Always with Us

REVIEW BY RICHARD A. BOOTH

In *Fraud*, Edward Balleisen recounts the evolution of attitudes toward and responses to fraud from the middle of the 1800s to the present day. Needless to say, this is a big subject with many moving parts. But Balleisen, a professor of history and public policy at Duke University, has written a readable—and enjoyable—account of how fraud as variously defined has shaped the very idea of free enterprise in America.

As noted in the jacket blurb: “The United States has always proved an inviting home for boosters, sharp dealers, and outright swindlers. Worship of entrepreneurial freedom has complicated the task of distinguishing aggressive salesmanship from unacceptable deceit, especially on the frontiers of innovation.”

To be clear, the book focuses on frauds perpetrated by businesses on individuals and other businesses. It does not address frauds perpetrated by individuals as individuals. In other words, the book deals with the business of fraud (so to speak). But its real contribution is that it traces the variety of methods by which government, consumers, and business itself have sought to remediate and prevent fraud. Perhaps more intriguing, Balleisen describes how attitudes toward fraud have shifted over time from the days of strict *caveat emptor*, to the rise of the postal inspectorate after the Civil War, to the advent of the regulatory state beginning around World War I, to outright swindlers. Worship of entrepreneurial freedom has complicated the task of distinguishing aggressive salesmanship from unacceptable deceit, especially on the frontiers of innovation.

Balleisen also does a good job explaining how the word “fraud” has been mangled in popular usage to comprehend a range of abuses that often fall far short of true fraud. A business may be described as a “racket” or “scam,” but does that make it true fraud? On the other hand, Balleisen tends to succumb to the idea that for a business to fail suggests foul play of some sort. For example, he seems to see the failure of the automaker Tucker Corp. and its effort to market the Tucker 48 as not much better than the tactics of the disreputable Holland Furnace Company (of which more presently). As Balleisen notes, Tucker failed because of cost overruns and a lack of capital. In an effort to save the company, Preston Tucker sold dealerships to businessmen and options to purchase cars themselves to consumers. For this he was charged with mail fraud as well as securities fraud, but he was ultimately acquitted when the judge emphasized to the jury that to convict Tucker of fraud requires that in alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake (although malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally).

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It is not at all clear that Tucker Corp. should be seen as sketchy simply because it could not attract adequate capital. In the United States, we have largely eliminated generic capital requirements for business, relegating such regulations to financial businesses that handle other people’s money and thus assume a fiduciary or similar duty (even though there is little agreement as to how much capital is necessary even then). In contrast, the European Union has struggled to retain and rationalize the general requirement of legal capital and has suffered significantly slower recovery and growth. Incidentally, Tucker’s business model is similar in a way to crowdfunding, for which Congress carved out an exception to the securities laws in 2012. Maybe Tucker was just ahead of his time.

**Troubling tales** / The saga of the Holland Furnace Company, which Balleisen mentions in four separate passages, is another story altogether. Its business model was to offer a free in-home furnace inspection, which required the dismantling of the existing furnace. When the inspector discovered dangerous defects, he would refuse to reassemble the unit, leaving the homeowner with little choice but to buy a new furnace.

Ironically, Holland became the target of a takeover attempt in 1957 by Arnold Maremont, a businessman with a history of corporate takeovers and liquidations. Maremont thought the company’s so-called direct sales method was outmoded and he acquired a substantial block of shares presumably with a view to changing the strategy. The board of directors averted the overture by repurchasing Maremont’s
stock at a premium. Stockholders objected that the repurchase depleted company assets for the purpose of entrenching management. But the Delaware Supreme Court ruled that the use of corporate funds to prevent a takeover was permissible because it was for the legitimate business purpose of protecting the business strategy. Never mind that the strategy itself turned out to be illegitimate, as the Federal Trade Commission ultimately found. Nevertheless, the Delaware case *Cheff v. Mathes* remains good law and is often cited as drawing the line between permissible and impermissible “greenmail”—the strategy of buying stock in an apparent effort to take over a firm, but really to receive a premium repurchase offer from the firm.

The trials of Tucker are reminiscent of the 2002 failure of WorldCom and the fate of its CEO, Bernie Ebbers, who remains in jail today. Although there is no question that WorldCom was guilty of securities fraud by virtue of misreporting its financial situation, one of the accounting rules it violated was subsequently changed by the Financial Accounting Standards Board such that WorldCom would not have been in violation. Yet WorldCom was convicted under the old rule despite the fact that the trial occurred well after the rule change. Moreover, although WorldCom was quite aggressive about classifying cash outflows for fiber capacity as capital expenses giving rise to balance sheet assets rather than ordinary operating expenses that merely reduce earnings, it did not misrepresent the fact of such outflows. Neither the market nor WorldCom knew that so much fiber would remain dark for so long because of the “last mile” problem. But when the market woke up, Ebbers went to jail.

In contrast, around the same time that WorldCom was struggling with its underutilized fiber, Enron was reporting income from transactions that never really occurred. More specifically, buyers retained an option to resell the investments they bought if they declined in value. To be sure, the repurchase might come in the form of Enron stock rather than cash, but the net effect was to treat the issue of stock as income—a gussied up Ponzi scheme. Meanwhile, the management team of Kenneth Lay, Jeffrey Skilling, and Andrew Fastow sold $800 million worth of their own Enron stock while cajoling their employees to invest 100% of their retirement savings in the company.

**Someone to blame** / It is important to remember that most new businesses fail. And big ideas can fail big. But in the United States we do not subscribe to the so-called precautionary principle requiring assurances that new ventures will do no harm. Indeed, since the late 1980s we have made limited liability ever more available (as Balleisen himself notes with some dismay). Few would argue today that limited liability is intended to subsidize business by eliminating the downside for entrepreneurs. Rather, its function is to shift the burden to lenders to protect themselves by exacting security or a higher return. Without limited liability, entrepreneurs would be required in effect to risk all of their net worth in starting a business—as in an ordinary partnership. With limited liability, entrepreneurs know what they must risk to do business and can decide whether it is worth the candle. Moreover, creditors can manage risk through diversification. So limited liability arguably maximizes the availability of credit.

Limited liability can be seen as a tax, of sorts, on the creditor class by limiting what they can recover if the borrowing firm fails. If creditors want more return, then they must take more risk. In other words, U.S. law discourages the emergence of a rentier class of lenders. Thomas Piketty would approve. So it is not surprising that business equity, instead of bonds, is the single largest category of wealth for U.S. individuals. According to the Fed, as of year-end 2016, equity constituted 34% of all wealth, while 25% was real estate, 24% was debt instruments, and 11% was cash or near cash.

As for involuntary creditors—the victims of accidents and other torts that are bound to happen—the irony is that plaintiffs almost always would prefer to sue a big corporation with deep pockets anyway. Moreover, if the business is a small one, the chances are that the owner was personally involved in the mishap and thus liable as a participant irrespective of the insulation afforded by limited liability to owners as owners. And once a small business is big enough to hire a few employees, the owner is likely to have most of his wealth tied up in the venture and thus much to lose because the business itself always remains liable for the actions of its agents. So it is likely that the owner will invest significantly in training and monitoring employees who are bound to be less careful and diligent than would be the owner.

As Balleisen emphasizes, the general organizing principle for U.S. commerce in the mid-1800s was one of *caveat emptor*. And as Balleisen would likely agree, this policy was at least as much a positive choice as it was benign neglect. Consider the following passage from Oliver Wendell Holmes’ *The Common Law* (Macmillan, 1881):

>A man need not, it is true, do this or that act, the term act implies a choice,—but he must act somehow. Furthermore, the public generally profits by individual activity. As action cannot be avoided, and tends to the public good, there is obviously no policy in throwing the hazard of what is at once desirable and inevitable upon the actor. The state might conceivably make itself a mutual insurance company against accidents,
and distribute the burden of its citizens’ mishaps among all its members. There might be a pension for paralytics, and state aid for those who suffered in person or estate from tempest or wild beasts. ... Or it might throw all loss upon the actor irrespective of fault. The state does none of these things, however, and the prevailing view is that its cumbersome and expensive machinery ought not to be set in motion unless some clear benefit is to be derived from disturbing the status quo. State interference is an evil, where it cannot be shown to be a good. Universal insurance, if desired, can be better and more cheaply accomplished by private enterprise.

