt is fixed in real terms because, upon maturity, bondholders receive a premium payment linked to increases in the Consumer Price Index. The implicit debt for future entitlements—particularly Medicare, Medicaid, and Society Security—exceeds 400%

of GDP. There is little agreement on how to pay for these promises, Edwards notes, and at some point in the not too distant future the U.S. government may be forced to restructure its payments. This potential crisis, he argues, differs from the crisis of the 1930s because that crisis stemmed from deflation, exchange rates, and the structure of the monetary system. The modern problem arises from promises made in the present for the future delivery of services.

On all of these points, I agree with Edwards. I am, however, less hopeful for the future. The unsustainable federal debt is not an accident. I believe it was consciously created by Republican politicians to justify reducing (or eliminating) future federal entitlements. With Republicans in control of all three branches of the federal government, taxes cut, deficits up, and a recession on the horizon, the day of reckoning may soon be upon us. I anticipate a massive abrogation of federal medical and retirement entitlements within the next decade—sooner if Republicans retain control of Congress and the White House in the next two election cycles.

The roots of the past and current crises may have more in common than Edwards indicates. Most payments for federal entitlement programs are indexed for inflation. Federal entitlement obligations are, in other words, guaranteed in real terms, just like payments for Liberty Bonds 100 years ago. They cannot be adjusted on aggregate by monetary policies that generate inflation; they can only be adjusted through the legislature and the courts. On this point, Edwards’s *American Default* ends on a high note.

The ability of the United States to deal with the crisis of the 1930s and the abrogation of the gold clause demonstrate the strength of our legislative and judicial institutions. Given these, it is likely that our nation will be able to overcome future federal financial restructurings. Memories of those events will fade and be forgotten just like the events that Edwards masterfully recounts in his book, and America’s federal debt will remain the risk-free standard for the rest of the world. R

Tyranny by Facebook or by Leviathan?

◆ REVIEW BY PIERRE LEMIEUX

Despite being authored by a professor of politics at the grand Old Cambridge University, *How Democracy Ends* sometimes feels light. Its catchy formulas and cheesy pronouncements get annoying. A biological analogy is over-exploited: “Western democracy is going through a mid-life crisis”; “American democracy is in miserable middle age. Donald Trump is his motorbike.”

This should not distract us from the thesis of the book and the questions it raises. David Runciman argues that democracy is threatened by new sorts of predicaments. Military coups d'état are passé. Even Trump (or, I would add, his successor) doesn't represent the main danger; the new threats are subtler. Even people who subvert democracy, like populists do, believe or pretend that they are defending it. An environmental or nuclear catastrophe could end democracy, but a technological takeover is more likely.

Democratic failure / Runciman goes from a “minimal definition” of democracy as that which chooses its political leaders via regular elections, “which remain the bedrock of democratic politics,” to a more general and fuzzy one that includes such features as “democratic legislatures, independent law courts and a free press.” What about other individual liberties? Perhaps democracy also includes those, or perhaps not. The word “liberty” is absent from the book, although the less committal “freedom” occurs once every 15 pages or so.

Runciman believes that democracy is undermined by the decline of representative democracy and the rise of populism, which revolves around the idea that “democracy has been stolen from the people by the elites.” If democracy worked well,

he believes, there would be no populist backlash. Working well implies providing a “collective experience.” This so-called collective experience is more difficult to pull off in the absence of war—or, at least, of a traditional war, not waged by drones—and when great social reforms have already been accomplished, decades ago. In the Progressive Era, democracy was able to tame populism because of social reforms and World War I. In Runciman's view, war also has the benefit of reducing wealth inequality (because wealth is destroyed) and thus keeping populism at bay.

Runciman argues that referenda provide only the appearance of democracy, while elected representatives can manage the inconsistent, unrealistic, or inefficient demands of the electorate. Pure democracy is “reckless” and “terrifying.” But he also admits that representative democracy implies more power for the politicians and the experts.

At any rate, he writes: “The threat to democracy is not manipulation. It is mindlessness.” Both pure democracy and technology are fueling mindlessness.

One reason why modern democracy tends to destroy itself, argues Runciman, is a tension between individual dignity and “collective benefits.” Individual dignity is better satisfied by pure or direct democracy, but such democracy's inconsistent or irrational policies compromise the “collective benefits” of efficiency and economic growth. The resulting mess is easily exploited by populist leaders who sell “identity politics” as a booster to individ-

ual dignity. (In return, the populist leader gets more power for himself.)

Voters are not interested in big issues. Large risks like environmental catastrophe and nuclear war become difficult to control rationally. (It's unclear why those dangers wouldn't give us some good “collective experience.”) People grow more frustrated:

Modern democracy is riddled with holes. Many people do feel neglected. Their views seem to count for little and their representatives often appear uninterested in hearing them out. Contemporary populism feeds off this sense of disconnect.

How Runciman would reconnect people is unclear. How would representative democracy reconnect what it has disconnected? And how can populism and the mob do it?

How Democracy Ends neglects other promising explanations for people's growing frustration under the all-powerful democratic state. Standard public choice theory explains how organized interests game the system. Anthony de Jasay presents a different but astute theory. In his 1985 book *The State*, he argues that the more the state responds to sectional demands, the more it frustrates other parts of the public, and the more it must intervene to respond to the latter complaints, and so forth in a cascade of ever-frustrating interventions. Everybody is both helped and hindered by the state, which fuels growing discontent.

In de Jasay's perspective, authoritarian democracy is unstable because it is essentially unlimited—that is, responsible for everything and everyone. For Runciman, democracy seems to be a value by itself—perhaps the ultimate value—and only its subversion is dangerous. Democracy has failed; long live democracy!

Zuckerberg and Leviathan / A strong thread runs through *How Democracy Ends* that questions the new technologies represented by computers and robots. “Politics,” writes Runciman, “needs to regain a measure of control over these machines and over the people who currently control them.”

In his view, “the network” undermines democracy. This network is made of the

computers that connect people with others, people with machines, and machines with machines. This interconnectedness becomes essential to people's lives. Social networks provide "a sense of belonging" that substitutes for the state and enhances tribalism. Leviathan itself—the all-powerful state—is a machine, as Thomas Hobbes imagined. There is often something guru-like and vaporous in Runciman's descriptions.

Yet the Cambridge professor recognizes that digital technology has reinforced Leviathan more than it has fulfilled its original promises of liberating individuals from the powers that be. It also intensifies voters' cognitive biases through "fake news" and the isolation of individuals in partisan silos, as any regular user of social networks can observe.

Participation in social media may resemble ancient direct democracy, but without its built-in controls: "Twitter is sometimes described as being like the Wild West. But really it is the closest thing we have to democracy of the ancient world: fickle, violent, overpowering."

Reading Runciman on technology, I was reminded of Jacques Attali, a French economist who was an adviser to socialist president François Mitterand in the 1980s. In a 1978 book titled *The New French Economy*, Attali argued that "self-surveillance capitalism" was replacing the free market ideal, and that only socialism could prevent this new totalitarianism. He warned that pocket calculators were the prelude to surveillance by electronic devices. In my first book, *From Liberalism to Anarcho-Capitalism*, published in Paris in 1983, I mocked Attali's dramatization of the pocket calculator, but perhaps he was on to something.

Runciman sees the danger of mass surveillance but, just like Attali, he does not realize that the state is the problem. The author of *How Democracy Ends* thinks that Mark Zuckerberg is "a bigger threat to

American democracy than Donald Trump." Really? He views Leviathan as a potentially good machine that can regain control of the private and corporate machine: "Leviathan still has life left in it." Franklin D. Roosevelt was the face of "Leviathan in action," he writes approvingly. We need an activist democracy again:

If American democracy found the strength to face down corporate titans like Standard Oil at the start of the twentieth century, why shouldn't it take on Google and Facebook today?

