

IN REVIEW

Us or Them, or Us and Them?

◆ REVIEW BY PIERRE LEMIEUX

The question in the title of this review is paraphrased from the new book by Bas van der Vossen and Jason Brennan, philosophers at Chapman University and Georgetown University respectively. Their book, *In Defense of Openness*, presents a strong, well-argued case for global openness, by which they mean not only free trade in goods and services but also open immigration.

Global openness, they argue, is the only way to resolve the injustices that have generated or maintained so much poverty in the world. Their case is primarily a moral case: morally defensible individual rights include economic freedom across political borders. They argue that a strong presumption exists for liberty and this presumption is impossible to invalidate. They also present an economic case for openness, which is the only way to increase prosperity over the whole planet. It is an interesting book of philosophy informed by economics (as it should be).

Van der Vossen and Brennan believe that justice must be compatible with “common-sense moral intuitions and ideas” and with empirical facts. For example, economists have shown that the quality of institutions (social, political, legal, economic) is a determining factor in economic growth and we must include this factor in any theory of justice. What is needed is “positive-sum global justice”—that is, win-win cooperation among individuals as opposed to simply taking from some individuals to give to others.

Good institutions are built around the rule of law, private property rights, and economic freedom. These economic rights are “human rights” by themselves, the two philosophers argue, adopting the usual rights-talk of mainstream philosophers.

‘Yes’ to mass migration/ If economic rights

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are defensible within national borders, they seem to also be valid in interactions over national borders. Thus, there is a moral presumption for free trade and free international mobility, just as such a presumption applies within a given country. This presumption may be defeated, but only with justifications. To assert that normal economic freedoms stop at a political border because they are superseded by the group rights of people across the border presupposes a demonstration that group rights (already a fuzzy construct) are sufficient to defeat the presumption of liberty. This is not easy to do.

How could the moral presumption for free mobility and thus free immigration be defeated? Certainly not by economic arguments, the authors argue persuasively. Economic research suggests that free mobility of workers, whereby every individual can move wherever his work is most valued in the world, would greatly increase global GDP, perhaps by as much as 50% to 150%. Open immigration would be a win-win, just as free mobility within a country increases economic efficiency.

The two philosophers, who know much about economics, debunk standard economic objections to open immigration. Immigration cannot generally push down wages, if only because (as they could have noted) immigrants also increase the

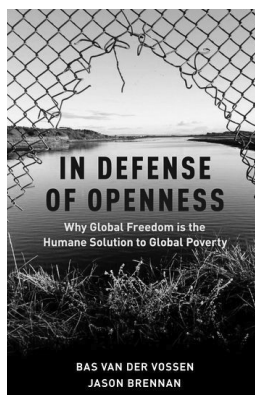
demand for other goods and services and thus the wages in those other industries. Did women push down wages when they arrived on the labor market? And, anyway, would that be a good objection to their freedom to work? The answer to both questions is negative.

As for the welfare state, it does not justify cutting immigration. As a matter of fact, immigrants in America don’t seem to use the welfare state more than the natives. Assuming there is a welfare-state problem, it would only justify cutting welfare payments to immigrants, not cutting immigration—although this would raise other issues.

Van der Vossen and Brennan confront the “illiberal immigration” argument proposed notably by economist Paul Collier. Van der Vossen and Brennan explain this argument as follows: “Immigrants bring along their cultures, ones that lack support for the rule of law, democracy, and freedom.” “As a result,” the argument continues, “allowing people to move freely from poor to rich societies undercuts the very institutions that make prosperity possible, and with it social stability and liberal freedom.” Open immigration would destroy the very institutions and features of free societies that make them attractive.

Note that Van der Vossen and Brennan use the term “liberal” and its opposite “illiberal” to refer to classical liberalism writ large and its opposite. “Liberals” include libertarians as well as those American-style liberals who believe in the presumption of liberty.

To the Collier “illiberal immigrants” objection, the book offers many counterarguments. First, the implied extreme scenario of the liberal receiving country transforming into a poor, illiberal country is not likely. Liberal cultures have proven to be extremely robust, as American history shows. Second, the authors admit that



In Defense of Openness: Why Global Freedom Is the Humane Solution to Global Poverty

By Bas van der Vossen and Jason Brennan

240 pp.; Oxford University Press, 2018

“forcibly preventing immigration could be justified if it really were necessary to avoid this nightmare scenario.” At worst, they add, the danger of illiberal immigration would be a reason to restrict immigration from institutionally bad countries only—assuming that such discrimination would be constitutionally or politically feasible.

And if it were legitimate to block illiberal immigrants in order to preserve the liberal society, would it not also be legitimate for, say, Virginians to protect themselves against West Virginians? It won’t do to answer, “No, because Virginians and West Virginians are from same country,” because the moral legitimacy of prioritizing fellow citizens is precisely what needs to be demonstrated.

We are back to the need to defeat the presumption for liberty in order to oppose international openness. “We need to know,” Van der Vossen and Brennan write, “why countries are supposedly justified in doing things to foreigners that they would view as horribly unjust if done to their subjects.” We must avoid the circular argument that fellow citizens must be prioritized over, and protected against, foreigners because the latter are different; and that the latter are different because fellow citizens must be prioritized.

Doubts about open borders / Is the two philosophers’ defense of open immigration as tight as it appears? Is the invasion objection so easily dismissed? Isn’t it likely that, past a certain threshold, illiberal immigrants would destroy liberal institutions and prosperity?

It is not mainly—or at least only—a matter of the right to vote, which immigrants don’t immediately obtain anyway and which could be postponed longer. It is more a matter of informal institutions being toppled by an invasion of people with different cultures. Think about the rules of tolerance. Or think about trust, a certain level of which is important, especially in a free society. Some research suggests that trust can be best, if not only, maintained among individuals who generally follow the same rules and share the same culture.

Assume a million-strong liberal soci-

ety with liberal institutions and imagine that two million illiberal immigrants take up residence in their midst. It seems obvious that the invasion will change this society’s institutions. Predictability of human behavior will diminish. Mistrust will increase. People will self-segregate in different enclaves. Individuals will feel more and more insecure. To maintain some sort of social peace, laws will eventually change. Social relations will become more regulated and individual liberty more controlled.

James Buchanan’s contractarianism may illuminate the problem under investigation. The parties to a Buchanan-type of (implicit) social contract would see their country as a club with a controlled membership precisely in order to preserve their liberal institutions. This approach, which Van der Vossen and Brennan do not discuss, would not justify completely closing the border to foreigners. It is unlikely that the contracting individuals would unanimously agree that, for example, foreign spouses could not immigrate or that citizens could not hire foreigners as nannies or business employees. But it could justify some reasonable and not-illiberal control on immigration.

Free trade: a simple case / Compared to the murky case of immigration, trade represents a simple case. Van der Vossen and Brennan argue that the right to trade internationally is, just like the right to trade domestically, a basic right that is essential for an individual to pursue justice and the good life—notwithstanding philosopher John Rawls. The moral presumption for the freedom to trade internationally seems as irrefutable as other economic freedoms.

The economic case reinforces the moral presumption: free trade has been shown to lead to increased production and a radical drop in poverty. Following the law of comparative advantage (of which Van der Vossen and Brennan provide a good explanation), free trade benefits both poor and rich countries, just as it benefits different regions within a country. The authors could have added to their arguments that free trade between California and Missis-

sippi benefits people in both states even if wages are 40% lower in the latter.

In Defense of Openness finds that no good philosophical argument overcomes the moral presumption for free trade. For example, “exploitation” in sweatshops is not a good argument. Working there is the best option for the poor who choose it; otherwise they would have chosen another option among those open to them— scavenging dumps or prostitution, for example. Closing a sweatshop amounts to removing the best option of its workers, making them worse off. “We shouldn’t take away a victim’s best option on the grounds that it is unjust unless we can replace it with an even *better* option,” they write (emphasis in original). (See “Defending Sweatshops,” Spring 2015.)

The two philosophers also answer an argument of Aaron James, a philosopher at the University of California, Irvine. Abolishing a tariff (or another obstacle to trade), James argues, hurts those who benefited from it just as establishing it hurts those who previously traded freely. In both cases, he claims, some lose and some win, and there is no presumption one way or the other. Ignore the fact that those harmed by a tariff shoulder a higher cost than the benefits of those it favors, which is the same as saying that free trade leads to a net benefit in terms of money. Van der Vossen and Brennan emphasize that the ban of a liberty does not have the same moral status as the restoration of a liberty.

Note that a Buchanan type of social contract creating an island of liberty cannot conceivably limit free trade as it can constrain immigration. The parties to the contract are unlikely to unanimously accept that protecting their liberty and liberal institutions requires limiting their freedom to trade goods and services over the country’s borders more than within their country. On the contrary, the power to limit trade with foreigners would put too much power in the hands of Leviathan.

Positive-sum justice / One major strand of *In Defense of Openness* is the idea that justice or the correction of injustices—the focus

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of the political philosopher—can best be attained through individual liberty and economic growth. Consider the injustices created by colonialism, which may partly explain the poverty of many of today's underdeveloped countries. The two philosophers point out that the depredations of the natives may explain as much. Moreover, the residents of the colonizing countries were probably exploited by their own imperial governments: "Empires don't pay for themselves." The moral and efficient way to correct such past injustices is not to impose a collective responsibility on today's descendants of the colonizers, but for them to open their borders and markets. Since everybody would benefit, it would be positive-sum justice.

Many philosophers, such as Thomas Pogge of Yale University and Nicole Hasoun of Binghamton University, argue for some form of international redistribution toward poor countries. There is no need for morally and economically doubtful redistribution, reply Van der Vossen and Brennan. What is needed is simply to stop the current injustice of government-imposed obstacles to international trade and mobility.