To be sure, Holmes was struggling here with the fundamental question of why someone should not be held liable for any chain of events set in motion voluntarily. But the logic applies as much to the law of business organizations as it does to tort law. Indeed, it was only in 1875 that New Jersey made the corporate form generally available (although as Holmes himself notes it had been available for manufacturing companies since the 1820s).

When ventures fail and folks lose money, it is only natural to seek someone to blame. But it is often more interesting and useful to understand how fraud happens. As I have argued elsewhere, the 2008 credit crisis can be traced to an array of factors that would have been difficult to regulate in advance. Perhaps the most peculiar factor was that investment banks (as well as commercial banks) invaded the residential mortgage business, which as recently as the 1980s had been the province of the thrift industry. Think Bailey Building & Loan. Many commentators pointed at the repeal of the venerable Glass–Steagall Act, which separated investment banking from commercial banking. Specifically, the act prohibited commercial banks from dealing in equity securities as a way of insulating the core banking business from the risks associated with stocks following the Crash of 1929. But nothing in that act would have prevented investment banks from going into the residential mortgage debt business as they did.

Many observers focused on credit default swaps (CDSs) as the culprit. To be sure, CDSs led to underestimation of risk and thus probably to overinvestment in mortgage-backed securities. But the idea that we should re-regulate the futures markets by prohibiting off-exchange trading—or even return to the good old days when difference contracts (so-called) could be voided as illegal wagers—ignores the significant social benefit of such derivative instruments. Arguably, U.S. farming is as productive as it is because the futures markets have tamed the supply-demand cycle endemic in agriculture. But that is not enough to tame the moralistic objections of those who see such financial engineering as inherently wasteful because it produces nothing. The real wonder is that the zero-sum game of futures trading does in fact create value from nothing (which is not to mention its heartland pedigree). Here too, Justice Holmes played a significant role by recognizing the property rights of futures exchanges to their data in his 1905 Irwin decision.

In short, it is easy to rail at fraud in the unintended (ab)use of financial products, but it can be difficult to tell the whole story. The one thing that seems quite certain is that our attitude toward fraud is schizophrenic, as Balleisen vividly shows. We despise some fraudsters but admire others. And we adopt regulations to protect consumers while also blaming the victim under the doctrine of caveat emptor. I am reminded of the brief but brilliant TV series Max Headroom, in which every person had the right to unlimited consumer credit, but credit fraud was a crime worse than murder.

Advisers and broker-dealers | Balleisen is at his best discussing the curious concept of self-regulation mostly in the context of the rise and fall of the Better Business Bureau. But he also provides a useful history of the Investment Bankers Association, which became the National Association of Securities Dealers and ultimately the Financial Industry Regulatory Authority (FINRA). As Balleisen shows, a self-regulatory organization (SRO) can be an efficient response in a business where the danger of fraud is acute or conflicts of interest are endemic. After all, it takes one to know one. But SROs can shade into restraint of trade or regulatory capture.

Stockbrokers (like real estate brokers) are paid mostly on commission. And commissions tend to be higher on riskier stocks. The result is that brokers are tempted to churn customer accounts and recommend unsuitable stocks. (As Woody Allen said, a broker is someone who invests your money until it’s gone.) On the other hand, FINRA provides arbitration services for aggrieved investors, the results of which turn out to be much more generous than litigating such claims in federal court. Then again, it could be that industry arbitrators are motivated to punish fellow securities professionals who get caught as a way of eliminating some of the competition. Indeed, when the New York Stock Exchange (NYSE) began to lose listings to NASDAQ because the latter permitted listed companies to have shares with differing voting rights, the NYSE prevailed on the Securities and Exchange Commission to mandate a uniform rule despite the potential competitive benefits of exchanges with differing listing standards.

Incidentally, the recent flap about whether some brokers-dealers should be deemed to be fiduciaries is just the latest installment of a controversy that goes back at least to 1933. A broker-dealer may sometimes be a broker and thus an agent for the client. But a broker-dealer may sometimes act as a dealer in a trade—as a principal thereto—when the security is sold from inventory or added thereto. Think of a real estate broker, who owes a duty at least to the owner of the listed property, as opposed to a car dealer, who has a duty to no one. In the securities markets, both modes of trading are legitimate, whether on an exchange (as broker) or over-the-counter (as dealer). Indeed, there are arguments for the superiority of both. But the
point is that the role of the broker-dealer is fluid.

On the other hand, investment advisers (who purport to serve the best interest of their clients) are quite clearly fiduciaries, while a broker-dealer may sometimes act as an investment adviser for a customer. That is why broker–customer disputes often turn on whether there was a relationship of trust and confidence between the two—whether the broker-dealer had assumed a fiduciary duty. The European Union is currently in the process of rationalizing these roles with the promulgation of the second installment of the Markets in Financial Instruments Directive, which will create a bright line between the provision of investment advice for a fee and execution services that may no longer be bundled with supposed free advice. Good luck with that.

Notwithstanding the foregoing defense of the status quo, it is not at all clear that individual investors should ever engage in stock-picking and active-trading. It is well documented that it is impossible to beat the market any more often than is consistent with chance. Indeed, since the market is the aggregate of trading, it is difficult to see how things could be otherwise. But whether or not one believes in the efficient market, investment advice and trading are costly and entail the risk of picking the wrong stocks. So the choice is whether to pay 1–2% annually for active investment management, or to invest in an index fund for as little as three basis points and eliminate all of the risk that goes with individual stocks. To be sure, the latter strategy assumes that others will trade and drive market prices to appropriate levels. But studies indicate that only about 10% of all trading at current levels is necessary to do so. Thus, one could say that the retail securities business is a form of licensed fraud. But it is difficult to argue that individuals should not be permitted to day-trade if they want to do so.

If there is a moral to this story—and Balleisen’s book—it is that fraud will always be with us. There is no cure. There is only management. In the end, regulation will always be one step behind.

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Origins of the Entitlement Nightmare

REVIEW BY DAVID R. HENDERSON

Currently, the U.S. federal government spends about $2.4 trillion per year—about 12% of GDP—on entitlement programs. This amounts to $7,500 per person annually. Only 48% of this spending goes to people officially classified as poor. The federal government provides more than $50,000 per year in Social Security and Medicare benefits to retired middle-income couples. And this is at a time when almost half of households headed by people under age 65 have incomes less than $50,000.

How did we get to this fiscal state? When did Congress’s irresponsibility with entitlement spending begin? When the federal government ran budget surpluses, how did that affect Congress’s decisions about entitlements? What president in the 20th century made a heroic effort to restrain entitlement spending and then, later, created the largest and most expensive such program in the century? What Republican president helped increase Social Security benefits by a double-digit percent? Finally, is there a way to rein in this spending in the future without kicking the restraints would be undone? Hoover Institution economist John F. Cogan answers these questions and more in his fact-filled, carefully researched book, The High Cost of Good Intentions. (Disclosure: John Cogan and I are colleagues at the Hoover Institution.)

Cogan tells the story of how the programs grew—a story that turns out to be virtually the same for each federal program, whether in the 19th or 20th century. Start with the aforementioned pensions for Revolutionary War veterans. The program started small. Congress passed a temporary law in 1790 and made the program permanent in 1792. It granted pensions to regular army officers, soldiers, and seamen, but only to those who had suffered injuries in battle and were impoverished as a result. The law excluded members of the state militias.

But from 1803 to 1806, the booming U.S. economy led to large budget surpluses for the federal government. Writes Cogan, “Advocates argued that military veterans were no less worthy of disability pensions than Continental Army veterans.” That argument won the day. In 1806, Congress
extended pensions to volunteers, members of the militia, and state troops. Then, in 1809, the U.S. government’s embargo on British and French ships cut federal revenue by half. Although Congress responded responsibly by cutting overall spending substantially, it left veterans’ pensions untouched. This, points out Cogan, would be a pattern for virtually all future entitlements: (1) start small; (2) expand eligibility to those whom many consider “no less worthy,” especially when budget surpluses are large; and (3) protect entitlement spending from cuts even when budget deficits appear.