Instead of criticizing corporations, online advertising, and "the consumerist madness" à la John Kenneth Galbraith, Runciman should focus on the danger of Leviathan. Information and surveillance are dangerous when they can be used by the state

for coercive control. Of course, the state can be captured by private interests, but the problem is the state, not the private interests. The power of advertising is nothing compared to the state's prisons.

Libertarianism to the rescue / Runciman idealizes democracy as a system of government. He thinks that "collective decision-making works better than any individual's choices if our biases are allowed to cancel each other out." That's a big "if." He generally ignores voters' rational ignorance—the fact that an individual votes blind because the process of gathering and analyzing information is not worth the cost when he has only one vote. "Every vote counts," Runciman echoes. A single vote may count to boost individual dignity, but not to change election results. The author of *How Democracy Ends* does not seem to see how voting and mindlessness fit together.

He ignores the problem of aggregating preferences among different individuals. He throws around the word "we" like bread at the Multiplication of the Loaves

and Fishes, ignoring the demonstration (notably by Kenneth Arrow in his 1951 seminal book *Social Choice and Individual Values*) that, at least in most cases, collective values are either meaningless or totalitarian. He also ignores public choice analysis.

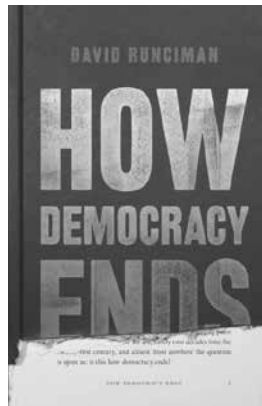
Ideally, Runciman seems to believe, democratic politics should control everything. But he does not explain how that would not be the dictatorship of the mindless. Representative democracy does not solve the problem for the simple reason that the representatives are elected.

Sometimes the reader will be puzzled by Runciman's economics. For example, he does not seem to know what "public goods" are, since he wants them to be "equitably distributed." By definition, a public good can be consumed by everybody once it is provided to anybody. Perhaps he is not using the expression in its technical sense. Or perhaps he is thinking of "public goods" that are only such for part of the public, but this opens a Pandora's box and an explanation would have been welcome. Then again, he may just be speaking in catchy formulas.

He blames economics for supplanting "the messiness of political life" by "the clean lines of perfect competition and efficient markets." With due respect, his own argument would have been less messy with some cleaner modeling.

I am puzzled by a remark he makes when contrasting his ideal of slow-moving, thoughtful representative democracy with the addiction and superficiality of social networks. He claims that "buyer's remorse is relatively uncommon in the world of online commerce because there isn't time for it." This looks hopelessly Galbraithian, again. According to the National Retail Federation, 15–20% of items bought online are returned, which actually fuels a whole industry that purchases returns for reselling (at Dollar stores, for example) or recycling. One would like to be so easily reimbursed when not satisfied with public services. Many would like to be able to change countries as easily as they switch from Amazon to Walmart.

After briefly discussing Robert Nozick's anarchist utopia, Runciman dismisses it,



How Democracy Ends
By David Runciman
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2018

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perhaps because he does not find it practical. But there are more practical versions of this ideal. In his 1969 *In Praise of the Consumer Society*, the late French philosopher Raymond Ruyer wrote that “real anarchism, feasible and realized, as opposed to mere emotional statements, is simply the [classical] liberal economy.”

If he studied libertarianism more carefully, Runciman might realize that democracy is just an imperfect means of managing public goods, changing the political guard when necessary, and restraining the state. Democracy should not be imagined as a way to choose coercive moral values. In *Law, Legislation and Liberty*, Friedrich Hayek wrote that “democracy is basically a negative value which serves as protection against despotism and tyranny.”

Contra Runciman, politics is not a panacea, “political emptiness” is not a terminal disease, and it is not true that “only politics can rescue politics.” Private and voluntary activities would beneficially replace a large part of politics. If the rule of the mob, the rule of the experts, and the rule of the politicians are all fraught with great dangers, which Runciman might concede, the problem must be the rule itself or its scope, not who happens to rule. The solution is to severely constrain state power.

What about tyranny? / Philosophers or political scientists usually imagine that democracy ends with some form of tyranny. Jean-François Revel, author of the 1983 book *How Democracies End*, saw communist totalitarianism as the danger. For de Jasay, democracy ends in state capitalism, where the democratic state monopolizes both political and economic power. This state will ultimately terminate electoral competition because it is inconsistent with economic management: the workers cannot decide their own salaries at the ballot box.

Tyranny is quiet in Runciman’s book. The word “tyranny” appears only four times in the body of the text—including once as “corporate tyranny.” To be fair, another occurrence refers to Tocqueville’s “tyranny of the majority.” Runciman admits that “pure democracy is a terrifying thing. It’s all

too easy for the crowd to turn on any individual who displeases it.” Indeed. But perhaps he should name tyranny as the danger.

The book’s conclusion is anticlimactic: at some point in the future, democracy ends or perhaps it does not end; and there is no solution to this non-event. The last two sentences of the book (before a science-fictional epilogue) read: “This is not, after all, the end of democracy. But this is how democracy ends.”

More to the point, Runciman suggests, democracy will have changed but, in most places, will have remained democracy of a sort. It will reign over a nonviolent and dull society of old people going through the motions of voting occasionally. They will find partial dignity in the network, but many governance problems will be unsolvable. Addicts and suicide deaths will be numerous, as prefigured in many

advanced societies of today.

Let me complement the description. Individuals—if we can still call them such—will smile and be happy, like in Aldous Huxley’s *Brave New World* or Patrick McGohhan’s *The Prisoner*. They won’t have much choice anyway. Why doesn’t Runciman call this tyranny? Not Facebook “tyranny,” but real tyranny from Leviathan, even if it is softer than in George Orwell’s *1984*. Runciman brings us close to this, but he stays fixated on Zuckerberg against the good Leviathan.

I would agree that Facebook’s “community” gibberish and standards à la Mrs. Grundy often look like the Brave New World. But Leviathan’s power is the real danger. It’s much easier to disconnect from Facebook than to close one’s account with the state. *How Democracy Ends* may help ask the right questions, but it does not provide useful answers. R

Perspective on the Terrorist Threat

◆ REVIEW BY DAVID R. HENDERSON

In 2007, Princeton University economist Alan Krueger published a short book, *What Makes a Terrorist*, based on three lectures he gave in Britain debunking many of the myths about terrorism. Now he has published a 10th anniversary edition with a new prologue and updated material. What distinguishes his work from many

others on the subject is his empirical approach: he looks carefully at the data.

The three chapters of the book are titled, “Who Becomes a Terrorist? Characteristics of Individual Participants in Terrorism,” “Where Does Terror Emerge? Economic and Political Conditions and Terrorism,” and “What Does Terrorism Accomplish? Economic, Psychological, and Political Consequences of Terrorism.” In each chapter, he draws on data to answer those questions,

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and what he finds is striking:

- International public opinion surveys find that support for terrorism is higher among those who are more highly educated and have higher family income. One striking statistic comes from a survey of 1,318 Palestinians in the West Bank and Gaza Strip: 86.7% of merchants and professionals, versus “only” 73.9% of the unemployed, supported armed attacks against Israeli targets.
- Terrorists “are more likely to be well educated and less likely to come from impoverished backgrounds” than the

populations from which they come.