Foreign aid cannot be defended from either a moral or an economic viewpoint. As many economists have observed, the large amounts of aid given over the last five decades have had practically no effect—or worse, have fed corrupt regimes and thus retarded economic growth. Experience has shown that trade liberalization is the way to cut world poverty. Trade, not aid! "The main way people in developed societies have contributed to ending poverty abroad," write Van Der Vossen and Brennan brilliantly, "has been through buying Made in China products." And the buyers have benefited, too.

Free trade *is* justice. "Not only do people have a *prima facie* right to exchange goods without coercive interference," the authors write, but also "allowing them to do so generally works to the benefit of everybody."

Climate change—which the authors take very seriously—is often used as an argument to restrain economic growth. To the con-

trary, the book argues, growth can provide the resources to mitigate the effects of climate change without harming developing countries, which are responsible for much of the current growth in greenhouse gas emissions. But economic growth requires international openness, which would also allow the people who are most harmed by climate change to move to more hospitable places. "The choice, the authors write, "is largely between a world much better equipped to deal with poverty *and* climate change, and a world much worse in both respects" (emphasis in original).

"What we owe people around the world is *openness*," concludes the book's post-

script (emphasis in original). Van der Vossen and Brennan provide several strong arguments for abolishing at least some immigration restrictions, but I have argued that completely open immigration is very questionable. In fact, the two authors are often less radical than they appear at first sight. The presumption of liberty perhaps is what's most important: departures from it need justifications. At any rate, the book remains a good antidote to the current irrational discourse and callousness against the convenient scapegoats that immigrants represent. And Van der Vossen and Brennan's case for free trade is unassailable. R

The Truth about Economic Incentive Programs

◆ REVIEW BY GREG KAZA

The oft-stated goal of government economic development incentive programs is to create jobs. Yet policymakers and program advocates seldom conduct careful analysis of these programs to determine how well they work. Given how many states use these programs liberally yet fail to even keep up with national job-creation rates, one suspects these efforts are largely ineffective. So why do these programs continue to multiply?

In this new book, Nathan Jensen (University of Texas, Austin) and Edmund Malesky (Duke University) advance original arguments that explain the ubiquity of these incentives and offer technically feasible and politically practical reforms to rein in these programs. The issue is topical: in recent decades government pandering with incentives has grown in response to threats by sports teams, movie companies, and manufacturing firms to relocate their operations.

Zero-sum games / Government incentives can be discretionary ("deal-closing funds") or statutory. Oftentimes they are targeted by policymakers to assist only a small

number of firms in the vast universe of enterprise—sometimes even a single firm (think of the goodies different states and localities recently offered for Amazon's HQ2). These incentives have grown in size, with at least 17 single-firm state packages eclipsing the \$100 million mark in recent decades. Examples include South Carolina's \$130 million-plus offer to attract a BMW plant (1992) and Georgia's \$258 million to land a Kia plant (2006). Less well known is the aggressiveness of city and county programs. One example Jensen and Malesky share is Lenoir, NC offering a quarter-billion dollars in incentives (mainly tax breaks) over 30 years to woo a Google server farm. That equals roughly \$1 million for each center employee.

The economic inefficiency of these programs is a recurring theme in the book. The authors tell the story of an "incen-

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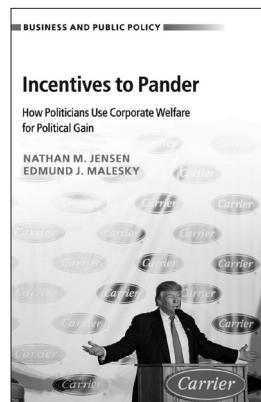
tive war” between Kansas and Missouri that resulted in employers of 3,200 workers moving from the east side of the Kansas City metroplex to the west, and employers of 2,800 workers moving from the west to the east, which the authors term “the very essence of a zero-sum game.” There is no clear evidence that incentives create net public benefit, however, as numerous academic studies have shown them to be ineffective and redundant.

Why use such a flawed policy? And why do politicians herald these incentives rather than hide them? Jensen and Malesky present “puzzles,” building on Gordon Tull-

ock’s insight that voter ignorance about incentives is rational given the absence of knowledge of their true costs. Incentives are the perfect “pandering tool” for politicians engaged in “credit-claiming and blame-avoiding roles” with voters. The “consistent use of incentives in press releases by governors’ offices around the country and in campaign materials,” they write, “suggests that politicians see the use of incentives as an asset, not a liability.”

Given that, we must conclude that the main purpose of these incentives is for political gain. Apparently, politicians use incentives to signal alignment with voter interests, assuming that voters have imperfect knowledge of incentives’ importance. The counterfactual is unobserved: voters don’t know that most incentives are given to firms that are already planning investments. They may lower firms’ costs but they seldom create jobs.

Pandering / Jensen and Malesky develop a “theory of pandering” to explain this bad public policy. They begin by rejecting the argument, commonly found in the popular press, that incentives are driven by corruption or as legal means to obtain campaign contributions. They dismiss the



**Incentives to Pander:
How Politicians Use
Corporate Welfare for
Political Gain**

**By Nathan M. Jensen
and Edmund J. Malesky**
258 pp.; Cambridge
University Press, 2018

corruption charge because “politicians do not hide their allocations of incentives to firms. [This is] far from what we would expect from under-the-table exchanges of campaign contributions for financial support.”

Indeed, elections provide politicians with an incentive to *publicize* incentives. Voters prefer incumbents who take credit for creating jobs over those opposed to incentives. Voters also prefer incumbents who try to attract jobs with incentives even if they fail, instead of critics who vow to eschew the practice. Politicians exploit their “information advantage” by providing too many and too generous

incentives. This “information asymmetry between voters, politicians, and firms” can lead incumbents to use incentives to take credit or reduce the blame for economic outcomes. Politicians will use incentives, regardless of investors, if voters *believe* they are effective.

Consider Donald Trump’s highly publicized move in late 2016 to retain manufacturing jobs in two counties in Indiana. The authors write, “From the start, there

Voters prefer candidates who try to attract jobs with incentives, even if they fail, instead of candidates who vow to eschew this practice.

was some fuzziness in the numbers” of jobs ostensibly created or saved by Trump and Indiana officials’ efforts. In fact, Bureau of Labor Statistics data show total employment in one county *declined* after the announcement, while the other county experienced an employment increase of only 0.3% versus the national average of 2.5%. Capital movement influenced by globalization, they write, “can provide

politicians with opportunities to pander to the public and take credit for new investment. ... Rather than making domestic politics irrelevant, globalization can lead to increased political activity.” Incentives give politicians reason to take credit.

This process is also visible at the local level, where cities with mayor–council systems offer more generous incentives but are less likely to mandate performance requirements and benefit–cost analyses. The authors find mayors “are more prone to use incentives for electoral gain.” Incumbents facing electoral pressure are more likely to use incentives than city managers shielded from the ballot.

Regressive incentives / How do local politicians pay for these programs? Oftentimes, regressive sales and excise taxes shift burdens onto the poorest taxpayers. Call it “economic development by sales tax,” bad public policy that drives economic inequality. Incentives create a reverse Robin Hood effect, as wealth is transferred from the poor and middle class to wealthy residents. For instance, Ferguson, MO politicians filled their budget hole from funding new incentives by increasing the revenue from fines and penalties, fueling racial acrimony through increased policing. Critics of incentives should explore this common ground with citizens who are troubled by inequality and injustice.

Incentives’ use is not restricted to western-style governments. Authoritarian regimes, especially those linked with meritocratic performance at the local level, are associated with higher levels of use of these programs than their democratic counterparts. Incentives are more likely to be provided to foreign investors if the regime has strong protections for meritocratic promotion for sub-national leaders. Central government elites want gross domestic product, government revenue, and employment growth, and are agnostic about how those gains are achieved. The

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authors term this phenomenon “upward pandering” and note it exists in single-party states with quasi-meritocratic institutions until the point when officials are no longer eligible for promotion. Aging Vietnamese officials, Jensen and Malesky observe, abandoned the use of tax incentives once they became ineligible for promotion. Interestingly, “personalist regimes” such as Russia under President Vladimir Putin offer far less in incentives because loyalty trumps performance.

Jensen and Malesky pose a series of questions about incentives that should be answered by every politician contemplating their use. Are they worth the cost? Are they effective at attracting or retaining investments? Can governments target firms and pick winners? Do they generate jobs and are those jobs worth the cost? Are the incentives the only option for generating economic development? Most incentive-happy politicians answer in the affirmative.

One recent exception, to some extent, was Michigan governor Rick Snyder. As a businessman turned candidate in 2010, he criticized tax incentives during his election campaign, though he did simply relabel some of the incentives “grants” when he continued them once he took office. But he also signed a 2012 executive order dissolving the Michigan Economic Growth Authority (MEGA), established in 1995 over the objections of the Mackinac Center, a market-based think tank, and state legislators. (Disclosure: I was among those critics.) MEGA’s demise is significant for two reasons. First, BLS records show total Michigan employment declined (4,450,800 to 3,893,700) under Snyder’s predecessor, Jennifer Granholm, an incentives proponent. Since the U.S. economy began expanding in June 2009, a period that largely coincides with Snyder’s tenure, Michigan has been one of the 17 states with a job-creation rate above the U.S. average. Invert those circumstances by postulating a state that does not use incentives and records negative jobs growth, or a state that ends a program like MEGA and trails the nation in jobs creation, and what would political commentators say? Incentive

critics should always present their case to the public using the easiest-understood argument: lack of jobs means incentive programs should end.

Researchers, good-government activists, and policymakers can use other strategies to challenge these programs. State-level researchers focus on local programs. One example: Jacob Bundrick of the Arkansas Center for Research in Economics found “no evidence that the [state’s] Quick Action Closing Fund (a discretionary program)

provides meaningful increases in employment or net business establishments at the county level.” Clawbacks allow tax dollars to be recouped when programs do not meet political promises. Written performance criteria provide greater transparency. GASB Statement No. 77 (2015) requires disclosure of the true cost of tax abatements.