In 1816 and 1817, restored prosperity led once again to federal budget surpluses. With the March 1818 pension law, President James Monroe and Congress gave a lifetime pension to all veterans who had served in the Continental Army for at least nine months and were “in reduced circumstances.” Gone was the requirement that they had been injured.

Cogan shows that this law led to a result that became another repeated pattern for future entitlements: people came out of the woodwork to claim the benefits. Whereas the law’s proponents had estimated that fewer than 2,000 veterans would qualify for the benefits, more than 28,000 people applied and over 16,000 applications were approved. The number of applicants, writes Cogan, “exceeded the entire number of Continental Army veterans thought to be still alive.” Pension outlays rose from 1% of the federal budget from 1800 to 1811 to a whopping 11% after the law passed. In response to charges of fraud and to a recession-induced budget deficit in 1820, a May 1820 law imposed means testing. Veterans had to reapply, but only 17% of reapplicants were denied, and once federal revenues returned to their pre-recession level Congress restored benefits to the denied reapplicants.

One other early pension program set a precedent for how Social Security was funded in the 20th century: the Navy’s trust fund. In 1799 and 1800, Congress established a separate Navy pension program to provide benefits to Navy personnel who had suffered disabilities in the line of duty. These benefits were financed by a trust fund that, in turn, was financed by the sale of captured enemy and pirate ships and their contents. As the trust fund grew, so did Congress’s spending. In 1813, it granted pensions to widows and children of seamen who were killed in action or died from wounds received in the line of duty. Again and again, Congress relaxed the standards for who could get benefits, and the unsurprising result was that the trust fund went bankrupt in 1841. Congress, however, bailed out the fund with general revenues.

The experience with Civil War pensions for Union soldiers was similar to that with the Continental Army, with two new twists. First, because the war involved such a massive mobilization, the number of those who qualified for pensions, once all the expansions of eligibility had occurred, was massively greater than in the earlier case. The number of pensioners peaked at just under one million in the early 1900s, and in the mid-1890s spending on those pensions reached over 40% of the federal budget. The second twist was that, from the 1890s to the early 1900s, the Republican Party figured out how to use pensions to realign the electorate and get veterans’ votes. Letter of the Democrats would use that same strategy with Social Security and Medicare.

One of the pleasant surprises in the book is that FDR—at least early in his first term. He believed that military veterans did not deserve pensions simply by virtue of being veterans. In his first month in office, he persuaded Congress to pass the Economy Act of 1933, which gave him the power to set new eligibility rules. As Cogan notes, for the first time in U.S. history, a large entitlement had been repealed. On June 30, 1933, 412,482 World War I veterans with nonservice-connected disabilities received pensions. Just one year later, only 29,903 were on the rolls and they were all permanently and totally disabled.

**Social Security** / The bad news for those who dislike forced government redistribution is that in 1935 FDR introduced Social Security. Cogan refers to this as “The Birth of the Modern Entitlement State.” He tells how the dominant view before FDR was that the welfare of the poor and elderly should be taken care of by private institutions or by state and local government. FDR rejected that view, believing instead that welfare was a federal responsibility. The Social Security Act of 1935 created the program that we’re all familiar with, plus three new programs that entitled state governments to matching payments for state-run programs: Old-Age Assistance, Aid to Dependent Children, and Aid to the Blind. On top of that, it created a federal–state unemployment “insurance” program.

The Social Security benefit was financed with a payroll tax. Whereas in 1937 only 1.8 million households with income below $3,000 ($52,500 in 2017 dollars) paid any federal income taxes—the income tax at the time was referred to as the “class tax”—Social Security changed all that. With all employment income up to $3,000 subject to the payroll tax, Social Security forced 25.8 million workers to pay de facto income taxes. The 1935 law specified that Social Security benefits would start to be paid in 1942. But, naturally, the revenues coming in from the payroll tax led to pressures to start paying benefits earlier. So the feds began to pay benefits in 1940. Also early on, as Cogan explains in fascinating detail, the program became a pay-as-you-go scheme rather than one with a real trust fund containing real assets. He also tells how a challenge to the constitutionality of the law led the Supreme Court to find that Social Security and unemployment insurance were constitutional, even though its decision rested only on dicta in a decision 14 months earlier.

As revenues built up the “trust fund,” Congress and both Democrat and Republican presidents raised real benefits to retirees. In 1967, President Lyndon Johnson and Congress increased benefits by 25% for retirees with low earnings and 11% for those with high earnings. The average increase, 13%, was twice the growth in consumer prices that had occurred since the
previous increase in benefits in 1965. Then, during the Nixon administration, benefits increased by 69% over their 1968 level. In a 1972 bill, Congress and Nixon raised benefits another 20% and began indexing. Benefits were indexed to the cost of living, while the ceiling up to which wages and salaries were taxed was indexed to wage growth.

Great Society / Social Security was not the only entitlement spending that grew. LBJ, declaring the War on Poverty in 1964, persuaded Congress to fund community groups to work with welfare recipients. He envisioned these groups helping people get off welfare. But hundreds of these groups had a very different vision. They used federal funds to hire lawyers to sue local, state, and federal governments for benefits. Writes Cogan, “Armed with federal funds, poverty lawyers brought lawsuits in federal courts on behalf of welfare recipients. . . . The poverty lawyers challenged virtually every welfare eligibility rule, including residence requirements, suitable home provisions, and willingness-to-work requirements.” The final result: “By 1970, the poverty lawyers had succeeded in fundamentally transforming welfare from an act of legislative charity—a government-granted gratuity—into an entitlement that ensured all eligible people a legal right to benefits.” This happened, he notes, “without any accompanying legislation.” In a 7–2 Supreme Court decision in 1969 that overthrew residence requirements for those on welfare, Justice William Brennan, who wrote the decision, argued that residence requirements for welfare violated the right to travel. Writes Cogan with wry humor, “The Court also concluded that although federal involvement in public welfare had never entered the founding fathers’ writings, the founders had meant to prohibit state welfare residence requirements.”

LBJ’s other contribution to entitlements, of course, was his initiation of both Medicare and Medicaid. This happened in 1965, after many more Democrats, riding on Johnson’s coattails in his landslide defeat of Goldwater in 1964, had been elected.

That dramatically changed the ideological composition of Congress. Cogan tells the story well, but could have incorporated the masterful analysis by Boise State University economist Charlotte Twight. (See “Medicare’s Origins: The Economics and Politics of Dependency,” Cato Journal, Winter 1997.) Medicare spending, which in 2016 was $595 billion, is now second only to Social Security (at $916 billion) as the government’s largest expenditure program.

Reagan reforms / From 1983 to 1985, Cogan was an associate director of the Office of Management and Budget under director David Stockman, all under President Reagan. Probably for that reason, he gives a lot of detail about Reagan’s success in slightly reducing the growth rate of entitlement spending. He also points out that in May 1981, Reagan tried to do too much too soon by proposing a 31-percent cut in Social Security’s early retirement benefit, which would have taken effect in January 1982. Democratic and Republican members of Congress almost uniformly opposed such a large almost-immediate cut, and Reagan quickly withdrew his proposal.

Instead, he and Congress kicked Social Security reform to a commission headed by Alan Greenspan, which, in January 1983, came out with its proposals for shoring up finances. Virtually none of the proposed changes, though, were to reduce the growth of spending. Instead, the commission recommended bringing new federal employees into the program, getting rid of exemptions for nonprofits, hastening an already-legislated increase in the payroll tax rate, and taxing Social Security benefits for higher-income people. Congress implemented virtually all of those proposals.

Only one major reform occurred on the spending side: a gradual increase in the age at which one could receive full benefits, from 65 to 67 by the year 2027. But this reform was not one proposed by the Greenspan Commission. Instead it was the handiwork of Jake Pickle, a Democratic congressman from Texas, whose mentor, interestingly, had been LBJ. Cogan mentions the age increase but does not specify Pickle’s role or the fact that the Greenspan Commission had recommended no such age increase. He does point out, though, that “remarkably, the slowly increasing retirement age since 2000 has occurred with little or no controversy.”