- International terrorists—Krueger never defines the term but, in context, he means (and he confirmed this by email) those who engage in terrorism against foreign targets, whether in their own or in other countries—tend to come from countries whose governments suppress civil liberties and political freedom.
- There is no connection between a country's income per capita or illiteracy rate, on the one hand, and the number of international terrorists from that country, on the other.
- Terrorists' preferred targets tend to be wealthy countries whose governments respect civil liberties and political freedom rather than poor countries with repressive governments.
- Distance matters; that is, international terrorists and foreign insurgents tend to come from countries that are geographically close to the countries they target.
- For their acts to have the desired effects, terrorists who use conventional methods of terrorism "need the media to propagate fear."

Understanding terrorism / To discuss terrorism, you first need to define it. Krueger characterizes terrorism as "premeditated, politically motivated violence." He notes that although this characterization doesn't exclude state-sponsored terrorism, his goal is to consider "substate organizations and individuals with the intent of influencing an audience beyond the immediate victims."

In context, his winnowing down to non-state actors makes sense because what many people would like to understand is who the substate actors are and what motivates them. I think I understand, for example, the vengeance motive that led the U.S. government, early after its entry into World War II, to send Lt. Col. Jimmy Doolittle and his squad's airplanes to fire-bomb the Japanese mainland. But what many people aren't entirely sure of is what causes various non-state actors to attack

the targets they choose in, say, the United States. Krueger doesn't answer everything we might like to know, but he does give some answers and is careful not to go far beyond what he can extract from the data.

On the lack of a connection between terrorism on the one hand and poverty and low education level on the other, Krueger, besides looking at his assembled data, makes a big-picture empirical point: "If poverty and inadequate education were causes of terrorism, even minor ones, the world would be teeming with terrorists eager to destroy our way of life." In fact, he notes, uneducated poor people are particularly unlikely to participate in any political processes, terrorist or otherwise. They are too busy trying to make a living.

When we think of terrorism, many of us think of Muslims. University of Chicago political scientist Robert Pape, who gathered data on every known case of suicide terrorism between 1980 and 2003, found little connection between it and Islamic fundamentalism. Krueger cites Pape and reports on his own study, co-authored with David Laitin, that found similar results for terrorism in general. Krueger and Laitin looked into whether a country with a high percentage of Muslims is more likely to be a home to terrorists than a country with a high percentage of Christians. They found no significant difference.

What motivates terrorists? Krueger found that "countries that occupy other countries are more likely to be targets of terrorism." That certainly makes sense. Interestingly, though, he also found that countries that are occupied are only "slightly more likely to be perpetrators of terrorism." Of course, countries can't perpetrate terrorism. Krueger is clearly referring to terrorists and identifying them by the country they came from. And many terrorists seem to come from

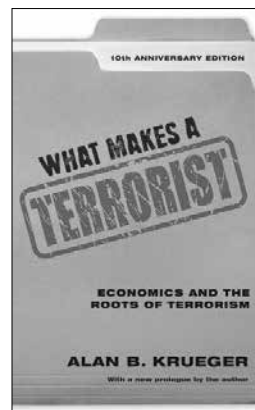
third countries, rather than occupier or occupied countries.

Inflating the risk / How serious a problem is terrorism? Krueger's table of relative risks shows that the answer is "not very." An American's lifetime risk of being killed by a terrorist, calculates Krueger, is 1:69,000. Compare that to the 1:88 chance of being killed in a motor vehicle accident and the even more serious 1:7 risk of dying from cancer and 1:4 risk of dying from heart disease. Based on other risks he shows in his table, he writes, "In 2005 the average American's chance of being killed by a terrorist was much less than his or her chance of being killed by lightning or in an airplane crash."

People often respond to this by pointing out that, with terrorism, someone is actively trying to kill others, whereas with the other risks, fatalities "just happen." While that certainly should affect our moral evaluation—lightning is amoral, while a terrorist is virtually certain to be immoral—it should not affect one's evaluation of relative risks. Krueger doesn't address this response, probably because he sees it as the red herring that it is. But his table of risks implicitly

answers the argument. He shows that an American's lifetime probability of being murdered is 1:240, which is 287.5 times the probability of being killed by a terrorist. In both cases, the killing is intentional.

Given the small risk of terrorism, Krueger is right to decry government officials' pronouncements that hype the threat. He reports that in July 2007, Michael Chertoff, then secretary of homeland security, told the *Chicago Tribune* of his "gut feeling" that al-Qaeda might attack the United States that summer. His reasoning was that "summertime seems to be appealing to them." But Krueger, using the government's own data, found no summer



What Makes a Terrorist: Economics and the Roots of Terrorism

By Alan B. Krueger

195 pp.; Princeton University Press, 2018

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spike in al-Qaeda terrorist attacks between 2004 and 2006. He found 10 attacks in the winter, 13 in the spring, nine in the summer, and seven in the fall.

He notes that in the summer of 2007, someone had brought his evidence to the attention of the Department of Homeland Security. Did DHS then say, “Oops, our bad?” Dream on. Instead, DHS spokesman Russ Knocke responded, “If any doubt lingers in his [Krueger’s] mind about activity in spring and summer months in recent years, he need only ask the families of victims from London, Madrid, and 9/11.” In his book, Krueger has a great comeback: “Evidently Mr. Knocke does not think it important to consider the victims of terrorist attacks that occurred in winter and fall.”

More than a decade before giving these lectures, Krueger was the chief economist in President Bill Clinton’s Department of Labor; after giving these lectures, he went on to become chairman of the Council of Economic Advisers (CEA) under President Barack Obama. His experience in government doesn’t seem to have led him to the same skepticism about government competence that I had in my two early-career stints at the CEA.

He does find fault, quite justifiably, with the important statistical errors issued by the State Department under President George W. Bush’s secretary of state, Colin Powell. For instance, a major report on world terrorism in 2003 was supposed to cover the entire year, but the last terrorist attack it listed in the appendix was on November 11. This made no sense, argues Krueger, because on November 15, there were attacks in Turkey on two synagogues, the British consulate, and a British bank. Krueger’s solution is for the State Department to have its own statistical agency, but he doesn’t express any overall skepticism about the government’s competence in dealing with terrorism.

At one point, he notes that terrorists may be “motivated by some grievance concerning American activity in the Middle East, such as the presence of American troops in the Persian Gulf and American support of autocratic regimes friendly to the United States.” He concludes that we

“have to confront their grievances.” But he adds, “And we may not want to confront their grievances.” His solution instead, which he admits is unlikely to be “an important part of the solution,” is to have the government—presumably he means the U.S. government—control the content of education that people in other countries receive.

He never suggests that government officials be fined or even fired for misreporting facts. But he doesn’t have the same tolerance for private-sector actors. He writes, “Perhaps the FCC could keep track of inaccuracies in reporting on terrorism and fine media outlets if they repeatedly make mistakes.” It is certainly true that the media hype terrorism and that that has

bad effects. But his confidence in proposing that a government agency be given the power to fine those who are exercising their freedom of speech is breathtaking.

While I recommend the book overall, I point out one thing that is missing. In a well-referenced book, nowhere does Krueger mention an article that makes many of the points he does about relative risks and about how the main damage from terrorism comes not from terrorism per se, but from its provoking destructive government policies. The article I’m referring to, published over a year before Krueger’s 2006 lectures, is Ohio State University political scientist John Mueller’s “A False Sense of Insecurity” in these pages (Fall 2004). R

A Degree Too Far

◆◆ REVIEW BY DWIGHT R. LEE

In his latest book, George Mason University economist Bryan Caplan has done what educators universally laud and applaud: he has impressively applied critical thinking to an important issue. Yet most educators will be appalled by *The Case Against Education* because it argues that most of what is spent on education in America is wasted.