Politicians’ embrace of incentives means researchers should embrace this book for its insights about political pandering. R

Let’s Hear It for the Standard Narrative

◆ REVIEW BY VERN MCKINLEY

The year 2018 marked the passing of a decade since the lowest point of the financial crisis. Observers of the financial industry rehearsed the various narratives of the crisis as part of a burst of anniversary commemorations. The dominant narrative about the policy response to the crisis (although not necessarily the most accurate or fact-based one) is what might be called the standard narrative: the interventions of the financial authorities during 2008 and 2009 likely saved us from another Great Depression. There are variants of this standard narrative, but most of its adherents believe that either the response (consisting of bailouts and massive financial support) was measured and effective, or else the authorities should have been even more aggressive in their interventions.

This book, *Fighting Financial Crises* by economists Gary Gorton and Ellis Tallman, supports the latter version of the standard narrative. Interestingly, the book liberally cites fellow standard narrative advocates Ben Bernanke and Timothy Geithner, who were the chief architects of the U.S. response. Bernanke even provided a blurb for the book’s jacket cover.

Gorton is a professor at the Yale School of Management and is widely known for

advancing the argument that the financial crisis was a “run on the repo market.” He was also an adviser during the crisis to American Insurance Group, which was one of the largest government bailout recipients during the crisis. Tallman is the director of research at the Federal Reserve Bank of Cleveland and is known for his work on the history of banking panics and liquidity lending during financial crises.

The premise of *Fighting Financial Crises* is that, consistent with the authors’ prior research, there is a “plug and chug” formula for responding to financial crises. Whether we look at the panics of the Gilded Age or the recent crisis, this formula requires that the financial authorities need only do some basic research to determine the appropriate policy response to the crisis. Specifically, they need to:

- Find the short-term debt causing the instability (run).
- Suppress individual institution financial information.

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- Open emergency lending facilities.
- Prevent systemic (too-big-to-fail) institutions from failing by bailing them out.
- Circumvent any laws and regulations that stand in the way of this response.

Panics and bailouts of the 19th century /

The authors open the book with a deep dive into the National Bank panics of the Gilded Age. They divide these into more severe panics (1873, 1893, and 1907) and less severe panics (1884, 1890, 1896, 1914) in order to judge the prudence of interventions in each panic. Disappointingly, the authors do not explain clearly what distinguishes the more severe from the less severe panics and the comparative data Gorton and Tallman provide do not clearly support such a classification.

The authors then shift to a detailed discussion of the New York Clearing House Association (NYCHA), its history, and what tools it used to fight panics. The NYCHA was a privately organized association, modeled after a counterpart in London, through which the New York banks would “settle their accounts with each other and make or receive payment of balances and to ‘clear’ the transactions of the day for which the settlement is made.” It also conducted periodic bank examinations of its members to assess the risk the individual banks posed to the clearinghouse members: “Each member has a direct interest in every other, for it does not wish to run the risk of loss in giving credit to checks of an insolvent institution.” Special examinations, which were more targeted, were triggered by rumors of weakness. If a bank did not follow the recommendations incorporated into an examination report, it could be suspended or expelled from NYCHA membership. As Gorton and Tallman describe it, the function of the NYCHA was akin to a “regulatory and central-bank-like role.”

In the early stages of a panic, the NYCHA’s supportive response involved three actions:

- issuance of clearinghouse loan certificates, which were short-term,

- collateralized loans “effectively guaranteed by the clearinghouse membership jointly”;
- bailouts of too-big-to-fail institutions; and
- suppression of financial information of individual institutions.

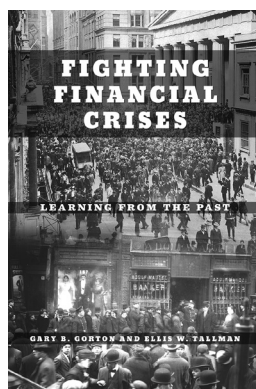
In their chapter “Too Big to Fail Before the Fed,” which is also the name of a National Bureau of Economic Research paper they released in March 2016, Gorton and Tallman make the case that the megabank bailouts of the past 35 years had their origins in similar bailouts through the NYCHA during the 19th century.

The chapter starts off with a direct attack on the “moral hazard” argument against bailouts:

Banks have allegedly engaged in taking risks greater than they otherwise would because of a belief that they would be bailed out by the government, possibly causing or contributing to the financial crisis of 2007–8, because large banks believe they are too big to fail. ... In the modern era it has been hard to find evidence that large banks are the beneficiaries of implicit too-big-to-fail government policies and become riskier as a result.

The chapter then walks through case studies of how and why it made economic sense for the member banks of the NYCHA to support too-big-to-fail institutions during the panics of the 1800s:

Because a private-market coalition of banking institutions took these actions, it strongly suggests that a too-big-to-fail practice or policy per se (and the associated “moral hazard” problem of exacerbating bank risk taking) is not the problem causing crises.... In the pre-Fed era, bailing out large, interconnected banks



Fighting Financial Crises: Learning from the Past

By Gary B. Gorton and Ellis W. Tallman

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was a reasonable response to the vulnerability of short-term debt to runs that could unnecessarily threaten large banks and thereby the entire banking system.

MNB/ To support their case, the authors set out statistics for the 12 outright bank failures and five “bank assistance transactions” in New York City from 1864 to the creation of the Fed in 1913. Gorton and Tallman choose a case study of a bailout by the NYCHA of Metropolitan National Bank (MNB) in 1884. MNB was double the size of the average clearinghouse bank and was quite

interconnected based on the data the authors reference: “Had the clearinghouse not acted with admirable promptness in coming to its assistance, there is little question that out-of-town banks would have become alarmed for their deposits, not only in this bank but for those in the banks generally.” A bailout of \$6 million was extended by the NYCHA to MNB: “Private-market participants were therefore acutely aware that their actions were effectively a bailout of the stricken bank. The benefit was the prevention of banking panic on a wider scale.” MNB ultimately failed outright several months later, after the panic subsided.

Gorton and Tallman state that the bailout of MNB does “align closely to our view of proper responses to fight financial crises.” There were questions of the bank’s solvency, as there often are during crises. The bank had a high degree of interconnectedness, there was a risk of losses to clearinghouse members as a result of the bailout, and the implication is that MNB was “systemically important.” The authors go on to make an analogy to the bailouts of the 2000s crisis, claiming MNB was “a model for an orderly resolution.” The authors contrast MNB with the NYCHA’s decision during the Panic of 1907 to allow

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Knickerbocker Trust to fail, which they argue “led to the most severe period of the financial crisis of 1907, and likely the ramifications of that failure contributed largely to that distress.”

Conclusion/ Gorton and Tallman’s historical details of the panics of the 1800s for the New York banks at the epicenter of the financial system are unequaled, based on my research. The authors have taken stories from the contemporary New York press and employed available financial data from bank reports to develop a narrative and accompanying tables that bring to life the panics of that era. These details alone make the book worthy of a place on any financial historian’s bookshelf.

Where their effort falls short is in the policy conclusions they draw from those details. I’m not convinced by their arguments justifying the public sector bailouts

that have become so familiar in the past century. There is an enormous difference between a voluntary organization of bankers like the NYCHA bailing out an institution based on their own financial interests and the case where government authorities use public funds to bail out politically connected institutions.

As for Gorton and Tallman’s consideration of moral hazard, if you look at a too-big-to-fail bank with a long history, e.g., Citi, you find that during the Gilded Age it was a rock-solid bank that absorbed weaker institutions during panics. Since the creation of the Fed and the proliferation of government bailouts in the last century, Citi has now morphed into a perpetual ward of the state. This would have been a good moral hazard case study for Gorton and Tallman to consider. Unfortunately, it seems they already had their chosen narrative and stuck to it. R

Landsburg’s New Puzzles

◆ REVIEW BY PHIL R. MURRAY

Steven Landsburg teaches at the University of Rochester, where he ponders the “big questions” and writes terrific, accessible books on economics. His latest is *Can You Outsmart an Economist?* and it continues this tradition. To Landsburg, “Economics is, first and foremost, a collection of intellectual tools for seeing beyond the obvious.” “If this book has a moral,” he professes, “it is this: *think beyond the obvious.*”

The book offers a number of puzzles involving economics, probability and statistics, and more. They range from easy to difficult. Consider this easy one:

Suppose the government imposes a price ceiling on wheat, so that instead of selling at the current price of, say \$4 per bushel, nobody is allowed to charge more than \$3 a bushel. What happens to the price of bread?

Don’t be fooled into thinking that wheat will be more abundant. Those who are

fooled will conclude that the price of bread will fall. A student of economics knows that price ceilings cause shortages. Wheat will become scarcer, the supply of bread will decrease, and the price of bread will rise. Puzzle solved.

Now consider a more difficult puzzle:

My wife and I each drive exactly the same number of miles every day *and would continue to do so even if we upgraded our vehicles.* Now, which would save more gas—replacing my wife’s 12-mile-per-gallon SUV with a 15-mile-per-gallon SUV, or replacing my 30-mile-per-gallon car with a 40-mile-per-gallon car?

The trap here is to think that replacing the

car is a better idea because getting another 10 mpg beats getting another 3 mpg with the SUV. Or that replacing the car is better because 40 mpg is 33% more than 30, whereas 15 mpg with the new SUV is only 25% more than 12. To the contrary, Landsburg explains, “the SUV uses so much gas to begin with that a little added efficiency goes a long way.” Replacing the car would reduce the Landsburgs’ fuel consumption by 7%, but replacing the SUV would reduce it by 14%. Landsburg later adds that the assumption that he and his wife wouldn’t change their driving habits despite the vehicle change is an “arbitrary (and probably quite unrealistic) assumption.” It would be realistic to assume that after replacing the SUV with one that gets better gas mileage, his wife will drive more. As a result, they wouldn’t get the 14% reduction in fuel consumption.