Cogan also doesn’t mention that in pushing for a cut in the early retirement benefit, Stockman had focused on short-run rather than long-run savings. When asked in a famous 1981 interview why he had done so, Stockman answered, “I’m just not going to spend a lot of political capital solving some other guy’s problem in 2010.” Because of his short-run thinking, Stockman successfully killed a competing bipartisan Senate proposal that would have raised the age for full Social Security benefits to 68 by the year 2000. My back-of-the-envelope estimate is that this proposal would have saved the feds, by now, well over $1 trillion more than the current policy has saved.

Cogan does draw the right conclusion from the 1981 debacle: it’s very hard to cut benefits for current recipients or for those who are about to become recipients. What the age 67 policy shows, though, is that it’s much easier politically to cut benefits prospectively with lots of lead time for people to adjust. And given that the even bigger problems with entitlement spending are in the future, cutting future benefits would be responsive to what otherwise might be the nightmare in our future. But we had better start soon.

People often wonder how “the land of the free” acquired such a huge government that interferes with so many parts of our lives. Cogan has shown how that happened with entitlement programs, which are a huge part of government. In his 1987 book Crisis and Leviathan, economic historian Robert Higgs showed how three crises—World War I, the Great Depression, and World War II—led to more regulation, higher taxation, and higher government spending, including spending on entitlements. Someone who wants to understand the growth of government in America would do well to read Cogan’s and Higgs’s books in tandem.
Loving the Poor, but Loving Political Privileges More

**REVIEW BY DWIGHT R. LEE**

Richard Reeves is a senior fellow in economic studies at the Brookings Institution. Like so many intellectuals, he is concerned about income and wealth inequality in the United States. Reeves was born and educated in England, but always found the American idea of a classless society a deeply attractive one. Having moved to the United States in 2012 and become a citizen in 2016, he “has been disheartened to learn that the class structure of my new homeland is, if anything, more rigid that the one [he] left behind and especially so at the top.”

**What Cheryl deserves** / While Reeves has plenty of company in his concern about inequality, he stands largely alone among academics in whom he blames for the problem. The much-maligned top 1% of the income distribution is almost completely ignored in his book as he focuses on those in the 81–99 income percentiles, which he calls the upper middle class. What are members of this class (in which Reeves includes himself and most of his colleagues and friends) guilty of? Favoring their children by engaging in unfair “opportunity hoarding.”

He stresses that some opportunity hoarding, such as “reading stories [to one’s children], helping them with homework, providing good food, and supporting their sports and extracurricular activities” is consistent with “being a good parent.” Yet it is clear that he sees a fine line between those activities and providing unfair advantages.

It doesn’t take much to cross that fine line into unfair opportunity hoarding. He senses that “some of us in the upper middle class already feel a degree of cognitive dissonance about the advantages we pile up for our kids, compared to the truncated opportunities we know exist for others.” And in some cases he is convinced that those who take advantage of their positions or friendships to obtain opportunities for their children are “thoughtful and liberal enough to know, at some level, their actions [for example, using one’s legacy status to get a child admitted to an Ivy League college] were morally wrong.”

He assures us that he supports market competition that rewards merit, but he is always quick to qualify that support. For example, he recognizes that the “labor market does a good job rewarding the kind of ‘merit’ that adds economic value—skills, knowledge, intelligence. The unfairness lies not in the competition itself but in the chances to prepare for it.” In other words, he is “arguing for a meritocracy for grown-ups, but not for children.”

But this statement rings hollow given the additional distortions and limits that would have to be imposed on market competition if Reeves’ proposals for addressing opportunity hoarding are to be adopted. Consider his hypothetical example of Cheryl, a “highly intelligent, creative, and ambitious person . . . [who most likely will] end up making a lot of money.” Even if she gets rich by increasing market efficiency, “this is not the same thing as saying she deserves to be rich” (Reeves’ emphasis). He continues that “winners have no moral claim to keep all of their winnings, especially when their redistribution may be needed to equalize opportunities for the next generation to prepare for the next contest.”

No one argues that winners should pay no taxes in a meritocracy, but at some point higher taxes start seriously undermining the personal and social benefits of competition that rewards economic merit, a fact that Reeves acknowledges. Yet he never suggests a limit on the cost of the additional public investment necessary to equalize the next generation’s opportunities. He does tell us, however, that if there is additional cost, “it is reasonable to raise some of [it] from the upper middle class. Even if we haven’t admitted it yet, we can afford it.”

**Reeves and Rawls** / Reeves never gives any indication of how much of our income is appropriate to keep. There is an obvious reason for this: neither he nor anyone else has any idea how much anyone “deserves” or what a fair income distribution is.

He deserves credit, however, for avoiding the philosophical quicksand of trying to parse out what is a fair or unfair income. Instead he argues that opportunity hoarding by the wealthy is a significant reason for income inequality. Hoarding is a pejorative term, suggesting keeping something for one’s self not primarily to use it, but to prevent others from doing so. Many readers will intuitively see any amount of opportunity hoarding as unfair, particularly if it benefits wealthy hoarders by reducing opportunities for the poor.

He does appeal briefly to the ideas of John Rawls, who argues for a “Fair Equality of Opportunity” in his *A Theory of Justice* (Harvard University Press, 1971). According to Reeves, “fair equality of opportunity demands not simply an open competition but an equal chance to prepare for it.” So in addition to having the emotional support of many of his readers, he lets us know that he is drawing on Rawls’ impressive intellectual capital. Taken seriously, achieving Reeves’ interpretation of Rawls’ Fair Equality of Opportunity would be impossible. Not surprisingly, Reeves is reluctant to take it completely seriously.

**Markets and parenthood** / He makes clear that when parents give a child opportunities to develop skills that benefit him as an
adult, they do so by reducing the opportunities of less advantaged children to succeed as adults. For example, he claims “the best philosophical treatment” on helping one’s children is by political philosophers Adam Swift and Harry Brighouse, who in their 2014 book *Family Values* (Princeton University Press) write, “Whatever parents do to confer competitive advantage [on their children] is not neutral in its effects on other children—it does not leave untouched, but rather is detrimental to, those other children’s prospects in the competition for jobs and associated rewards” (Reeves’ emphasis).

He seems to recognize that few parents who prepare their children to be productive and successful adults will be sympathetic to the charge that they are hoarding opportunities and harming others’ children by doing so. This could explain his rather feeble qualification that “although I think Brighouse and Swift go too far, they are onto something important with their distinction between the kind of parental behavior that merely helps your own children and the kind that is ‘detrimental’ to others.” He also qualifies what he means by “detrimental” by saying that “in a society with finite rewards, improving the situation of one child necessarily worsens that of another, at least in relative terms.” But once “detrimental” is considered in relative terms, the idea of opportunity hoarding requires that the role of the market be ignored.

It is obvious that no society can provide more than finite economic rewards. Societies rely on markets to routinely motivate people to use their opportunities to benefit others by rewarding them roughly in proportion to their success in doing so. This does not result from people hoarding productive opportunities. Rather, it is an example of a sharing process in which people, given the opportunities and innate abilities they have, acquire productive skills to cooperate better with each other in mutually beneficial ways. Of course, this is a process that inevitably results in some people improving their situations relative to others as opportunities expand for everyone. In markets, good parents never have to say, “I’m sorry.”

**Loving political privilege** / The idea of opportunity hoarding has some relevance when it comes to politics. Some people routinely acquire opportunities by reducing them for others. Anger at the wealthy, not concern for the poor, often motivates support for enacting or expanding programs ostensibly intended to reduce income inequality but that harm the poor, and Reeves recognizes this.

He points out that “it seems to be those near the top of the [income] distribution who are most angry with those at the very top: more than a third of the demonstrators on the May Day “Occupy” march in 2011 had annual earnings of more than $100,000.” Reeves thinks they didn’t realize their own “privileged” status. The point of his book is that “rather than looking up in envy and resentment, the upper middle class would do well to look at their own position compared to those falling further and further behind.” But what if upper middle class Americans love their political privileges more than they love the poor?