Caplan has no illusions that his argument will be widely embraced. Most people have heard all their lives that spending more on education is the best way to improve the futures of our children and the prosperity of our country, and they serve as Baptists in the political process for the well-organized bootleggers who profit from education spending.

Politicians and organized groups, including educational professionals, routinely justify government support for activities benefiting them by claiming they create positive externalities: social benefits that are not captured by those providing them. Thus educational professionals argue that, without government

support, less education will be provided than is socially desirable. Unfortunately, even when there is a positive externality, it is often used to justify government spending that creates a more-than-offsetting negative externality: social costs that are ignored by those benefiting from the spending. Caplan’s case against the existing level of educational spending is that it creates negative externalities by motivating people to increase their education even when the social costs exceed the social benefits. The book makes this case more effectively than it has been made before, by considering the theoretical and empirical implications of applying the concept of signaling to education.

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Signaling / Signaling occurs when an individual’s actions communicate useful, if only probabilistic, information about himself that is not otherwise apparent.

For example, how people dress, the conspicuousness of their tattoos, and whether they support the arts signal information about them to others, such as potential employers. The amount and difficulty of the formal education a person has acquired is obviously such a signal and was mentioned by the Nobel Committee in 2001 when announcing Michael Spence's Nobel Prize in economics for his work on signaling.

Caplan considers whether an individual benefits from the signal a good education sends to prospective employers, and whether that signal is an accurate measure of the social benefit of that education. He provides plenty of evidence that getting a good formal education yields the educated person a very attractive financial return. For readers interested in how to make the best use of educational signaling to increase their financial payoff, his Chapters 4 and 5 are worth the price of the book.

But Caplan also wants to know whether this individual benefit also benefits society. The answer depends on how much it contributes to a student's productive characteristics as opposed to how much did those characteristics preexist his education and contribute to his educational achievements.

Economists and educators have always recognized that productive characteristics both facilitate and are facilitated by education. The widely held view, according to Caplan, is that the dominant direction of educational cause and effect runs from education to productive ability. He refers to those who hold this view as "human capital purists."

Contrary to the purists, Caplan argues that empirical research supports the alternative view that education is more a signal of the productive characteristics students bring to their education than of the produc-

tive abilities they develop *because of their education*. The most obvious characteristic students bring to school is their intelligence, which most agree cannot be increased much, if at all, by education. Obviously, the more intelligent can compile an impressive educational record that sends a useful signal to employers on both their intelligence and what they have learned in school. But except for strongly applied studies such as accounting, engineering, and pharmacy, employers are more interested in prospective employees' ability to learn rather than in what they have already learned. One might argue that, this being the case, a lot of time and money spent on education could be saved by simply giving prospective employees an IQ test.

However, Caplan notes, there are legal limitations on requiring potential employees to take IQ tests. More importantly, intelligence is not the only thing employers are looking for. They are also interested in a person's willingness to work hard and to adhere to prevailing social norms. Completing a degree also signals information on these characteristics. A person may have an IQ of 150, but if

he doesn't go to college, his apparent lack of diligence and unwillingness to do what is expected of highly intelligent people are red flags to employers. This explains why high-school graduates earn more than dropouts, even if the latter pass the tests necessary to earn a General Equivalency Diploma. As Caplan says of the GED, "Its chief function is to signal employers, 'I have the brains but not the grit to finish high school.'" There is a "sheepskin effect" to education signaling seen in a sharp income increase from staying in school long enough to receive a diploma. Tenacity and "fitting in" may not be as strongly determined by heredity as intelligence, but by the time a person reaches high school it is unlikely these characteristics will be

improved by forcing unmotivated students to sit through hours of what they consider boring lectures.

Caplan recognizes that education signals useful information to employers on the productivity of potential employees. That information, in turn, will affect those workers' salaries. He finds, however, that most of the productivity signaled by formal education is not the result of the education itself but of the characteristics students bring to their high school and college experiences. He illustrates his argument with the analogy of a sculptor and appraiser:

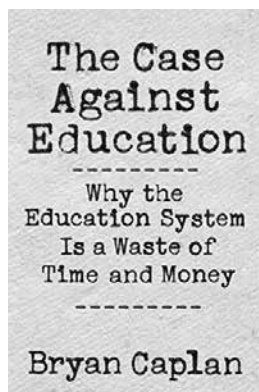
The sculptor raises the market value of a piece of stone by *shaping* it. The appraiser raises the market value of a piece of stone by *judging* it. Teachers need to ask ourselves, "How much of what we do is sculpting and how much is appraising?" (Caplan's emphasis.)

Teachers do some sculpting and appraising, but careful and multiple empirical approaches point to what Caplan labels "a reasonable estimate of 80%" as the "share of education's effect on earning and employment [that] stems from signaling" or appraising. That leaves 20% as education's sculpting contribution.

Negative externalities / Without using the term, Caplan gives an example of the type of negative externality educational signaling motivates with the following:

The person who gets more education, gets a better job. It works; you see it plainly. Yet it does not follow that if everyone gets more education, everyone gets a better job. In the signaling model, subsidizing everyone's schooling to improve our jobs is like urging everyone to stand up at a concert to improve our views. Both are smart for one, dumb for all.

Everyone standing up at a concert is a commonly used example of a prisoner's dilemma, in which all are worse off when each does what is in his best interest. It is also an example of the negative externalities each creates when trying to increase his benefit by imposing an uncompensated



The Case Against Education: Why the Education System Is a Waste of Time and Money

By Bryan Caplan
416 pp.; Princeton University Press, 2018

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cost on everyone else. The result is everyone ends up worse off in futile attempts by each to become better off.

In the case of education, the higher salary from getting one more degree makes it financially attractive for students, even though the social cost of the additional education is greater than the social value it contributes by increasing productivity. This can motivate wasteful spending on education even if students or their families are paying the full cost. It is a larger problem when government is paying for much of the cost, which motivates more students to get—or attempt to get—a higher degree to signal qualifications greater than justified by their natural abilities and what they learn in school. As more people try to signal their productivity with more education, employers will find the signals becoming less impressive and students will find it less beneficial to send them.

Yet this doesn't reduce the appeal of additional education, even to weak students. The student who doesn't try for the extra education is now signaling to employers that he cannot even send a weak signal. So more weak students try for degrees they don't complete, which means the signal they send is even weaker. Furthermore, those with the ability to earn an extra degree find that the signal they now want to send requires education beyond that degree. As in Caplan's prisoner's dilemma example of standing at the concert, as educational signaling motivates students trying to get the edge on other students by getting relatively more education, it takes more years in school for all students to maintain the value of their signaling. Yet dropping out of this educational race would be the equivalent of sitting down at the concert while others continue standing; by sitting, a person would no longer be imposing a negative externality on others, but the harm imposed on him by those still standing would be greatly increased.

Caplan recognizes that there is social benefit from signaling information on students' natural abilities that are otherwise difficult to observe. But he also recognizes that even a large total social benefit from

educational signaling doesn't indicate much, if anything, about its marginal benefit. If Caplan is correct that "employers' knowledge of worker quality would be essentially identical if everyone had one less degree," then he is also correct when saying that "in economic jargon, the *marginal* social benefit of signaling is roughly zero, even though its total social benefit is substantial" (Caplan's emphasis). The "roughly zero" is a hedge, but not a troublesome one. Before the marginal social benefit of educational signaling reaches zero, it is sure to be less than its marginal social cost, in which case reducing that signaling by spending less on education is socially beneficial.