Better solutions to puzzles anticipate changes in behavior. Landsburg follows up the fuel efficiency puzzle with one about child safety:

Infants traveling on airplanes are currently permitted to ride in their parents’ laps. Every five years, approximately two of those infants die from injuries sustained during turbulence. If a new rule required each infant to be strapped into a separate seat, how many infant lives could be saved?

Reckoning that the regulation would save two babies per five years fails to anticipate changes in behavior. Landsburg asks:

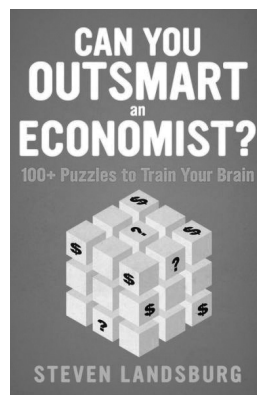
Under the new rule, how many families would choose to drive rather than pay for an extra airline seat? How many of those families would be involved in car accidents? How many of those car accidents would result in infant fatalities?

He reports that economists who tackled those questions found that “for every two infant lives saved in the air, there would be about seven infant lives lost on the roads.” The effect of a regulation requiring infants to have their own airplane seats would therefore be a net loss of five babies’ lives.

Many solutions require a calculation. Take “The Gender Gap.” “Alice” observes that women earn 77% of what men earn. “Bob” is skeptical of this because it suggests that employers are leaving money on the table; for example, if a manager is paying a man \$10 an hour to generate \$11 of revenue per hour, he could substitute a woman for the man, pay her \$7.70 per hour, and increase his profit from \$1 to \$3.30 per hour.

Landsburg supposes that half the labor force is women. Firms pay two-thirds of their revenue to workers. Of the other third, they pay half to bondholders and half to stockholders. “To a very rough approximation,” he continues, “the total value of the bond market and the total value of the stock market are equal.” Given those assumptions, Landsburg calculates that by substituting women for men in the workplace and paying them 77% as much, managers would increase profits by 42%. Without doubting that some employers may be oblivious to increasing profits this way, Landsburg argues that a 42% increase in profits is so “huge” that its “widespread” existence must be “implausible.” Confident that gender discrimination does not explain why women earn 77% of what men earn, Landsburg speculates as to what else might account for the gap.

This reviewer wants to question a few of the author’s “rough but reasonable” assumptions. If the labor force consists of more men than women, won’t it become increasingly difficult to substitute lower-paid women for higher-paid men? In order to measure the gain to stockholders, is the relevant comparison between “the total value of the bond market” and “the total value of the stock market,” or the market for *all* corporate liabilities including bank loans and the stock market? If the latter, and corporate balance sheets show more debt than equity, will substituting women for men be even more profitable? By ques-



Can You Outsmart an Economist?
100+ Puzzles to Train Your Brain

By Steven Landsburg
288 pp.; Mariner, 2018

tioning these assumptions, I am not arguing that they are unacceptable; I am merely trying to test my understanding and join the fun of solving the puzzle.

Exploiting irrationality / Economists conventionally assume that individuals are rational. On one level, this means that if an individual prefers apple pie to blueberry pie, and blueberry pie to cherry pie, he’ll prefer apple to cherry. Landsburg introduces Sidney Morgenbesser, who ordered apple among those three flavors.

When the waitress mentions that she actually has no blueberry pie on hand, Morgenbesser changes his mind and picks cherry. That’s not only funny; it’s irrational.

Landsburg writes, “You’re irrational if your preferences allow me to bleed you dry.” He would offer Morgenbesser the

Economists usually assume that people are rational, but some aren’t. Landsburg writes, “You’re irrational if your preferences allow me to bleed you dry.”

apple, blueberry, and cherry pie, and Morgenbesser would pick apple. Landsburg would then say there really was no blueberry, prompting Morgenbesser to pick cherry. Landsburg agrees so long as Morgenbesser pays a nominal charge for the switch. Landsburg would then announce that blueberry is back on the menu. Now Morgenbesser selects apple and is willing to pay another nominal amount to get it. Landsburg would then continue to remove and replace the blueberry pie, pumping money out of Morgenbesser and proving that Morgenbesser is irrational.

Buyers of the book can take Landsburg’s quiz that evaluates how rational they are.

Most questions, by themselves, do not reveal whether an individual is rational. Answers to pairs of questions, however, can reveal inconsistencies that suggest the quiz taker is irrational. One question asks how much the reader would give up to avoid playing Russian roulette with two bullets in a pistol with six chambers. The next question would note that the six-shooter now holds four bullets and ask how much the reader would pay to remove one of those bullets. Although I thought carefully about my answers, my score was mediocre. If I lose my job as an economics professor, maybe I’ll look for work as a “performance artist.”

Many puzzles involve probability and statistics. For instance, Landsburg enjoys demonstrating what is known as Simpson’s paradox, a phenomenon in probability and statistics in which a trend appears in several different groups of data but disappears or reverses when the groups are combined. In perhaps the best-known real-world example of this paradox, in the 1970s lawyers sued the University of California, Berkeley on grounds of sex discrimination in admissions. Their evi-

dence was that graduate programs admitted 46% of male applicants versus 30% of female applicants. Landsburg presents a table showing the numbers of men and women that applied to each of six departments,

as well as the numbers accepted. Half the departments admitted more women than men. Four of six departments accepted a greater percentage of women than men. How did a smaller share of all women get accepted overall? Landsburg explains, “Women were being disproportionately rejected because women were disproportionately applying to the most selective departments.” Using the numbers Landsburg provides, 72% of female applicants applied to the three departments with the lowest acceptance rates for women. Meanwhile, 34% of male applicants applied to the three departments with the lowest acceptance rates for men. “The moral,”

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the author warns, “is to beware of aggregate statistics.”

Albert and the dinosaurs / There are some puzzles I can solve without peeking at the solution. There are many I was unable to solve, though I could understand the solution once I read it. Some have solutions beyond my understanding.

One of the most challenging puzzles is “Albert and the Dinosaurs.” Albert is trying to drive home from work without being attacked by dinosaurs. Apparently, he does survive the attacks, but he’d prefer to avoid them, as much as possible. To avoid them, he must go straight at the first intersection and right at the second. What makes this a puzzle is that “Albert is extremely absent-minded” and does not recognize either intersection. The author anticipates in the introduction that “you might be tempted to ask: ‘But what has this got to do with economics?’” His response is that economics is “anything to do with thinking beyond the obvious.” Albert will need to do that in order to avoid the dinosaurs as much as he can.

Landsburg explains that, given Albert’s absent-mindedness, his optimal course of action “is to flip a fair coin at each intersection, with the faces labeled ‘straight’ and ‘right.’” On any day, there are three possible outcomes.

- The coin shows right at the first intersection with probability 0.5, and Albert is attacked by a dinosaur.
- The coin shows straight at the first intersection and straight at the second intersection with probability $0.5 \times 0.5 = 0.25$, and Albert is attacked by a dinosaur.
- The coin shows straight at the first intersection and right at the second with probability $0.5 \times 0.5 = 0.25$, and Albert makes it home unmolested.

But this is only scratching the surface because Albert cannot recall at which intersection he is. The first question is: “What’s the probability that Albert is approaching First Street?” Imagine what

happens day after day. Each day Albert arrives at the first intersection. Half the days he makes it to the second intersection. So over the course of say, 100 days, he arrives at the first intersection 100 times and arrives at the second approximately 50 times. Thus, on these 150 times when he’s arriving at an intersection, two-thirds of the times ($100 \div 150$) it’s the first intersection. Does this change the probability that Albert gets home? Landsburg shows how it might and adds that “it depends on exactly how we interpret the word *probability*.” The discussion becomes very complicated thereafter.

Readers who demand more relevance of Albert and the Dinosaurs to economics will probably not be satisfied. Landsburg leaves whatever applications there are to

the imagination. The puzzle serves to show the extensive amount of thinking one can do beyond the obvious.

Conclusion / The author delivers on his intention to show the reader a good time. Landsburg’s enthusiasm for solving puzzles is contagious. He introduces puzzles he has known since his childhood as well as some that perplex full-time thinkers. One should expect a few humbling experiences.

The author also delivers on his intention to squeeze in some intellectual edification. There are “morals” galore. Unfortunately, one puzzle the author doesn’t grapple with is why citizens who wouldn’t challenge say, a scientist, nevertheless expound uninformed on economic affairs. R

An Open and Enlightened Libertarianism

◆ REVIEW BY PIERRE LEMIEUX

Is it worth saving a person’s life today at the cost of 39 billion deaths (or perhaps non-births) some five centuries later? What about killing a baby if it saves \$5 billion of GDP, equivalent to a new \$200,000 house for 25,000 poor families? Those are some of the questions Tyler Cowen considers in *Stubborn Attachments*,

a book of political philosophy informed by economics.

Cowen is a creative thinker who teaches economics at George Mason University. The scope of his new book is indicated by its subtitle: “A Vision for a Society of Free, Prosperous, and Responsible Individuals.” As for the title (not to mention the overall thesis), it is a subtle extraction from a sentence on the first page: “We need to develop a tougher, more dedicated, and indeed a more stubborn attachment to prosperity and freedom.”