Unfortunately, Reeves is willing to go only so far in reducing the scope and power of government to free up the market process and expand rather than limit the benefits from opportunities. Early in his penultimate chapter entitled “Sharing the Dream,” he tells us that rather “than trying to rectify inequality post hoc through heavy regulation of the labor market, our ambition should be to narrow the gaps in the accumulation of human capital in the first two and a half decades of life.” He makes and discusses several suggestions “aimed at reducing opportunity hoarding ... [and] to reduce anticompetitive behaviors.” I shall consider three of his proposals, which would be more effective if two policies that currently restrict opportunities for the poor were eliminated. Unfortunately, the two policies are sacred cows to American liberals, and Reeves goes so far as to call for protecting one of them.

**Less zoning and better teachers** / He opposes exclusionary zoning restrictions that place “onerous restrictions ... on housing development in many parts of the country.” He correctly points out that these restrictions often “deepen the wealth divide, worsen economic segregation, and contribute to inequalities in schooling.”

In a previous chapter he connects these problems to distortions resulting primarily from policies of the federal and local governments. The federal tax code allows homeowners to deduct state and local property taxes and mortgage interest from their federal taxable income. These deductions are worth far more to high-income than low-income families. They also increase the amount that the wealthy are willing to pay for expensive houses, typically located in public school districts that contain the best schools, which further increases the houses’ price. Eliminating these policies would reduce the value of upper middle class houses.

Reeves considers ways to improve the public schools that the poorest students attend without threatening the value of upper-middle-class housing or the quality of upper middle class neighborhoods’ schools. He recognizes correctly that to improve educational outcomes, what “clearly ... counts is teacher quality.” So he wants to increase the salaries of inner-city teachers to be equal to, or greater than, the salaries paid to those who (according to Princeton economist Alan Krueger) “work in the fancy suburbs.” Reeves mentions that former “education secretary Arne Duncan
estimated that for $15 billion a year teachers in the poorest 20 percent of schools could be given more than a 50 percent pay raise.”

Yet, nowhere does Reeves mention firing bad teachers, which would be necessary if poor students are to benefit from effective teachers. Allowing incompetent teachers to continue hoarding teaching jobs (with big new raises!) and destroying the opportunities of poor children to succeed in life surely ranks near the top of any list of social injustice.

Not only would the market competition created by school choice reduce opportunity hoarding in public school classrooms, it would also result in positive-sum opportunities to significantly improve inner-city schools without spending another $15 billion on teachers and without reducing the quality of the schools in the suburbs. Indeed, the resulting competition between schools, and a strong motivation to replace incompetent teachers (who aren’t found in only inner-city schools) with competent ones, would increase educational quality in all school districts. The equalization of public schools might reduce the value of expensive houses in the suburbs a bit, but the student bodies in public schools might become more diverse. Surely political progressives would consider the former a small price to pay for the latter.

Internships / Increasing internships may seem a small step in addressing what Reeves sees as the problem of opportunity hoarding. He makes a strong case, however, that good internship opportunities “have become more important transitional institutions, so their allocation has become a more important issue for social mobility.” Although he favors paid internships, he accepts that “for the foreseeable future … unpaid internships will be with us.” The challenge he sees is to bring these internships “within reach of less-affluent young adults.”

I have good news for him. There are thousands of businesses that would provide what are in effect paid “internships” to less-affluent young adults, increasing their opportunities for better jobs later. All that is needed to bring many of these internships to fruition is to abolish the minimum wage. But Reeves doesn’t call for this. He does mention the minimum wage, but to emphasize how important he thinks it is “to increase the regulatory oversight of internships, to prevent abuse, and to ensure that minimum wage and fair employment laws are properly enforced.”

Conclusion / Opportunity hoarding, which Reeves describes and finds so troubling, can be thought of, at best, as a zero-sum activity resulting commonly from politically influential groups using government to capture privileges and protections at the expense of less influential people. The problem with Reeves’ book is that he largely ignores the most effective way to expand opportunities for those in the lower-income groups, which is by eliminating many existing government restrictions on the positive-sum potential of market competition.

**A Milestone on a Long, Bumpy Road**

The year 2017 marks the 70th anniversary of the publication of Frank Knight’s [*Freedom & Reform*](https://www.amazon.com/Freedom-Reform-Selected-Works-Frank-Knight/dp/0815727522), a collection of 14 essays initially published in the 1930s and 1940s. The thread running through the book is how to realize social reforms (when needed) while maintaining individual freedom. This issue is at least as important today, after seven decades of reforms that have very often reduced freedom.

Frank Hyneman Knight (1885–1972) was “arguably the most important non-Keynesian American economist of his generation,” according to Michigan State University political and economic historian Ross Emmett, a Knight scholar. Knight was also, and perhaps mainly, a moral and political philosopher; at the end of his career at the University of Chicago he held a double appointment as professor of the social sciences and professor of philosophy. [*Freedom & Reform*](https://www.amazon.com/Freedom-Reform-Selected-Works-Frank-Knight/dp/0815727522) comes from the philosophical Knight: only two of the articles in the book appeared in economics journals, compared to half a dozen in philosophy journals.

**What is economics? /** Knight considered economics to be the study of “the effective use of means to realize ends.” Problems arise from the fact that the means (miscellaneous resources) are limited, while individual or “social” ends seem practically limitless. This conception differs in important ways from today’s mainstream notion of economics as a method of analyzing all human behavior on the basis of rational-choice assumptions, as pursued by Gary Becker and a later generation of Chicago economists.

Knight believed in reason and truth, writing that “the obligation to believe what is true because it is true, rather than to believe anything else or for any other reason, is the universal and supreme imperative for the critical consciousness.” He criticized the contamination of the social sciences by “romantic ethics” and preaching. But he also attacked scientism—that is, the blind application of the methods of the natural sciences to the social sciences—which he thought leads to social engineering by government experts.

Although there is no evidence that he
was interested in the debates on welfare economics, he correctly saw that any policy decision based on economics ultimately requires value judgements, thus drawing a red line between economics and ethics. “No discussion of policy is possible apart from a moral judgement,” he wrote. In his mind, freedom is both an instrumental value and a value in itself, and it ultimately must be founded in generally accepted ethical principles. Coercion—the opposite of freedom—can only be defined in terms of what is judged to be wrong.

Liberalism and exceptions / Philosophical and political issues form the backbone of Freedom & Reform. Knight found many problems in both the theory of liberalism and in the societies (including America) that had rejected it. Knight always used “liberal” in its original sense of “classical liberal.” Emmett presents Knight as a disenchanted liberal who was trying to preserve the main tenets of the doctrine. Freedom & Reform contains both a defense and a critique of liberalism.

Most (non-anarchist) libertarians would approve Knight’s characterization of a free society:

The essential social-ethical principle of liberalism or liberal individualism may now be stated, for the purpose of examination. It is that all relations between men ought ideally to rest on mutual free consent, and not on coercion, either on the part of other individuals or on the part of “society” as politically organized by the state. The function and the only ideally right function of the state, according to this ethic, is to use coercion negatively, to prevent the use of coercion by individuals or groups against other individuals or groups. (Knight’s emphasis.)

“The main emphasis,” he explained, “needs to be placed on freedom ... Accordingly, sound policy requires restricting the positive function of government to things on which there is general agreement.”

Freedom & Reform often seems written for today’s Americans. It laments the rise of “a new type of leadership” that “does not claim to know, or make its appeal on grounds of knowledge or reason.” It cites protectionism and nationalism as examples. It criticizes “the Leader in Washington” and “the ‘New Deals’ in Germany and the United States,” which “use different catchwords, but are variants on the same theme. ... The cry is ‘All pull together,’ meaning ‘Follow me’ (and don’t ask critical questions).”

In Freedom & Reform, Knight even used the term “libertarian” once in describing the “modern Western man”: “Our ideal of life is active, progressive, and individualistic, or libertarian, as against ‘community’ in any mystical sense.” He stated that “where there is any serious difference of opinion as to any rule, liberty must prevail.” The reader may be reminded of the presumption of liberty defended by Anthony de Jasay, a current philosopher in the libertarian tradition. (See “The Valium of the People,” Spring 2016.)