The marginal cost of providing this signaling is enormous. Government spending on education in 2010–2011, including federal assistance to individuals (and removing double counting), was over \$960 billion, significantly higher

As more people try to signal their productivity with more education, employers will find the signals becoming less impressive.

than the \$700 billion in the military budget. According to Caplan, "If half [of that] is wasteful signaling, we are wasting [almost] half a trillion dollars a year." Even with this optimistic assumption on signaling waste, taxpayers end up paying \$960 billion for \$480 billion worth of education. That education does create some positive externalities, which are continuously being used to justify the \$960 billion paid in taxes. But those benefits are not worth anywhere near the \$480 billion needed to cover the negative externalities on taxpayers plus those on large numbers of students. As he writes:

My own calculations incorporate multiple positive externalities. What low and negative returns show is that standard pro-education arguments are

incomplete.... Counting everything that counts, industrial policy for education has clearly gone too far. The United States—and probably the rest of the world—is overeducated.

Conclusion / He ends the book by reemphasizing what few people have considered, much less accepted:

Academic success is a great way to *get* a good job, but a poor way to learn how to *do* a good job. If everyone got a college degree, the result would not be great jobs for all, but runaway credential inflation. (Caplan's emphasis.)

From the very beginning of his book until the end, Caplan makes it clear that he believes the net social benefit from education would be larger and the world would be a wealthier place if we would "cut the subsidies" to education or "slash government subsidies" to education. And government subsidies are not the only way the cost of education has been reduced for students. Although he does not mention grade inflation, it has greatly reduced the study time

required by students to send what used to be an impressive academic signal, but one that has been significantly reduced in value. In other words, teachers are failing at their most important job: accurately appraising student performance.

Caplan devoted six years to making a powerful case for significantly reducing the money spent on education, even though this would threaten the career he loves. Why did he do this? Because of a "blend of idealism and cynicism." He says he is "duty-bound to blow the whistle on my industry's vast, ongoing abuse of the taxpayer." But he is also convinced that "even the most intellectually compelling arguments won't convert the typical voter to distasteful conclusions."

Having written *The Myth of the Rational Voter* in 2007, he sees no threat from voters. But there could be a threat that

he has not considered from private markets and rational voters. The *Wall Street Journal* ran a recent article on the rapid growth of one-year private alternatives to college that focus on vocational training. Expanding such opportunities could find students voting for them with their feet, a means of voting that encourages rational consideration of competing alternatives.

This should not worry Caplan, however. Even if his educational recommendations were implemented fully, there would remain academic positions for individuals with his intellectual ability, not to mention his willingness to work hard. The only concern he might have is his inability to accept the prevailing wisdom on an increasing number of topics. R

of income inequality over the past three decades. He does not provide much empirical evidence for this, but the hypothesis looks reasonable: many of the super-rich—who are found not only among CEOs of large companies and high-tech entrepreneurs, but also among entertainers and athletes—would not be skewing the income distribution as much if the government did not protect flimsy intellectual property—and both “intellectual” and “property” deserve to be put in quotes.

Tanzi, who earned his doctorate in economics from Harvard University in the roaring 1960s, is familiar with the economic literature. He also seems to have duly read the defenders of what he calls “market fundamentalism”: Milton Friedman, Friedrich Hayek, Robert Nozick, and many others he cites. He believes that “some libertarian aspirations suffer from lack of realism” and that laissez-faire is “naive.” He is not easy to pin down on the usual (and not very useful) left-right spectrum but, as we will see, he suffers from his own naiveté.

Contrary to many economists—and a vast multitude of non-economists—Tanzi understands and explicitly recognizes the implications of Kenneth Arrow’s Impossibility Theorem. (See Arrow’s 1951 book *Social Choice and Individual Values*.) Arrow later shared a Nobel Prize in economics for his

work in this area. The theorem fundamentally challenged the concept of “public interest,” except in the rare cases when it is a *common* interest. It is generally impossible to aggregate divergent interests without imposing the preferences or values of some individuals on other individuals. Yet Tanzi often slips into invoking the notion of public interest. For example, he calls for “an income distribution closer to the one that society would consider desirable.” Considering something desirable is precisely what society cannot do, as per Arrow’s theorem.

I think that Tanzi is critical

The Ideal Fox in the Ideal Henhouse

◆ REVIEW BY PIERRE LEMIEUX

Vito Tanzi is a former academic and high-level bureaucrat in the International Monetary Fund and the Italian government. He is also a prolific author. His latest book, *Termites of the State*, covers 400 pages (excluding the bibliography and index) in 34 short chapters. It is easy to read but loosely structured and often repetitive.

Summarized in a few sentences, his thesis is that many new problems have, like termites, undermined the market and made it less free and less equitable—sometimes because of state intervention. The state itself, victim of its own termites, has become less efficient at solving these problems. Yet we must look to the state for solutions.

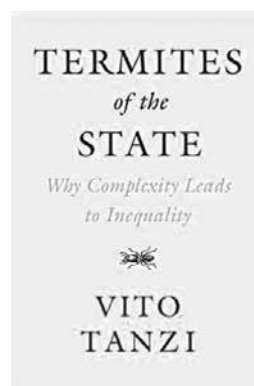
The termites of the state are “various elements that enter into the political system and that corrupt, or distort, the legitimate economic role that governments try to play.” Similarly, the termites of the market are factors that “distort the legitimate functions of markets.” Inequality and externalities are two big market termites.

Something rotten in the state | *Termites of the State* can be read as arguing that the state must mend its ways and that the market is desirable to ensure prosperity and protect individual freedom. The state, Tanzi suggests, has become so complex and so capturable by special interests that it has turned the free market into crony capital-

ism. Further, public policy has contributed to redistributing income from ordinary individuals to the rich and well-connected. He has a point.

He makes an interesting case against intellectual property rights as they are now protected by the state. Patents only became widespread in the second half of the 19th century, well into the Industrial Revolution. Copyrights developed from the 17th century on but were not fully protected until the 19th century. For a long time, the U.S. government did not protect foreign copyrights; Alexander Hamilton was all in favor of stealing industrial secrets from the British, for instance. But today, trademarks, concerts, sport games, and even the images of famous athletes or entertainers are protected.

Tanzi argues that the proliferation of these little state-sanctioned monopolies has contributed to the rise



Termites of the State: Why Complexity Leads to Inequality

By Vito Tanzi
454 pp.; Cambridge University Press, 2017

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of economic freedom for two reasons. His main normative value lies in some ideal or preferred income distribution that only the state can establish. And he sees the termites (or failures) of the market as worse than those of the state.

Market termites / The market, Tanzi argues, is highly imperfect: it “does not work well enough, especially in some sectors.” Consumers are often irrational and, if only because of information asymmetries, badly informed. Nowhere, however, does he explain how the state is more rational and better informed, and why we should expect it to promote some common interests—instead of, say, favoring its cronies. Moreover, the proliferation of laws and regulations, which Tanzi himself criticizes, must generate tremendous asymmetric information—not to speak of political deceptions, which are in the interest of politicians.

Tanzi repeats the oft-cited statistics on how income has become more unequally distributed during the past three decades in developed countries. He focuses on relative shares instead of the absolute levels of income, and probably underestimates the growth in middle class incomes. (See “The Unintended Case for More Capitalism,” Fall 2014.) He neglects the many legitimate reasons that have influenced recent trends in the distribution of income, such as rapid technological change or, as research indicates, changes in the marriage market. Whom people choose to marry (assortative mating has been on the rise: physicians marry physicians instead of nurses) and how many people remain single may explain one-third of the increase in the Gini coefficient, according to recent research.

Another factor in growing income inequality lies in the actions of the state itself, as we have seen in the case of intellectual property. Tanzi also recognizes that cronyism—the state helping large corporations at the detriment of consumers, for example—has fueled income inequality. But he continues to focus on the need for new government interventions as if the state could be termite-free.