Distant future / So what of that tradeoff of

one life for 39 billion? Assume, as benefit-cost analysis does, that future lives must be discounted just like other benefits (e.g., money) are. Assume a discount rate of 5%. How many lives in 500 years are equivalent to one life today? Multiply 1 (one life) by 1.05 (1 plus the discount rate) raised to the 500th power (500 years). The result is 39,323,261,827 (lives). The magic of compound interest is always amazing. Cowen notes that, under this line of thinking, one life today “could even be worth the entire subsequent survival of the human race, if we use a long enough time horizon for the comparison.” It is difficult not to agree that this result hurts “common-sense morality,” which would seem to counsel that one life does not outweigh 39 billion or more.

PIERRE LEMIEUX is an economist affiliated with the Department of Management Sciences of the Université du Québec en Outaouais. His latest book is *What’s Wrong with Protectionism: Answering Common Objections to Free Trade* (Rowman and Littlefield, 2018).

It may thus be argued that, as far as human lives are concerned, the discount rate for the far future should be zero or at least much lower than what we usually assume. This means that if we have to choose between different paths of economic growth—what individuals will be able to consume in goods or leisure as time passes—the path that is consistently higher should always be chosen. It is moral to choose to have more today only if this choice also implies that individuals in the future will obtain more than they would have received otherwise. We must have a “deep concern for the distant future.”

The practical implications are massive. One implication is that environmental problems, such as climate change, gain a heightened importance if they will retard economic growth long-term. More generally, we should be concerned with the long-term future of our civilization.

Need for economic growth / Like interest, economic growth is compounded—growth applies to the result of previous growth—and produces the magical inverse of discounting. Indeed, the same math underlies both processes. At a growth rate of 1%, income doubles every 69 years. At a growth rate of 10%, which we saw in China during its liberalizing spree, income doubles every seven years. What’s great about the growth of income—or gross domestic product, which is the same thing—is that “wealthier societies offer greater opportunities and freedoms to pursue one’s preferred concepts of happiness.” Life expectancy, diet quality, and leisure time grow. Since 1870, in developed countries a typical employee’s working time outside the home has decreased by nearly half. No wonder that, as recent research confirms, economic

growth makes people happier.

Money may not buy happiness, but it certainly makes life easier. Cowen would probably add that, in the long term—if, for example, incomes have been multiplied by 39 billion after five centuries—it does buy happiness *ceteris paribus*.

Sustainability / It is true that standard income (GDP) figures don’t provide a complete picture of how production con-

If we must choose between different paths of economic growth, the path that is consistently higher should always be chosen because of its benefits.

tributes to happiness. To GDP, Cowen prefers a theoretical concept that he calls “Wealth Plus,” a measure of well-being that incorporates leisure time, domestic production (goods and services produced in the home), and “sustainability,” along with standard economic production. (Instead of “Wealth Plus,” by the way, he should have written “Income Plus” because wealth is a stock while income and GDP are flows.)

Cohen rescues the idea of “sustainability,” which has become a mantra in environmental discourse. His notion of sustainability includes the environmentalists’ “environmental amenities” and “the prerequisites for a durable civilization.” Over and above individual preferences, which can be “irrational or misguided,” he welcomes the “plural values” that may be required for the good society.

“Sustainability” is largely left undefined and raises many problems that Cowen brushes aside a bit too easily. Keep in mind, however, that *Stubborn Attachments* is a short book obviously written for a general

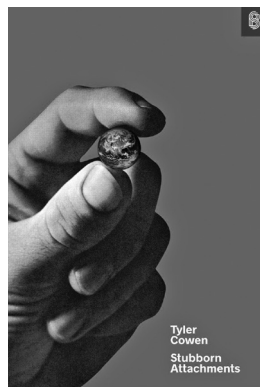
public of intelligent laymen.

Problem of aggregation / Sustainable economic growth, Cowen argues, helps resolve problems stemming from clashing preferences among different individuals, especially in the long run where growth produces “an overwhelming preponderance of benefits.” “The wealthier society will, over time, make just about everyone much better off.” All problems are flattened by the benefits of long-term growth. Just let “happiness talk”! Turning Keynes on his head, Cowen basically says that in the long run we are all good.

Do the long-run benefits of economic growth sidestep the aggregation problem, as Cowen claims? This problem, best represented by Kenneth Arrow’s Impossibility Theorem, is the mathematically demonstrated proposition that, under realistic conditions, it is impossible to derive from the preferences of all individuals a consistent and non-imposed “social welfare function” telling us what “society” wants. This amounts to saying that “society” cannot want anything that would be consistent and equally representative of all individuals’ preferences. Cowen suggests that all individuals will agree on what Wealth Plus means. This agreement is precisely what appears to be impossible.

For example, how do “we” choose a path of economic growth or reach any other social choice? Who is this “we”? For the reader conscious of this problem, the constant use of “we” in *Stubborn Attachments* becomes annoying.

A related problem that pops up is the scientific impossibility of comparing the utility or happiness of different individuals. We can only indirectly measure ordinal utility, that is, the degree of happiness of a given individual. We cannot measure cardinal utility and add it over many individuals, even indirectly. Cowen recognizes this problem but dismisses it. It does seem to



**Stubborn Attachments:
A Vision for a Society
of Free, Prosperous,
and Responsible
Individuals**

By Tyler Cowen

**160 pp.; Stripe Press,
2018**

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make sense to say that most individuals are better off in a wealthy society than in a poor society, but it may be because the “we” has been more effectively silenced—the state has put its nose in fewer activities—in the former than in the latter. The reader—or at least this one—would have liked to hear more from Cowen on that.

Principle of economic growth / As we’ll see shortly, epistemic humility is in order. If we suspend difficult questions about aggregation and interpersonal utility comparisons, and focus instead on social coordination and common-sense morality, we get Cowen’s “Principle of Growth”: “maximize the rate of (sustainable) economic growth” and, when in doubt, choose growth. This seems to make sense.

How to reconcile this ode to economic growth with the “great stagnation” to which Cowen’s name is now associated? (See his book *The Great Stagnation: How America Ate All the Low-Hanging Fruit of Modern History, Got Sick and Will (Eventually) Feel Better*, 2011.) He anticipated that question and answers that “progress is unevenly bunched,” implying that the great stagnation is only temporary.

Consequences / Economists are natural consequentialists: they are interested in the social consequences of individual actions and public policies. But we face what philosophers call the “epistemic problem.” As Cowen phrases it, “We hardly know anything about long-run consequences.” How can we seriously evaluate individual actions and public policies?

It is a troubling problem. If Hitler’s parents had conceived him in a slightly different position in bed or at a different time, his genetic make-up would have been different. *He would not have been Hitler*. He could have become the grandfather of a second Mother Teresa or, better for economic growth, the father of another Jeff Bezos. Many things would be different today and in 500 years’ time. Changed genetic identities change the genetic identities that follow. This problem is especially acute if the long-term future is discounted

at a lower rate because good and bad consequences loom larger in our eyes.

Cowen argues that the epistemic problem should not paralyze us. It should instead bring us to focus on big actions more likely to push in the right direction. “We should not discriminate on the basis of relatively small benefits and losses,” he writes, because “anything we try is floating in a sea of long-term radical uncertainty.” We should “pursue values that are high in absolute importance” and are consistent with doing the right thing given broad rules of moral action. This may not be a totally satisfactory answer, but Cowen is after some common-sense morality.

Cowen sees the case for (nearly) inviolable human rights as bolstered by the “froth of massive uncertainty” that covers long-term consequences.

Individual rights / Not everything must be sacrificed to economic growth, as “sustainable” as it might be. Cowen argues that the principle of economic growth must be constrained by “nearly absolute” or “semi-absolute” “human rights.” (Instead of “individual rights,” he uses the more faddish expression “human rights.” The latter term can be seen as the degenerated and politically correct version of the 18th-century “rights of man” or Adam Smith’s “natural liberty.” The degenerated version is quite certainly not what Cohen means by “human rights,” so I don’t contradict him by using “individual rights” instead.)

The rights Cowen has in mind follow Robert Nozick’s model in that they define strict constraints on what individuals (alone or in gangs) may do to others. Cowen is even less explicit than Nozick, and not necessarily as radical-libertarian, about what these rights are or should be. The “nearly” or “semi” qualification to the absolutist character of rights is intended to cover minor practical exceptions where exercising a right would generate very large

costs. But it does not affect the Principle of Growth, which applies to a phenomenon for which, nearly by definition, the benefits are massively larger than the costs.

It follows that “*the dual ideals of prosperity and liberty will be central to ethics*” (Cowen’s emphasis). The motto is “Growth and Human Rights.” In a kindred political regime, one can do what one wants, provided only that it is compatible with what others want.

Cowen sees the case for (nearly) inviolable human rights as bolstered by the “froth of massive uncertainty” that covers long-term consequences. “Rights rarely conflict with consequences in the simple ways set

out by philosophical thought experiments,” he writes. “We can think of radical uncertainty as giving us the freedom to act morally, without the fear that we are engaging in consequentialist destruction.”

The case of the baby’s life versus \$5 billion illustrates these points. Such an alternative is meaningless because there is no way to know what would be the long-term consequences of killing the baby or, for that matter, of losing \$5 billion of GDP. You might be killing baby Hitler, but then you might be killing baby Mozart—there’s no way to know. On the other hand, it is a bad rule to kill babies if one wants to preserve civilization and its institutions, which are the conditions for future economic growth. If killing babies doesn’t violate individual rights, nothing will. So, even in a consequentialist perspective, don’t kill the baby.

Stubborn attachment needed / What is “the appropriate scope of redistribution,” to borrow the title of one chapter? “Our strongest obligations,” Cowen writes, “are to contribute to sustainable economic growth and to support the general spread of civilization.” Some redistribution is warranted only to the extent that it contributes to these general objectives. The book contains an interesting discussion

on why anybody living in a rich country is not morally compelled to give all his income to much poorer people in poor countries. One reason, of course, is that self-sacrifice by everyone would be self-defeating because there would be nothing to share; productive people in developed nations would soon lose their motivation to produce. Cowen continues to sail close to common-sense morality—or at least to what people in the classical liberal tradition consider such.