Often, though, Knight resembled the typical conservative, who makes so many exceptions that one wonders what remains of freedom. In his view, the state can intervene to fight monopolies, to combat externalities, to control money, to ban narcotics, “to promote the diffusion of knowledge and the advancement of science, art, and general culture,” to alleviate poverty, and to fight economic inequality. He argued for progressive taxation, especially of inheritances. He represented the old Chicago economics tradition, not the postwar “Chicago school” created by more libertarian economists like Milton Friedman, George Stigler, and Becker. (See “A Ghostly Chasm,” Fall 2016).

Question everything / More than a set of solutions, Freedom & Reform can be read—or should be read—as raising deep questions related to the foundations and workings of the free society. “Knight often said that his purpose was to ask questions, rather than answer them,” Emmett observes. Indeed, there are more serious questions than serious answers in life; intellectual inquiries must start from there.

Knight raised intriguing questions about human nature. He argued that “human nature is a function of the nature of society, and both are historical products.” The proof is how men have changed from the primitive tribe to the modern, liberal man. Similarly, he claimed that “there really is no such thing as individual rationality. Rationality itself is social in nature and a product of stable group life.” Friedrich Hayek would not have disagreed.

Knight also questioned the characterization of man as a “social animal.” According to him, man is more strikingly an individualistic and antisocial animal, a lawbreaker. He is a “romantic fool,” “the discontented animal, the romantic, argumentative, aspiring animal,” a “capricious and perverse animal.”

The challenge Knight saw was how to have a free society in which such individuals can cooperate peacefully. Who will deny that he was on to something?

For him, a value is any principle that is generally accepted in a given society; or more specifically, accepted by discussion and agreement in a free society. These values are the true natural law. This means that natural law “properly defined is the opposite of ‘natural.’” It is created or reinforced by human institutions, including the democratic state—-institutions that he saw in a voluntarist and even rationalistic way quite different from Hayek’s more passéiste conception. It also means that, in the realm of values as in the scientific realm, there is no “absolute absolute,” but only “relative absolutes,” which are true until potentially proven false. Nothing, no authority, whether religious or political (or both), is above questioning; but some
values must be provisionally taken as relative absolutes.

Relative absolutes are worth defending and sometimes warring for. “It is surely the height of the immoral,” Knight wrote, “to contend that as a general principle men ought to yield to wrong, or what they seriously believe to be such ... for the sake of agreement and pleasant personal relations.” Hence the problem with pacifism, which “would call for the abandonment by all, or at least the masses, of all rights, including life itself, except love and obedience, left, perhaps, to serve as ‘opium.’” He opposed both nationalism and “dictatorship on a world scale,” illustrating how classical-liberal moderation can be libertarian.

As a critical thinker, Knight wasn’t always sure of the solutions to the problems he raised. “It is not part of the aim of this article,” he wrote in 1944, “to give a solution of the problem of world organization, free from war but without sacrificing essential human values. The writer does not know the solution, if any exists.”

**Problems** / Knight’s liberalism is not without problems. As we saw, the author of *Freedom & Reform* envisioned a quite wide scope for government. He tended to eschew clear principles. He argued that “liberal thought has always recognized a large range of positive functions for the state, to be determined by expediency, but limited to matters on which there is substantial agreement.” Of course, this last restriction would seriously limit the scope of government.

In practice, though, it is not clear what Knight actually wanted. Take the field of education. Like many liberals, the author of *Freedom & Reform* believed that the maintenance of a free society requires a liberal public opinion, which should be gradually attainable through education. But he seemed to accept a rather open-ended scope of government intervention in this field. For example, he wrote that “education for freedom involves a large moral factor... Probably limits will have to be set even to freedom of expression.”

A related problem is Knight’s apparent contradictions between his fear of “the omnipotent state” and his frequent willingness to trust it with wide powers. Some passing remarks are troubling, such as his justification of “one-sided control ... in the case of ‘infants’ to be educated, or that of adults objectively determined to be antisocial or undeveloped and subject to reeducation, and of any who require overt control to prevent their acting destructively.” Knight was not a progressive and this book does not argue for eugenics, but a cryptic remark may be read as suggesting that it is not off-limits if human nature could be changed for the better in only that way. His prose is often obscure. Despite Knight’s doubts about political processes in practice, he still hoped his majoritarian democracy would somehow work. Of course, we must remember that *Freedom & Reform* predates public choice economics.

Modern libertarians can charge Knight with being middle-of-the-road. When a practical problem appeared, he tended to compromise on the statist side.

Knight’s influence / The most interesting feature of Knight’s ideas may be the influence they had on the following generation of classical liberal economists. Consider the central place that *Freedom & Reform* gives to exchange. “Since free exchange must benefit both parties,” he wrote, “it follows that any arbitrary dictation of any price, against free market forces (apart from fraud and monopoly), must injure both parties.” This had been a standard idea among economists for about two centuries, but Friedman and James Buchanan—as well as other University of Chicago economists like Stigler—gave it potency. That Friedman, Buchanan, and Stigler were all students of Knight and that each eventually won Nobels in economics testifies to their professor’s talents.

One cannot read Friedman’s 1962 book *Capitalism & Freedom* without recognizing Knight’s ideas, often in improved form. (And they were further improved as Friedman became more radical with time.) *Capitalism & Freedom* argued for re-appropriating the label “liberal.” Friedman emphasized, again a la Knight, that freedom was a rare occurrence and a great blessing in the history of mankind. He better explained how the free market is the only way to combine efficiency in production and individual freedom, and how it “permits unanimity without conformity.” He also drew a cleaner distinction between freedom (as absence of coercion) and the power or capacity to act. He reinforced the conception of society as a collection of individuals. And he was less concerned than Knight about monopolies and more suspicious of government.

Knight obviously struggled with the problem of aggregating the preferences of all members of society. “National interests are not unitary,” he correctly noted. He often put “society” or “we” in quotation marks. Yet, he could not resist invoking some sort of “social will” and even the “general will,” the very expression used by Jean-Jacques Rousseau in his defense of totalitarian democracy in *Of the Social Contract*.

Buchanan also inherited many ideas from Knight, including those on the importance of agreement, exchange, and equality of opportunities (an idea that neither Knight nor Buchanan rejected, contrary to most libertarians). More importantly, Buchanan devised conceptual tools to escape the contradiction between the Knightian ideal of “general”
or “substantial” agreement and the reign of numerical majorities (or even minorities, when not every voter votes). Perhaps we can say that Buchanan rescued Knight from Rousseau. Buchanan did this by constructing a social contract theory of the state in which unanimity is conceptually reached at the “constitutional stage,” while ordinary electoral decisions, constrained by the constitution, are made at the “post-constitutional stage.” The implicit unanimous agreement provides the justification for, and limits to, state intervention under majoritarian democracy. The state is limited because the parties to the social contract will only agree on what is in the interest of each of them—the substantial agreement Knight was after.

Whether one agrees or not with Buchanan’s social contract, it is a brilliant construction. And while developing what came to be known as constitutional economics, Buchanan also became the main founder of the public choice school of economic analysis, which provides further arguments for limiting the scope of the state. Public choice theory has had a major influence on the study of politics and the evaluation of public policies.

By asking deep and often challenging questions, Freedom & Reform helps revisit the foundations of the free society. Complicated topics require nuanced evaluations and the analyst looks like he is taking both sides of an issue—a problem that, in my opinion, often affects Knight’s analysis.

Yet (let me add another of my own qualifications!), one cannot read Freedom & Reform without many questions bouncing around in one’s head. This is certainly proof that the book was worth reading and an indication of how good a professor Knight was. At any rate, the book is very interesting from the viewpoint of the history of philosophical and economic thought. It was a milestone on the long, bumpy road to truth and liberty.

Forecasting Regulatory Failure

Can regulators carry out two separate and sometimes conflicting missions at the same time? More importantly, should politicians want them to do both or leave bureaucrats dedicated to a single mission? Scholars have written tomes about the causes and consequences of regulatory failure, but few have taken a novel and rigorous quantitative approach to explain how organizational design and political pressure can make or break regulatory performance.