In his view, negative externalities are

another huge class of market termites. Negative externalities, we may recall, are costs that bypass the market and are shifted to people without compensation. Air pollution is a standard example; antibiotic resistance is an even clearer case. Externalities are usually defined to exclude non-physical and (in some sense) non-significant effects. The mere awareness of what is happening to others is generally not considered an externality, nor is the lighted cross on your property that your atheist neighbor may deem to be photon pollution. Extending the concept of externalities renders it useless, especially because private property is precisely a means of reducing negative externalities in society. Anybody can do what he wants on his own property, except for significant physical spillovers onto somebody else’s private property.

But Tanzi adopts a very wide concept of externalities, which includes “psychological” and “aesthetic” ones: things that

The distribution of income has become more equal over the whole world. Shouldn't everyone across the political spectrum be happy about this?

some people don’t like to see, or negative perceptions even if mistaken (that some foods are not safe, for example). He views relative poverty and the envy it generates as a negative externality: “the spending habits of some of today’s rich and super rich ... are likely to create externalities of a psychological nature,” he writes. By making differences in wealth more visible, the new communication technologies have multiplied this envy externality. The state must thus intervene against this “market failure.”

If we follow Tanzi’s approach, greater social complexity multiplies negative externalities that call for government intervention. In *The Road to Serfdom*, Hayek objected to Mussolini’s statement that “the more complicated the forms assumed by civilization, the more restricted the freedom of the individual must become.” On the

contrary, Hayek argued, it is because, and to the extent that, society is free that it can become complex. Tanzi borrows Mussolini’s quote from Hayek but opines that “we must recognize, though we may not wish to accept” the idea it conveys. In practice he often seems to accept it, which I think is not warranted.

Bleeding hearts / Tanzi frequently repeats that laissez-faire is not a solution. He seems to want both a not-too-intrusive state and a state that corrects everything that “society” thinks is wrong.

Focused on the distribution of income in rich countries, Tanzi plays down a stunning story of the past few decades: thanks to liberalization and trade, many poor countries have started to grow. The proportion of the world population living in extreme poverty has fallen from 42% to 11% between 1981 and 2013, according to World Bank data. The distribution

of income has become more equal over the whole world. Shouldn’t everyone across the political spectrum be happy about this? Wasn’t dire poverty a huge negative externality à la Tanzi?

I have other quibbles with *Termites of the State*. The author claims that the move of manufacturing to less developed countries “has led to the deindustrialization of advanced countries.” This is an exaggeration. What happened is that traditional “dirty” manufacturing has moved to poor countries and been replaced in developed countries by more sophisticated, automated, and efficient manufacturing. Higher productivity has reduced manufacturing employment since the early 1950s in America, but it has also increased manufacturing output. Official federal figures show that America’s real manufacturing output has nearly tripled since 1972. Value added in manufacturing, which measures the sector’s contribution to GDP, is up 40% in real terms since 1997 (the first year available for this series) despite the dip caused by the Great Recession.

Which presumption? / Tanzi's favored policies to reduce income inequality include a more redistributive tax system and a basic minimum income, besides the good but underplayed idea of abandoning the state's activities that fuel inequality. In the last chapter of the book, he invokes "the new wisdom for a new age" that Keynes was calling for in *The End of Laissez-Faire* (1926). This new wisdom, writes Tanzi,

would allow both democracy and the market to continue to operate closer (in reality and not just in theory) to the way they should ideally operate. ... Wise experts, from different disciplines, should focus on generating that wisdom.

Tanzi, it now seems, is after an ideal state that will bring about the ideal market: the ideal fox in the ideal henhouse. And we will owe this nirvana to the rule of experts? This is not consistent with the skepticism toward the state that Tanzi showed at the beginning of the book.

The author of *Termites of the State* entertains a strong presumption for the state. I would argue the exact opposite: we should defend a strong presumption for individual liberty and only accept state intervention when it is indispensable to protect liberty, to produce other public goods narrowly conceived, and to combat narrowly defined negative externalities. Strictly limiting the state is a condition for liberty. R

Prins' approach / Her method for laying out the facts is relentless. Her formula is to choose five global economies: Mexico, Brazil, China, Japan, and Europe. She explains how the Fed conjured up money to prop up the banking system in the United States and then how, in rapid-fire succession, central bankers in each of the other economies responded to the Fed.

Prins tracks Mexico's two central bank governors during the crisis and summarizes their balancing act between looking inward to respond to domestic pressures and outward to coordinate interventions with the Fed. She explains how Guillermo Ortiz (late 1990s through the end of 2009) and Agustin Carstens (2010 to 2017) "reacted in different ways to the push from the Fed and the pull from their country."

Ortiz cooperated with the Fed on issues like a \$30 billion foreign currency swap line that supported the Mexican financial system and he even dabbled with quantitative easing. But he was not seen as a team player, as he took the opportunity of the crisis to stress that the G10 economies, especially the United States, failed at regulating and supervising their financial institutions. As Prins puts it, "Ortiz had gone too far" and was replaced by Carstens, who was "likely to be more of a yes man.... With his establishment background, he would be a point person of the Fed and offer a gateway to Washington Beltway economic leaders." Although Carstens did criticize U.S. monetary policy at times, he was considered much more of a team player.

The leadership of Brazil's central bank fell to the hawkish Henrique Meirelles during the crisis years through January of 2011. As Prins bluntly states it:

Meirelles did not blindly follow the Fed's money-conjuring policies. Instead he was forced to balance domestic requirements against those of external monetary doves espousing cheap money as a cure-all for economic woes.

Brazil made it through these years with a relatively mild recession in 2009. During 2010, a year Prins labels "The Best of

Colluding with Central Banks, Not Russians

REVIEW BY VERN MCKINLEY

Three years ago, I reviewed Nomi Prins' last book, *All the Presidents' Bankers*. (See "Finance According to Non-Academics," Spring 2015.) The book traced a century of connections between U.S. presidents and U.S. banks. As I explained it, the book's endnotes made clear that Prins relied on "a wide range of contemporary books, articles, and original documents drawn from the deep bowels of the archives of numerous presidents."

In her new book *Collu\$ion*, she departs those dusty presidential archives for an around-the-world tour of many of the key global financial centers. According to her Author's Note:

To research this book, I set out on a global expedition. I visited Mexico City, Guadalajara, Monterrey, Rio de Janeiro, Sao Paulo, Brasilia, Porto Alegre, Beijing, Shanghai, Tokyo, London, Berlin and many cities throughout the United States.

As the book's subtitle makes clear, her focus is the world's central bankers and their method of creating money out of thin air. Throughout the book, she uses such verbs as "fabricated" and "conjured" to describe the many methods of creating money. No matter which descriptor she chooses or which global city she is talking about, the result is always the same:

Since the financial crisis, these illusionists have created money, altered the nature of the financial system, and orchestrated a de facto heist that enables the most powerful banks and central banks to run the world.... Much of the twentieth century belonged to Wall Street. The twenty-first century now belongs to the central banks.

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Times,” the Brazilian economy clocked a strong 7.5% growth rate in gross domestic product. That same year, voters elected Dilma Rousseff as president, which resulted in a change in central bankers, as Prins explains:

Rouseff changed the guard at the [Central Bank of Brazil]. Inflation hawk Henrique Meirelles got the boot. The dove Alexandre Tombini became chairman on January 1, 2011 when Rouseff took office.... Rouseff’s choice signaled that Brazil would follow the United States and Europe and embrace lower interest rates.