The book does not clearly answer the question of whether or when redistribution by the public sector is preferable to private charity. But the author obviously thinks that private charity (and perhaps some public redistribution) is good if it contributes to long-term growth. A short postscript explains how Cowen feels a stubborn attachment (the second and only other time the expression appears in the book)

to a poor entrepreneur he met in Ethiopia, to whom he is donating the book's profits.

One of the many originalities of *Stubborn Attachments* is how it invokes Ayn Rand, with some caveats. Rand almost certainly would not have given money to an Ethiopian quidam. But, as Cowen notes, she “is the one writer who best understood the importance of production to moral theory.” She also emphasized “the creative individual mind” and the importance of ideas, which are “the wellspring of economic growth.”

The author of *Stubborn Attachments* concludes that we should think big and entertain a utopian vision for the long-term future. Sustainable economic growth constrained by “semi-absolute human rights” should be our “working standard.” These ideas provide an imperfect ethics, but it hugs common-sense morality. In many ways, Cowen shows a path to an open and enlightened libertarianism. R

percentage of vehicles use relatively little or none of those fuels. As a result, the federal gas tax is less and less able to pay for our current highway system, much less any major upgrades.

And our highway system certainly could use some upgrading. Poole cites research showing that Americans waste at least \$160 billion per year because of highway congestion. Rational investments could greatly reduce that cost while modernizing many bridges that, though not “crumbling” (contrary to the claims of politicians eager for public money for their districts), are on their way to obsolescence. (Among the virtues of Poole’s writing is that he takes down exaggerated claims on both sides. He likes cool, sober analysis.)

Mired in politics / The main reason why we are behind some other countries in the modernization of highways is that our system is so entwined in politics. Resources are frittered away on low-priority projects, some of which don’t have the slightest connection to roads. Special interest groups involved in transportation are good at using their political clout to block changes to the roadway funding system that would upset what’s for them a comfortable status quo.

The federal Highway Trust Fund, Poole writes, has been gradually converted into “an all-purpose public transportation works program.” Money the public believes is going to highways is increasingly spent on other things like “urban transit, bike paths, sidewalks, recreational trails, historical preservation, and even transportation museums.” Naturally, voters are opposed to increasing the gas tax, in part because much of the money will get siphoned away into the kinds of projects that politicians love to brag about when they want to show their constituents that they’re “bringing home the bacon.”

Legislative maneuvering also undermines state highway funding. Prospective efficiency improvements are often delayed or completely sidetracked because each representative wants some chunk of the spending for his district.

Roads for the Future

◆ REVIEW BY GEORGE LEEF

Bob Poole is well-known for two things. First, he was one of the founders of *Reason* magazine in 1970, giving the nation a consistently libertarian investigative magazine. Second, he has devoted most of his career to the analysis of America’s transportation problems, especially our highways. This book brings together

decades of his research with the objective of showing how we could enjoy a far more efficient highway system if we would shift away from the heavily politicized approach to roadway funding that has predominated for more than a century, in favor of a utility model. In short, Poole argues that we should build and maintain our roads the same way we build and maintain our water and electric utilities: customers pay companies for their use.

Stuck in the past / We are rapidly approaching a turning point regarding highway policy, Poole argues. The reason is that

our old funding model for highways is breaking down just as many of our ill-maintained roads and bridges are.

Ever since the Great Depression, we have relied primarily on the federal gas tax to provide the money needed for roadways. At that time there was no convenient way to meter the amount of driving Americans did, so the best way to fund road construction was to tax gasoline and diesel purchases. Over the years, Congress often raised the amount of that tax, but it has not done so since 1993. The taxes on gasoline and diesel have been 18.4¢ cents and 24.4¢, respectively, per gallon for a quarter-century. Moreover, fuel economy has improved steadily and a small but growing

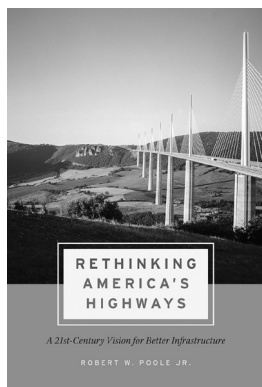
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Democracy has saddled us with a very suboptimal highway system. What America needs to do, Poole argues, is escape from “the mistaken belief that highways are the kind of thing that only government can provide.” History offers alternatives. In our early years, many toll roads were built privately and, as you would expect, cost less to construct than government roads. The federally built National Road that was begun in 1811 to open access to the Northwest Territories cost \$13,000 per mile, whereas the contemporaneous and private Lancaster Turnpike in Pennsylvania cost only \$7,500 per mile.

Unfortunately, private roads suffered from travelers avoiding paying the tolls. Most toll road companies went bankrupt. Government stepped in and the idea that roads must be provided by government took hold. However, modern technology has found ways to prevent this public goods problem—if only the United States would give private roads greater support.

Further harming roadway mobility in the United States is the popularization of the notion that America “can’t build its way out of highway congestion” and therefore ought to “get people out of their cars” and into governmental mass transit. On the contrary, Poole argues, we can build our way out of congestion if we allow the market to work, albeit usually in conjunction with government. Privately financed and operated highways can and do work, as he shows with numerous examples from both the United States and abroad.

The new toll roads / Highway privatization has been embraced in Europe, Asia, and South America for decades. Italy approved the first modern investor-owned toll road in 1921 and a network of privately owned highways now



Rethinking America's Highways: A 21st-Century Vision for Better Infrastructure

By Robert W. Poole Jr.
363 pp.; University of Chicago Press, 2018

operates there. Beginning in 1955, the French have built numerous tolled highways, usually financed with a combination of private and government funding. It is now common for the government to seek competitive bids from companies for new construction, such as the astonishingly beautiful Millau Viaduct that Poole pictures on the book's cover. Spain and Portugal have followed France in turning to private firms operating under toll concessions for improvements in their highway systems. So have Australia, Japan, South Korea, Brazil, and Chile.

Privately financed and operated toll roads are not, of course, unknown in the United States. Poole recounts in great detail the first such project here, the Dulles Greenway toll road extension. It was the brainchild of Reagan administration transportation official Ralph Stanley, who lobbied for the necessary legislation in Virginia and then oversaw the project, which opened six months ahead of schedule in 1995.

At the same time on the other side of the country, private toll roads were coming to the rescue of congestion-desperate drivers in California. The state legislature had approved a bill allowing up to four privately funded toll roads in the state. The SR-91 “express lane” toll road in Southern California was the first to open and was an immediate success.

Of course, some private highway projects have been losers, just as you would expect in any business. For example, the “Southern Connector” in Greenville, SC opened in 2001 and declared bankruptcy in 2010. The losses, however, fell upon the road's investors, not taxpayers. The creditors restructured their bonds and the roadway continues to operate today. The Dulles Greenway also experienced defaults in its early years and underwent a massive

refinancing in 1999, but since has come good. (See “A New Approach to Private Roads,” Fall 2002.)

Bringing in the innovative thinking and know-how of the private sector has proven extremely beneficial in some states, particularly Florida. Poole explains how partnering with one of the French highway firms enabled Florida's Department of Transportation to save a great deal of money in its Port of Miami Tunnel, built to alleviate congestion and wear-and-tear on surface streets from heavy trucks.

The bulk of the book is about highways, but Poole devotes a chapter to possible improvements in urban expressways and arterial roads. He envisions transponder technology, which enables road companies to bill drivers based on the amount and times they use roads as the key to revitalization and improved efficiency.

Prognosis / I find persuasive and appealing Poole's vision of depoliticizing roads and highways, turning them into network utilities where customers pay regular bills based on usage. But there are some powerful opposition groups who want to prevent that from happening.

First, there are conservative/populist enemies who fight any suggestion of privatization because “we already pay for roads with taxes” and anything more is “double taxation.” A relative handful of pundits, bloggers, and radio talk show hosts can move masses of people to register their opposition to toll roads. The cogency of the case for escaping from road socialism into a free market doesn't seem to have any effect on those people. Anti-toll forces of this sort have been especially effective in Texas.

Second, there are left-wing enemies who influence policy with claims that the roads rightfully belong to the people and private firms shouldn't profit from them. These critics argue against “selling our infrastructure” and quite a few Americans are persuaded by them.

Finally, there are interest groups that are wedded to the status quo. Governmental toll entities, for instance, do not want

any competition that would threaten their comfortable jobs. In 2007, when Pennsylvania Gov. Ed Rendell advanced a plan to privatize the Pennsylvania Turnpike, the existing toll authority fought and eventually defeated it. An even bigger obstacle is the panoply of environmental groups that dislike cars and oppose changes that would make driving more efficient.

In short, the road to the kind of market-based highway utility Poole has in mind is cracked and strewn with potholes. Nevertheless, he is optimistic. The good record of toll highways here and abroad should ultimately persuade people, but even more significant will be the federal government's

increasingly dire fiscal situation. As entitlements eat up more and more federal revenue, turning to the private sector to build and maintain our highways will become very hard to resist.

Poole concludes by stating that the Interstate Highway System is wearing out and will have to be replaced at a cost of around \$1 trillion. At present, we do not have a funding source for this. The good news, he writes, is that "large-scale investment capital is waiting for the opportunity to invest in replacing and modernizing U.S. highway infrastructure. It's time to begin the transition to this new and better model for 21st century highways." R

disregarded. And not just by the bank the lawyer supervises—but also by some of her fellow New York Fed regulators.

The reorganization / Segarra's first few weeks on the job at the New York Fed just happened to be at the same time that a bizarre reorganization of the bank's compliance function was in motion. Her new boss explained that the group in which Segarra would work was staffed by "relationship managers" who in the past were responsible for scrutinizing compliance at the megabanks. But, as part of the reorganization, the relationship managers would be replaced by "risk specialists," the role that she would play. These specialists were assigned to monitor market, credit, audit, operational, legal, and compliance risk. Most of these positions would be filled by experts who, like her, were new to the New York Fed.