In Structured to Fail, George Washington University public policy professor Christopher Carrigan surveys three well-known regulatory failures: the Mineral Management Service’s (MMS) role in the 2010 Deepwater Horizon explosion and oil spill, the Federal Reserve’s dual mandate to fight inflation and unemployment, and Japan’s Nuclear and Industrial Safety Agency (NISA), which was tasked with both promoting and overseeing that country’s nuclear power industry.

All three of those agencies had multiple and sometimes conflicting duties, referred to as “goal ambiguity.” How could the Federal Reserve promote economic growth, limit inflation, and regulate financial institutions during the Great Recession? Many would argue it failed in at least two of those duties. How could the MMS regulate safety, promote energy development, and collect revenue effectively? After the Deepwater Horizon spill, politicians who had only recently praised the agency decided to split it in three, concluding that its distinct and conflicting missions contributed to the worst oil spill in U.S. history. Similar criticism was leveled against NISA following the 2011 Fukushima disaster.

Goal ambiguity already has an expansive literature. Carrigan brings a deep statistical understanding of what drives successful agencies and the realization that goal ambiguity alone didn’t cause regulatory failure.

Quantitative approach/There is a general consensus that “multipurpose” agencies perform worse and produce inferior outcomes compared to agencies that solely regulate or simply do not regulate at all. In the words of former health and human services secretary Donna Shalala, “If you try to do everything, you’ll accomplish nothing.”

This might be an apt aphorism for government, but proving this, beyond the occasional anecdote, is difficult. Thankfully, a legacy of the George W. Bush administration and Rob Portman’s tenure as director of the Office of Management and Budget was the creation and use of a government-wide rating tool designed to measure agency performance. The Program Assessment Rating Tool (PART) studied the performance of nearly every federal program from 2002 to 2008.

To use the PART data, Carrigan laboriously matched each federal program to each agency and, using descriptive statis-
In Review

tics, tests, and regression analyses, examined the performance of multipurpose regulators, more traditional regulators, and agencies not responsible for regulation. Some critics might argue that a heavy-handed regulator that does an efficient job of destroying an industry, raising prices for consumers, or protecting industry incumbents at the expense of competition might perform well on PART scores. This may be true, but it is not Carrigan’s aim to determine the merit of regulatory output or the stringency of various rules. Instead, he is interested in the relative performance of agencies across the federal government, even if the agencies’ activities make devotees of limited government squeamish.

Skeptics might note that PART scores are hardly perfect. After all, it’s the executive branch rating the performance of its own regulators and programs. Confirmation bias and conflicts of interest abound in this model. Carrigan concedes this point, but stresses that PART scores demonstrate no obvious biases and were computed for almost all government programs, making them universal.

What’s amazing about the book is the sheer amount of information Carrigan compiled: a dataset of 144 federal agencies and 1,062 programs across six years. He then cleverly produced his own rating system: an average PART score from 0 to 100 for each agency. As previewed, multipurpose regulators fared worse than other regulators and nonregulators. On average, they score 32% lower than other regulators and 17% worse than nonregulators. But why? Is goal ambiguity the sole cause? Is it simply the fault of politicians for designing agencies with conflicting mandates?

The answers to the questions above might be yes, but Carrigan goes several steps further to consider agency design, organization, and operation. There is no perfect agency or regulatory program, as much as some politicians might like to take credit. As Brian Mannix of the George Washington University Regulatory Studies Center has described, every program suffers from the “Planner’s Paradox.” (See “The Planner’s Paradox,” Summer 2003.) That is, there is a tendency of the regulator or agency to assume planned solutions are superior to unplanned market answers. The planner might employ reams of data, analysis, and expertise, but the planner also brings biases to the decision and often cannot see beyond the four corners of the regulation. To the planner, the solution is elegant, maybe even perfect. When the program fails five years later, the paradox is finally revealed.

For the MMS, failure took much longer than five years. The agency was born from the U.S. Geological Survey, primarily from its failure to balance royalty collections with its science mission. When then-interior secretary James Watt created the MMS through a series of orders in 1982, the move was greeted with widespread approval from politicians, the Government Accountability Office, and even Time. Leading up to the Deepwater Horizon explosion, even President Barack Obama and members of Congress generally praised the MMS, only to condemn it and break it in three after the explosion, blaming its design for the oil spill.

Explaining the failure was easy for most politicians: they had tasked it with conflicting roles. Like many large catastrophes or complex problems, there is rarely one simple explanation. The proffered explanation might play well in a 30-second campaign ad, but Carrigan notes there were a host of reasons why the MMS failed and why other regulators perform poorly.

No one cause / Beyond the obvious yet incomplete explanation of goal ambiguity, there are other factors that contribute to regulatory failure. Political pressure is high on the list. A little over a decade after it was created, Congress almost scrapped the MMS. Agency heads, in conjunction with a congressional mission to increase domestic oil production, wanted it to assume a larger role in bringing in revenue for the federal government. After the Deepwater Royalty Relief Act was passed in 1995, the MMS had a mission to increase leasing and deliver tangible results (money) back to Congress. Barring a major setback (a massive oil spill), its role as revenue generator for Congress would help to secure its future. Revenues continued to increase and Congress and the industry were satisfied—until 2010.

Many ways to fail / The two takeaways from the book are that there is no right answer that explains all regulatory failure and there is no perfect way to design a federal agency. Carrigan cautions: even after breaking up a supposedly deficient agency, it’s not clear that the reorganized agency will excel. Congress occasionally intends for one agency to perform multiple tasks, but there are no assurances that multipurpose agencies will always fail, although they do perform worse compared to their bureaucratic brethren.

Structured to Fail provides several contemporary examples. The Consumer Financial Protection Bureau (CFPB) was established during a chaotic political climate, given vast powers, and cut off from the traditional congressional appropriations process. During its existence, it has been criticized for creating a hostile workplace, repeatedly overstepping its statutory bounds, and operating outside any political or structural checks on its authority.

As a consequence of its controversial birth, members of Congress continue to push for fundamental reform, or even abolition, of the agency. In the fall of 2017, Congress took the rare step of using the Congressional Review Act to rescind the CFPB’s arbitration rule. Despite the agency’s relative independence, it appears Congress will continue to chip away at the CFPB’s authority until lawmakers can, at minimum, install a new director. Did Dem-
Calabresi’s Law and Economics

GUIDO CALABRESI is a judge on the U.S. Court of Appeals for the Second Circuit and the Sterling Professor Emeritus of Law and Professorial Lecturer in Law at Yale Law School. In his recent book The Future of Law & Economics, he combines Coasean insights, his own contributions, and extensions of his work to write a history of thought in law and economics with recommendations for future scholarship.

“What I call Economic Analysis of the Law,” he explains, “uses economics to analyze the legal world.” The analyst evaluates laws “from the standpoint of economic theory” and may “argue for change in that legal reality.” “What I call Law and Economics,” he continues, “instead begins with an agnostic acceptance of the world as it is, as the lawyer describes it to be.”

The lawyer-economist also uses economics as a tool to evaluate the laws themselves. However if the legal environment is inconsistent with economic theory, the lawyer-economist may recommend modifications to economic theory. Calabresi exalts the law-and-economics approach so that we may gain a better understanding of both laws and economic theory.

**Merit goods** We may learn a lot by studying “merit goods,” he writes, referring to goods that are deemed “loathsome to price.” In obviously, that some lives, in some circumstances, are not worth saving.” The solution is to find the right tradeoff between commodification and commandification.

Tort law helps to find this tradeoff. “In effect,” he writes, “what we do in torts is to some extent pricing lives and safety, but we do this in ways that do not lead to the heavy moral costs that would be imposed if we did that pricing obviously and directly.” These moral costs are the offense we take at pricing life or limb. We tolerate the “huge costs” of tort law, such as litigation costs, because tort law lowers moral costs.

Other merit goods are such that “it is loathsome to allocate them through a prevailing wealth distribution that is highly unequal.” For instance, human vital organs belong in this class, Calabresi argues, because poor people may not be able to afford them, and poor people may be eager sellers of their own organs. In order to determine how many of these goods will be available and who will get them, he recommends “modified command structures” and “modified market structures.”