By 2013, Brazil “faced a potential currency crisis” and the financial system was “in distress.” Inflation rose and rates rose to double-digit levels and by 2015 a deep recession had taken hold. “Responsibility for [the] decline was connected to multi-party economic elites and political hits and errors,” writes Prins.

In China, Zhou Xiaochuan was the dominant figure in central banking circles since 2002, relinquishing his chairmanship earlier this year. Zhou chose to criticize the United States and leveraged the crisis to raise China’s profile and push the yuan as an alternative to the almighty dollar as part of the International Monetary Fund special drawing rights (SDR) basket of currencies. With the crisis still in full swing, he spoke publicly that the “financial crisis was a by-product of loose regulations and U.S. dollar dominance in the international monetary system.” In early 2008, when many in the United States were hoping the turmoil of 2007 would blow over, Zhou correctly predicted, “The crisis has not yet run its course and it shouldn’t be ignored.”

Notwithstanding his criticisms, Zhou followed the Fed’s lead in reducing interest rates during 2008. But the criticisms continued, as Prins explains how

Zhou presented a detailed critique of the monetary policies of major countries such as the United States, United Kingdom, European Union, and Japan. According to him, they negatively affected

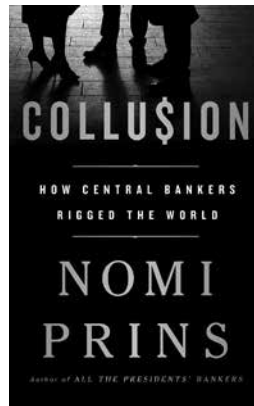
the way emergent countries were supposed to deal with their own monetary policies. He lambasted money-conjuring policies.

By late 2016, the yuan was included in the SDR basket. U.S. Treasury Secretary Jack Lew’s snarky response: “Being part of the SDR basket at the IMF is quite a ways away from being a global reserve currency.”

The leadership of Japan’s central bank has not been dominated by a single figure as in the case of its Asian neighbor. Masaaki Shirakawa was governor of the Bank of Japan during the height of the crisis from 2008 to 2013 and Haruhiko Kuroda has served in that role since 2013, chosen by Prime Minister Shinzo Abe. Prins does not hold back in her introduction of the latter governor: “Kuroda took the helm on March 2013, and proceeded to conjure money faster than any other central bank leader—including Ben Bernanke—ever had.” She further gives the Bank of Japan (and Shirakawa) credit for being “the original G7 money conjurer, formulating an early version of quantitative easing in 2001.”

Right from the start in 2008, Shirakawa was all-in with the Fed’s loose-money, coordinated approach: “He believed that there could be no solution to its pressures without collaborating, or colluding, with other central banks.” But Japan faced a problem because its rates were already quite low, so the first intervention was a cut of the key benchmark interest rate from 0.5% to 0.3%, combined with “powerful monetary easing.” Enter Kuroda in 2013, along with negative interest rates and the concept of “unlimited easing.” Even after the Fed ended its final round of “quantitative easing” in October of 2014, Japan still had its foot on the monetary accelerator: “Kuroda picked up where Bernanke left off.”

The last stop on Prins’ world tour is the European Central Bank (ECB), whose



Collu\$ion: How Central Bankers Rigged the World

By Nomi Prins

384 pp.; Nation Books, 2018

actions many readers who follow central banks are likely already familiar with. Prins dedicates one chapter to the term of ECB President Jean-Claude Trichet (“Monsieur Euro,” 2003–2011) and another to the term of Mario Draghi (“Super Mario,” 2011–present). She addresses their contrasting styles:

The French hawk and the Italian dove controlled money according to their monikers and on the basis of their individual relationships with the U.S. elite. And though Trichet was slightly reluctant to follow the Fed’s easy-money lead at first, Draghi would

adopt the Fed’s policies, hook, line, and manufactured-money sinker.

Trichet agreed to a swap facility of up to \$30 billion with the Fed in March of 2008, which would soon balloon to \$240 billion by September. But rather than fall in line with the thinking at the Fed and cut rates, Trichet chose to raise rates in July 2008. As Prins tells it, “He struck an independent path from his Fed brethren.” But by October, “Trichet realized that he would have to succumb to collusive forces.”

Prins’ finale/ Prins pulls together her work on the collusive central bankers in her final chapter:

Policies that conjured artificial money to deal with the crisis continued far beyond their originally stated purpose. Measures that were supposed to be temporary lingered, virtually unchecked, unquestioned, and unstoppable by an external authority.

She echoes Milton Friedman’s old line that central banks “vacillate between taking credit for what they deem are positive results in the world economy and remaining silent in the wake of catastrophic failures that result from their policies.” Her

final conclusion is not optimistic: “The threat of a collapse larger than the 2008 financial crisis looms because of the plethora of asset bubbles that central banks have created and fueled—setting the scene for a disastrous fall.”

My one substantive quibble with the book is that although Prins emphasizes

her travels in accumulating much of the material for the book, very few interviews are cited in the endnotes. The vast majority of the sources cited are online references to speeches and articles.

Readers of this review might think that a narrative discussing intervention after intervention for 250-plus pages could be a

dry read. They would be right. *All the Presidents’ Bankers* was more readable, thanks in part to its manageable chapter lengths of 15–30 pages as compared to 30–50 pages for *Collu\$ion*. But I am hard-pressed to say that there is a different way that the many monetary interventions could have been presented. R

Working Papers ⇨ BY PETER VAN DOREN

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

Drunk Driving

“Are Buzzed Drivers Really the Problem? A Quasi-Experimental Multilevel Assessment of the Involvement of Drivers with Low Blood Alcohol Levels in Fatal Crashes,” by Richard J. Stringer. March 2016. Available at https://docs.wixstatic.com/ugd/6b9875_8e07a3cd7e6c45cdadaf6a34cf4ba4d2.pdf.

In 2013 the National Transportation Safety Board recommended that states lower the legal blood alcohol concentration (BAC) for Driving Under the Influence from 0.08% to 0.05%. A 2007 article in the *Journal of Safety Research*, “Effects of Legal BAC Limits on Fatal Crash Involvement: Analyses of 28 States from 1976 through 2002,” by A.C. Wagenaar et al., claims that this reduction would save 538 lives, but this paper argues that simple arithmetic indicates that claim is overstated.

In 2012 there were 27,605 fatal accidents. Of those, 17,455 had driver BAC of zero. In contrast, there were only 646 fatal accidents in which the driver had a BAC between 0.05% and 0.08%. Thus, for the policy prescription of 0.05% to save 538 lives, alcohol would have to be responsible for over 80% of all such crashes and the policy change would have to be 100% effective. But according to the official traffic fatality reporting system, alcohol was deemed responsible for the accident in only 14% of those crashes.—P.V.D.

Misguided Mortgages and the Great Recession

“Mortgage-Backed Securities and the Financial Crisis of 2008: A Post Mortem,” by Juan Ospina and Harald Uhlig. April 2018. NBER #24509.

This September marks the 10th anniversary of the collapse of Lehman Brothers, arguably the watershed event of last decade’s financial crisis sparked by a collapse in residential real estate. The standard explanation for the crisis blames “loose” lending standards by mortgage originators, particularly for lower-income borrowers, combined with the repackaging of

mortgages into securities sold to investors falsely informed by misguided AAA ratings.

In previous Working Papers columns (Spring 2011, Fall 2012, and Spring 2014) I described papers that challenge the lower-income-borrowers portion of this narrative. This paper examines the other portion, asking how large were the investment losses on AAA-rated non-governmental mortgage-backed securities.