The idea was to replace the "relationship managers," who were former long-time bank examiners, in order to "upgrade the New York Fed's personnel." As Segarra summarizes it, "This convoluted and confusing structure had more to do with giving the old bank examiners the appearance of a job so as to improve their prospects of getting hired out of the New York Fed and less to do with how supervision would work moving forward under the new structure." Additionally, the manager she was replacing, Jonathan Kim, was supposed to transition out of the job within a month, but he ultimately remained in his position the whole time Segarra was at the New York Fed (about seven months). She states the obvious: this structure "made my job very difficult." Other relationship managers also remained or received promotions: "So much for getting rid of the old guard.... So much for changing a culture that was rotten to its core."

To add to the confusion, Segarra was not scheduled to receive vital systems training for her job until many months after her arrival. When she raised this concern with a colleague, the response was troubling: "Don't worry about that. I didn't do anything the first year I was here." During the transition before her training, she could

A Damning Portrait of the New York Fed

◆ REVIEW BY VERN MCKINLEY

Carmen Segarra's story broke in a big way in 2013 and 2014. It was a tale of big banks in New York, the supervisors of those banks, and tapes of sensitive conversations she secretly recorded before being fired as an employee of the Fed's most prominent regional bank. Her story revealed that, five years after the financial crisis,

there were still systemic problems, not just with the big financial institutions that received all manner of bailouts, but also with the Federal Reserve Bank of New York, which was at the epicenter of distributing those bailouts. Contemporaneously with the release of her story, renowned business writer Michael Lewis wrote an article claiming her revelations were a clear indication of "how dysfunctional our financial regulatory system is."

It has taken nearly half a decade, but now Segarra, the whistleblower who first told her story to journalists at *ProPublica*, has turned that story into a book. She is an attorney who worked in regulatory compliance positions in banks such as MBNA, Citigroup, and Société Générale before tak-

ing a job at the New York Fed.

Her work as a regulator was not that of a typical bank examiner who visits the banks to review loan files for asset quality and crunch numbers on the bank's capital, liquidity, and earnings. Rather, she specialized in areas on the "compliance" side of regulation to check matters such as how banks monitor their conflicts of interest. This position was a good match for her legal background and is why *Noncompliant* makes for a logical title for the book.

Segarra does a good job of summarizing the book in one of her final chapters:

A lawyer goes to work for the New York Fed. She is assigned to supervise a bank, verifying whether said bank is complying with the law. In the process the lawyer discovers that numerous laws, rules and regulations are being violated and

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do nothing more than listen closely and take meticulous notes. “Dysfunctional” seems like a kind assessment of the work environment.

Supervising Goldman / As luck would have it, Segarra was assigned to work on compliance matters for Goldman Sachs:

Long before I arrived at the New York Fed, Goldman’s reputation in legal and compliance circles was not good.... If the word on the street was right, my job would be incredibly easy. Finding issues with their legal and compliance programs would be like shooting fish in a barrel.

The oversight of Goldman was shared with the New York State Department of Financial Services and the Federal Deposit Insurance Corporation, with all the supervisors from the three working on the “Goldman regulator floor.”

The regulator floor and the Goldman offices are the primary settings for the book. The writing style of *Noncompliant* is not breezy by any means, but becomes predictable. Most of the storyline involves Segarra describing the meeting (or meetings) of the day, either with Goldman, her colleagues at the New York Fed, or the other agencies that oversee Goldman. She characterizes the sequence as “another mind-numbingly repetitive meeting.” One of her major findings was that “Goldman did not have a firm-wide conflicts-of-interest policy.” After she discovered this, countless meetings ensued and a Goldman legal counsel admitted, “There is no one policy per se.”

As the story unfolds, the reader gets bombarded with acronyms from the financial industry: CFPB, MRIA, RCSA, MOU, BSC, SR, IO, BSA, AML, CCAR. Reading the book is analogous to watching a very long episode of *The Office*, but without the bursts of humor.

Segarra reveals some really egregious practices: “Many New York Fed employees had side jobs.... We were free to set up our own legal practice on the side and make money practicing law while working full-

time at the New York Fed.” As for sharing information with colleagues at the Board of Governors in Washington to facilitate oversight of Goldman, a New York Fed colleague claimed, “We don’t share information with the Board.” Segarra claims that she was blocked from taking a tough enforcement stance against Goldman. “We made a deal with Goldman last year that we would raise their rating,” explained a veteran Fed colleague.

Insider trading apparently is a “side-gig” for some New York Fed employees. “Have you gotten any good trading tips yet?” one former employee asked Segarra. Regulatory capture was pervasive: “A number of the [New York Fed Goldman] team members often leapt to the bank’s defense and worried how Goldman would react to negative criticism from the risk specialists.”

The hammer falls / As Segarra pushed back against this culture, one of the managers she worked under made

clear that her moves were not appreciated and that “he had received some troubling feedback about [her] from a few people on his team.” Her notes of official conversations that were to allow her to both learn her job and create the official record for meetings were brought under scrutiny. One colleague interrogated her: “Isn’t it interesting how different people hear different things in meetings.... I don’t recall hearing a lot of these things noted in your meeting notes.” Segarra implies that the true meaning of the comments was clear: destroy her minutes of the meeting. That colleague would depart a few years later to work at Goldman.

With the evidence building that she was becoming persona non grata, Segarra began to realize that “I need to talk to a lawyer.” Her lawyer advised her to purchase a USB recording device.

With the end of her six-month pro-

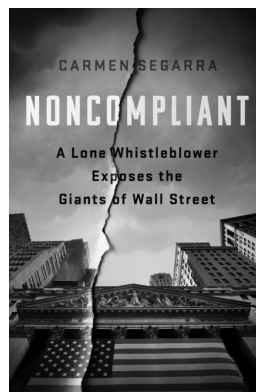
bationary period looming, she had concerns. But she took hope when Kim entered her in the performance appraisal system, believing “he would not have been bothering to [set me up in the system] if the New York Fed was planning to fire me.” But she would soon learn that, as with everything else at the New York Fed, the performance appraisal process was a “shit-show.”

The end came seven months into her tenure, when she was ushered into a conference room by Kim, where one of the managers and someone from human resources awaited her. “Carmen, I am here to tell you you’ve been released from the bank,” she was told. “We’ve lost confidence in your ability to allow your work to be adequately supervised.” Segarra fought her dismissal in court but her wrongful termination case was ultimately thrown out. “The experience had eroded my trust in the government’s ability to supervise the finan-

cial system and protect the savings of taxpayers,” she writes.

Conclusion / Segarra’s continuous narrative regarding one meeting after another could have been presented better in the book. For example, it would have been helpful for the reader if she had offered a simple scorecard of all the many players at the New York Fed, Goldman, and elsewhere. *All the Presidents’ Bankers*, a 2015 book also published by Nation Books, did just that.

Maybe she read too much into some of the comments of her colleagues. Maybe working in a bureaucracy was too much for her. Maybe some of her colleagues considered her insubordinate. But even if some of what she has to say in *Noncompliant* was exaggerated or misunderstood, the picture is very troubling for the fate of megabank oversight. R



Noncompliant: A Lone Whistleblower Exposes the Giants of Wall Street

By Carmen Segarra

352 pp.; Nation Books, 2018

Working Papers ➡ BY PETER VAN DOREN AND IKE BRANNON

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

The ACA and Opioid Deaths

"Health Insurance and Opioid Deaths: Evidence from the Affordable Care Act Young Adult Provision," by Gal Wettstein. Forthcoming in *Health Economics*.

Accidental drug overdoses have become the leading cause of death for those under age 50, and the rate of death via opioids has increased dramatically in the last few years. In 2017, approximately 72,000 people died of a drug overdose in the United States, which is nearly twice as many as in 2013 and four times as many as at the turn of the 21st century.

The recent spike in drug mortality coincides with the advent of the Affordable Care Act, which greatly increased the ability of young people to obtain medical coverage. In the years following the ACA's passage, insurance coverage for people between 18 and 25 increased from 70% to 87%. This has led some people to infer that the increase in insurance coverage contributed to the increase in opioid deaths. The rationale is that having a doctor and insurance coverage makes it easier for people to access and become addicted to opioids, despite attempts in recent years to restrict the availability of the drugs.

Despite the timing, it is not clear that the increase in opioid deaths has anything to do with the increase in health insurance coverage. In this paper, Gal Wettstein notes that, *ex ante*, the very opposite effect is possible: People with regular health care should have better health and thus have less reason to seek painkillers to begin with. Moreover, those who do become addicted will find it easier to access treatment via mental health counseling or medication, as well as follow-up care. Most importantly, addicts with insurance generally abuse prescription opioids, which are less risky than heroin or other narcotics bought illegally. Indeed, the Centers for Disease Control attributes fully 40% of all overdose deaths to fentanyl, an incredibly lethal drug that is often added to batches of heroin to accentuate the high it confers.

With such confounding intuitions, Wettstein turns to the data to attempt to determine if there is a connection between the ACA and opioid deaths. He uses the ACA's health insurance provision for young adults as a quasi-experiment. The ACA allows children to remain on their parents' health insurance until they turn 26, and this provision took effect upon the law's passage on September 23rd, 2010, while many other ACA provisions did not take effect until 2014. The distinct implementation dates mean that we should see the effect of the ACA on drug deaths—if there is one—occur at different times for different age cohorts.