Ospina and Uhlig examine all non-agency residential mortgage-backed securities (RMBS) issued between 1987 and 2008. They find that the total cumulative losses through 2013 were only 2.3% of the original principal for AAA-rated securities and only 0.42% for subprime AAA-rated securities. AAA securities provided a return of about 2.44% to 3.31% on average, depending on the assumptions regarding their terminal value. For reference, the yield on 10-year treasuries in 2008 was 3–4%.

The total investment loss on all non-agency RMBS amounted to less than \$350 billion, which was quite a bit less than the amount devoted to the 2009 American Recovery and Reinvestment Act. Write the authors, “We suggest that it is an interesting challenge to craft a theory of a world-wide recession, triggered by these losses.”—P.V.D.

Banking

“The Impact of the Dodd–Frank Act on Small Business,” by Michael D. Bordo and John V. Duca. April 2018. NBER #24501.

The consensus among economists is that banking regulation in the United States historically protected small banks whose loan portfolios were geographically and economically undiversified. (See “Banking Approaches the Modern Era,” Summer 2002.) This regulation stemmed from the important role of small banks in congressional electoral coalitions.

Congress recently repealed some Dodd–Frank regulatory restrictions on smaller banks. Ordinarily I would have viewed this as special interest mischief, but this paper demonstrates that Dodd–Frank had adverse effects on smaller banks and the small business loans in which they specialize.

The share of commercial and industrial loans of less than \$1 mil-

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lion at large banks—those with at least \$300 million in assets—has fallen by 9 percentage points since 2010. The share of small loans at smaller banks has declined by twice as much. The real volume of small loans declined sharply in 2011, and it has grown only slowly in subsequent years, while the volume of loans of over \$1 million has increased by 80% since 2011. This development marks a sharp break from the 1993–2010 period, when the value of small and large loan originations followed roughly similar trends. —P.V.D.

Stock Market Short-Termism

“Stock Market Short-Termism’s Impact,” by Mark J. Roe. May 2018. SSRN #3171090.

“Short-Termism and Capital Flows,” by Jesse M. Fried and Charles C.Y. Wang. May 2018. SSRN #2895161

American investors, and thus the companies in which they invest through public stock markets, are allegedly characterized by excessive “short-termism”—that is, their demand for quick returns undercuts long-term investment. This, in turn, supposedly is responsible for decreased research and development, and a subsequent decline in U.S. living standards. In my Winter 2017–2018 Working Papers column I described a paper by Steven Kaplan that presented data inconsistent with short-termism. These two papers also argue against the idea that changes in investing have reduced R&D and living standards.

Mark Roe notes that stock trading has increased enormously

and the average time investors hold stock has decreased drastically over time, but R&D has not. Instead R&D has increased from about 1% of gross domestic product in the 1970s to almost 1.8% now.

Many criticize stock buybacks as a sign of lack of corporate investment in the future. Stock buybacks have increased since the 2007–2008 financial crisis, but long-term borrowing rose in tandem. Low interest rates induced corporate America to substitute low-interest debt for stock. As a result, public firms have more cash, not less.

Capital investment is down in the past decade, but not because of stock market short-termism. First, factory capacity utilization in the United States has failed to fully recover from the 2007–2009 recession. Capacity utilization was still only 75% in January 2017, down from 81% before the recession. When capacity is more fully utilized, investment will rationally follow. Second, if the stock-market-driven story were correct for the United States, we should see differences between capital spending trends for the United States and for nations in which capital comes from banks rather than equity markets. But the capital expenditure decline since the 2007–2009 economic setback exists in Europe and Japan as well.

The Fried and Wang paper challenges an influential 2014 *Harvard Business Review* article entitled “Profits Without Prosperity,” by William Lazonick. According to him:

Corporate profitability is not translating into widespread economic prosperity. The allocation of corporate profits to stock buy-backs deserves much of the blame. Consider the 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012. During that period those companies used 54% of their net income—a total of \$2.4 trillion—to buy back their own stock, almost all through purchases on the open market. Dividends absorbed an additional 37% of their net income. That left very little for investments in productive capabilities or higher incomes for employees.

According to Fried and Wang, S&P 500 shareholder payouts provide an incomplete and distorted picture of corporate capital flows and their effect on firms’ investment capacities, for three reasons. First, companies are issuing new stock even when they are buying up existing stock. After taking into account equity issuances, Fried and Wang estimate that net shareholder payouts from S&P 500 firms during the years 2007–2016 were only about \$3.7 trillion, or 50% rather than 96% of these firms’ net income over this period. Second, a focus on S&P 500 firms—which generally have fewer growth opportunities than smaller and younger firms—creates a misleading picture of net shareholder payouts among all public firms. S&P 500 firms are net exporters of equity capital, but public firms outside of the S&P 500 are net importers of equity capital. Third, the focus on shareholder payouts as a percentage of net income is highly misleading because R&D spending (equal to about 25–30% of net income) is subtracted from corporate revenue before net income is calculated. In fact, a firm that spends more on R&D will, everything else equal, have a *lower* net income and a *higher* shareholder payout ratio. —P.V.D.

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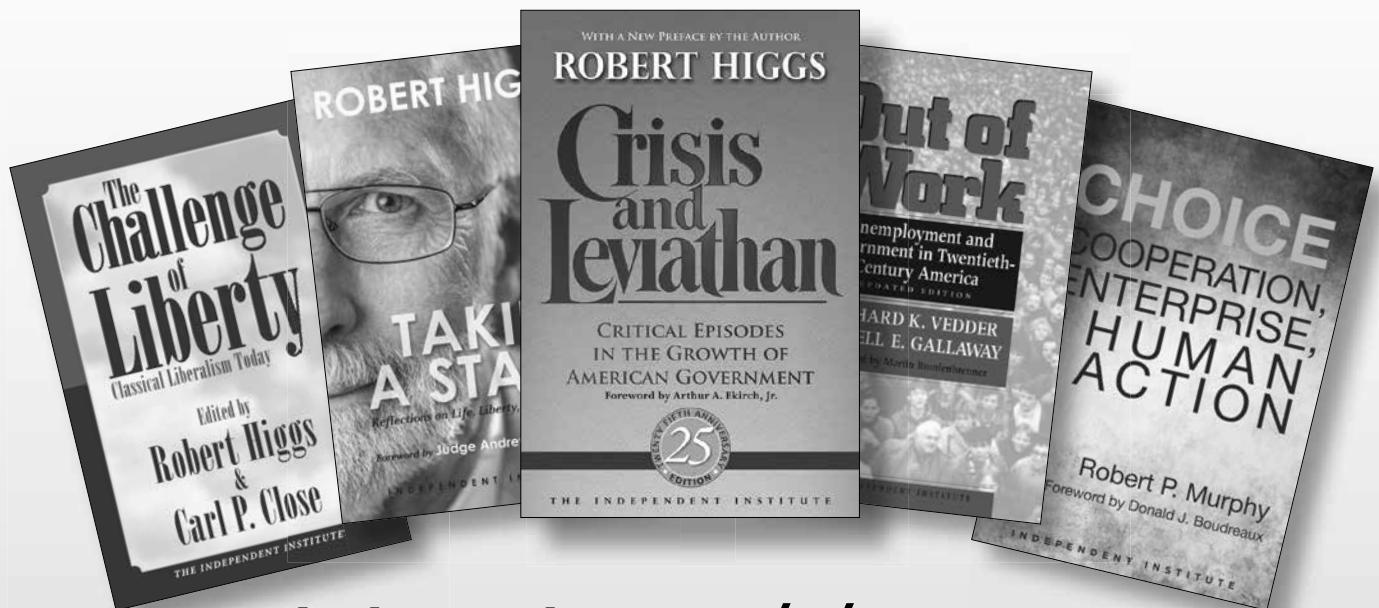
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