Two confounding events occurred between these two dates that

make this natural experiment a bit less than ideal. The first is that marijuana became legal (or quasi-legal) in several states over this time period, and there is some evidence that marijuana dampens opioid usage by serving as another way for people to deal with pain. Also, use of naloxone, a medication that can rapidly alleviate the effects of an overdose, became more prevalent over this time. It is possible naloxone availability could reduce overdose deaths; it is also possible it could contribute to them through moral hazard: people may be more willing to take risks with opioids if they know naloxone is at the ready in case of overdose.

Another problem in this analysis, Wettstein notes, is that it can be difficult to discern precisely what, in fact, killed someone. Not all decedents get an autopsy and coroners may forgo one if they believe that they can easily discern a cause of death from circumstances and there is no next of kin insisting that an autopsy be done. People who spent years abusing drugs and died of a heart attack at a young age may have clearly had their lives cut short because of drug abuse, but the coroner may attribute their death to natural causes.

Wettstein looks at opioid-related deaths of people ages 19–29 by year and state from 2011 to 2016. The 29-year-olds in 2016 could obtain coverage in 2011. He compares this cohort's overdose death rate to the overdose death rates via opioids for people age 32–36, which had no access to young-adult health insurance coverage.

He employs two distinct methods of analysis. The first is a difference-in-differences approach, which entails comparing the two groups. The second method is a simple dose-response model whereby he measures what happened after the implementation of the ACA while attempting to control for other factors.

Wettstein finds that the deaths from opioid abuse in the older cohort increased faster than the younger group post-ACA using the difference-in-differences approach. That leads him to tentatively conclude that health insurance access reduced deaths from opioids. However, there are caveats. One concern is that prescription opioids spill over between age groups within a state, confounding cohort comparisons. For instance, in their 2015 paper "How Increasing Medical Access to Opioids Contributes to the Opioid Epidemic: Evidence from Medicare Part D," David Powell, Rosalie Liccardo Pacula, and Erin Taylor found that states with higher take-up rates for Medicare Part D were associated with greater drug abuse for non-retirees as well. In other words, it may be that the younger people having more insurance may actually increase access to drugs for older people as well. This "dilutes the experiment," giving us one more thing that cannot be controlled for.

The regression results from the dose-response methodology show a decline in deaths from an increase in health insurance coverage. Wettstein does not discern any obvious stepwise linear tradeoff, but his data do suggest accumulated declines in drug

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abuse deaths. By looking at the entire panel of observations, he discerns a lagged effect to access to health insurance, with the reduction in death rates from health insurance access increasing in subsequent years. He estimates that a 1-percentage point increase in health insurance coverage ultimately reduces opioid deaths by 3.6 per 100,000, which is a 16.5% reduction.

Wettstein cautions against reading too much into his data, noting that 2011–2016 may turn out to be anomalous, with death rates much higher than in previous—and hopefully subsequent—eras. He concludes that health insurance seems to have reduced drug deaths from where they would be otherwise, and he suggests that it does so partly through the improved physical and mental health that regular access to health care begets. —Ike Brannon

Banking Regulation

“The Limits of Shadow Banks,” by Greg Buchak, Gregor Matvos, Tomasz Piskorski, and Amit Seru. October 2018. SSRN #3260434.

Traditional banks accept deposits that are federally insured, issue loans, are members of the Federal Reserve System, and are subject to safety and soundness banking regulations and examinations. Shadow banks, on the other hand, do not accept deposits; they raise money in the capital markets. They originate loans, not to hold in their portfolio, but to securitize and sell to other investors. Among those investors are the government-chartered Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), which also receive government subsidies.

The 2010 Dodd–Frank banking reform legislation, passed after the financial crisis in 2008 and the ensuing Great Recession, altered the regulation of traditional banks but not shadow banks. This paper argues that because shadow and traditional banks are partial substitutes for each other, the effects of regulatory reform on traditional banking has shifted some banking activity to the shadow sector, dampening any soundness benefits from Dodd–Frank.

The market for mortgages is segmented. Well-capitalized traditional banks issue so-called jumbo loans (above \$484,350, or \$726,525 in high-cost home areas) that cannot be sold to Fannie Mae and Freddie Mac. Thus, the traditional banks hold those loans on their balance sheets. Shadow banks originate loans to distribute to Fannie and Freddie or private investors through securitization. Poorly capitalized traditional banks with limited balance sheet capacity also originate loans to distribute to investors.

A central component of traditional banking reform has been increased capital requirements. The more equity in a traditional bank’s capital structure, the less likely depositors are to lose money if loans are not repaid in full. (See “Bank Capital Requirements,” Working Papers, Winter 2010–2011). Under Dodd–Frank, capital requirements were increased from 4% of assets (i.e., loans) in 2010 to 6% in 2015.

The central insight of this paper is that traditional banks rely

on deposit insurance to attract deposits while shadow banks and poorly capitalized traditional banks rely on the government subsidies to Fannie and Freddie to facilitate their business model. As subsidies for traditional banks decline because of increased capital requirements, jumbo loan activity declines but “conforming” loan activity—loans below \$484,350 or \$726,525 in high-cost loan areas—increases to take advantage of the mortgage guarantees provided by Fannie and Freddie. —Peter Van Doren

Soda Taxes

“The Impact of Soda Taxes: Pass-Through, Tax Avoidance, and Nutritional Effects,” by Stephan Seiler, Anna Tuchman, and Song Yao. January 2019. SSRN #3302335.

Taxes on high-calorie beverages, i.e., “soda taxes,” have become a popular policy response to the obesity epidemic. Mexico implemented a nationwide soda tax in 2014. Estimates of its effects have used standard elasticity estimates that a 1% increase in soda price results in a 1–3% decrease in consumption. In a previous Working Papers column (“Soda Taxes,” Winter 2017–2018) I discussed research that lowered those estimates by considering the purchase of cheaper soda (switching brands) as a taxpayer response.

In the United States, beverage taxes have been enacted by localities rather than nationwide. A response to such a tax could be shopping outside the jurisdiction and avoiding the tax. On January 1, 2017, Philadelphia imposed a 1.5¢ per ounce tax on sweetened beverages. This was a large tax, amounting to \$1.01 on a 2-liter bottle that had a pre-tax price of \$1.56—a 65% tax on the price. In comparison, the Mexican tax was 9% of the pretax average.

In this paper, the researchers found that the Philadelphia tax has had little, if any, effect on city residents’ consumption of caloric soda. The researchers found that beverage purchases within Philadelphia decreased by 42% after the tax, but that reduction was fully offset by an equivalent increase in purchases in stores outside of Philadelphia. —P.V.D.

Securities Regulation

“A New Market-Based Approach to Securities Law,” by Kevin S. Haerle and M. Todd Henderson. August 2018. SSRN #3233122.

Three claims are used to justify modern securities regulation:

- Firms fail to disclose enough information.
- Firms disclose untruthful information.
- Insiders trade on information, reducing their incentive to release information and the incentive of outsiders to invest in information production.

Modern securities regulation attempts to solve all three of these problems through mandates and restrictions.

Government-mandated production of information results in the overproduction of information irrelevant to firms' soundness (e.g., blood diamond disclosure, CEO pay ratios) and underproduction of relevant information. For instance, disclosure law has become a focal point and securities fraud litigation reinforces this legally defensible but mindless focal point. "Additional statements mean additional exposure to lawsuits based on the allegation that those statements are false or misleading," note the authors of this paper. Class action investor fraud lawsuits result in overcompensation (the authors point out in a footnote that, since 1996, these suits have named 35,000 defendants and produced \$95 billion in settlements) and are just a wealth transfer from one set of shareholders to another, with a healthy cut for the lawyers. (See "The End of Securities Fraud Class Action?" Summer 2006.) The marginal deterrence benefits from securities fraud are low because the payments are orders of magnitude greater than the actual level of fraud.

For the authors, the central economic problem with current securities regulation is that it mandates that firms provide information for free. The authors' solution is to legalize payments for early access to public information. This money would generate incentives for firms to provide the information that investors want. Participation in class action securities fraud suits would be limited to those who paid for early access, acted on that information, and lost money

because of fraudulent information. And corporate insider trading would be severely reduced because such behavior would now cost the firm money. Insider trading would undermine the firm's profits from selling early access to information.

The most important objection to their proposal is that, in this new regime with advanced disclosure, there would be no uninformed investors from whom the knowledgeable could buy and sell securities. The uninformed, who did not pay for access, would avoid trading during the publicly announced time periods in which some investors get early access to the information, thereby protecting the uninformed from getting fleeced by the informed. Thus, the only people trading in these periods would be the informed. Given the belief that serious money is made only by the informed trading with the uninformed, there wouldn't be anyone willing to pay for early access to information because they couldn't make any money from that information. In this view, the wolves make money only by selling to the sheep.

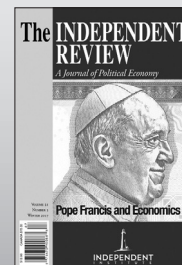
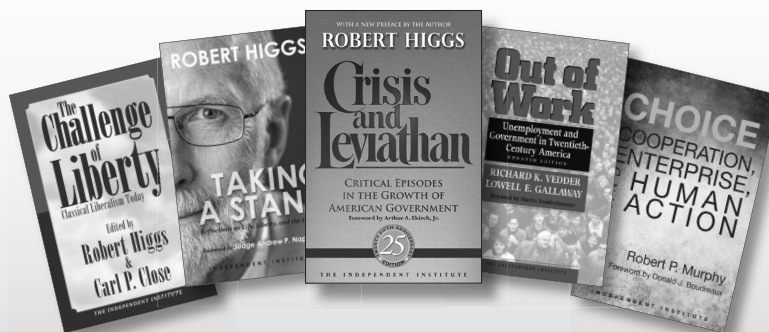
The authors counter that informed people now trade with each other because they differ on the implications of information that they all possess. "Information can be valuable even when other people have it (if you have different predictions or can get to market first) or if it can be used to predict outcomes in related areas." —P.V.D. R

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