**Compulsory service** The distinction between these structures is “nuanced,” to use one of the author’s favorite words. Consider “a rationing scheme” for national service. Assuming that “service” is mandatory and that there are multiple ways to serve, “each subject individual would be free to choose where and how to spend his or her time.” Calabresi imagines many possibilities. A young adult could serve in the armed forces, “an international peace corps,” or “in varied American ‘needy’ zones.”

The author imagines that “service in, say, sunny Italy or rainy England would be priced to take into account how much each was favored or disfavored by those who had to choose.” If this sounds unworkable, a “tax/subsidy scheme” is an alternative. He
then outlines three such schemes, with the goal of recruiting (or drafting) an equal percentage of individuals from each “wealth category.”

In one scheme, the government might make service mandatory, then tax those who want to avoid service based on their wealth. In the second scheme, government might make military service voluntary so that “the richest would be paid greatly to serve, the poorest not much.” These different pay levels would attract wealthier citizens and deter poorer citizens, but would hardly seem acceptable to the public. The third scheme is a combination of mandatory service and voluntary service with taxes and subsidies. “In effect,” Calabresi assumes, “one could tax the richest a large amount for nonservice, while simply paying the poor to serve.” If this sounds like a Rube Goldberg contraption of social engineering, he admits that “there are obvious problems with each of these (and any other yet more mixed schemes).”

His musings on the allocation of merit goods provoke thought. “Just as it is worthwhile to try to find ways of producing wheat more efficiently,” he reasons, “so it is worthwhile to search for less ‘costly’ ways of allocating merit goods!” These moral costs are the “pain” one feels knowing that goods are allocated through a market in which wealth is unevenly distributed. The author recognizes a tradeoff between reducing moral costs and maintaining incentives to produce. “On the one hand,” he observes, “many people prefer equality to inequality.” “On the other hand,” he recognizes, “many of these same people believe that a considerable amount of inequality is inevitable if we are to have the kinds of incentives needed to make more [goods] available for all to share (however unequally).”

The challenge is in determining which goods qualify as merit goods. They will be the goods whose modified market provision reduces moral costs the most with the least damage to incentives. He illustrates this notion using such examples as education, health care, vital organs, and campaign finance.

Readers may wonder what limits the number of goods provided through the many hybrids of markets and government that Calabresi envisions. For example, ordinary citizens regard an appendectomy as health care that is a merit good. But would they count cosmetic surgery? The author maintains that if society allows a limited number of merit goods to be allocated through some blend of markets and command, incentives to produce will be sufficient to achieve prosperity and objections to inequality will be few.

**Government-administered altruism** / Readers with socialist leanings may be shocked to learn that Calabresi sees “so much altruism” in free-market society. He believes that altruism is pervasive because it is both a means and an end. For example, he identifies “private altruism” and “state beneficence.” Is the latter an oxymoron, when whatever good deeds a government may undertake are backed by coercive tax collections? Perhaps this is why he thinks a government-provided safety net is legitimate: “But if everyone behaved altruistically toward others in the private sphere, people would be unhappy if their government were not also charitable and beneficent, at least to some extent.” Government welfare programs, if I understand him correctly, are “state beneficence.”

The author observes many “modified structures” producing altruism. One is the legendary Minneapolis 5 percent tradition: businesses based in that city donate 5% of their profits to philanthropy. Another is the tax deduction for charitable giving. Not-for-profit organizations are a means to produce merit goods such as education and health care. According to Calabresi, they also satisfy our desire for altruism. The author describes many different ways that people cooperate in order to produce altruism. Then he asks whether we have “the optimal amount of beneficence,” and “the optimal mix of different forms of altruism.” His answer is, “I have no idea.” He does not know because “we do not have a model that demonstrates that, under certain conditions, an optimal result is achieved.” The building of such a model is for future lawyer-economists.

**Pricing government intervention** / Lawyer-economists characterize the liability rule as a way to orchestrate an exchange that resembles a market transaction with “collectively set” terms of trade. These terms of trade are usually called a “price,” in keeping with the terminology of markets. We may also refer to the terms as a “penalty,” “assessment,” or “sanction.”

The author treasures the liability rule for its widespread application in what he calls “social democratic societies—in which the reigning ideology is neither libertarian nor collectivist.” Consider an application to tort law. If an airline loses a passenger’s luggage, the damages might be the market prices of the lost items. But the “polity” may add punitive damages to reflect sentimental values. Another example comes from property law. A government might use eminent domain to take land in return for the market price. In order to discourage takings of land with sentimental value, compensation might be set at a multiple of the market price. Alternatively, if a government intends to hasten economic development, compensation might be set below the market price.

“In such instances,” the author claims, the assessment that both allows and limits entitlement shifts may be chosen to reflect that policy’s liking for, and devotion to, its ideologically mixed foundation.” Calabresi urges us to recognize that “some people like markets, while others like command,” and he endorses the liability rule because it is an approach that a social democratic polity likes, in and of itself.

The author argues that economists don’t adequately incorporate “tastes and values” into their analyses, and that a law-and-economics approach may be used to evaluate them. Consider this bit of his reasoning. Calabresi assumes that people value a greater quantity of goods over a smaller quantity, a more equal distribution of goods over a less equal distribution, and creativity. Call these primary values. He then searches for “subsidiary” values that reinforce the primary values. These are “the desire for things which are in common supply in that society,” such as “ordinary water and wine,” “ordinary sport watching
and ordinary sex,” and “child rearing.” If prosaic is what we want, we will be able to produce great quantities, distribute them equally, and satisfy our desire to create. In contrast, if we want fine wine, fine cuisine, and “great athletic feats,” incentives to produce these exceptional goods will be necessary and we will fail to achieve all the primary values, in particular a more equal distribution of income.

Now the author asks, “What has this to do with laws and legal structures?” Using the law to promote values may cause “value-alteration costs.” His example of this is antidiscrimination laws. Though Calabresi doesn’t cite the Civil Rights Act of 1964, it’s safe to assume he has it in mind. Among other benefits, its passage emboldened women to enter the labor force. But it was not a true Pareto improvement. To the extent that raising children is valuable, a tradeoff occurred. Using the law to combat discrimination against women is commendable and effective. “It has,” unfortunately, “made ordinary, out-of-home, but not especially creative, jobs available to women and furthered legal structures that implied that holding a paying job is worth doing, while staying home and rearing children is not.” In the author’s terminology, we failed to achieve a “joint maximization” of all our values. Although we achieved what we value in terms of reducing discrimination against women, the unintended consequence was a “devaluing” of the creative activity of child rearing. Laws exist to correct the situation and support child rearing, he claims. He doesn’t explicitly mention a child tax credit, but again it’s safe to assume he has that in mind. His main message is that we should use law-and-economics analysis when making and evaluating laws.

Given the author’s fascination with the intersection of markets and government, libertarian readers will be wary of policy ideas that expand the role of government at the expense of markets. Other than that, I find little in the book to criticize. Calabresi, “an early tiller in the field” of law and economics, teaches much that the next generation may reap.

Confucius, Autonomy, and Capitalism

SOME three decades ago (has it really been that long?), I settled into my first Asian philosophy class at tiny St. Mary’s College of Maryland. The professor made an immediate impression: hair prematurely gray with black strands at the temples, stylishly dressed in a turtleneck and blazer, and with a voice that a classmate described (with a hint of infatuation) as “like velvet over gravel.” Henry Rosemont promised that first day that his classroom would be the most exciting place on campus—an exaggeration, but close enough to true that the room was always full.

Henry—using his last name would be inappropriately impersonal for me—began studying Asian philosophy while a Marine in the Korean War. On leave and both physically and spiritually exhausted, he visited a local temple in search of solace. He soon found himself in the lotus position (the virtue of which, he told us with his deep-chested laugh, is that when you fall asleep, you roll around safely on the floor) and his life’s work.

He went on to earn a doctorate in philosophy, specializing in Asian thought, at the University of Washington and did postgraduate work in linguistics under Noam Chomsky at MIT. His academic research, often in collaboration with the University of Hawaii, Manoa’s Roger Ames, focused on translating and understanding Confucian texts and brought him international recognition in that specialized field.

I didn’t find Asian philosophy nearly so satisfying (I’m hopelessly Western and Platonic), but I appreciated the professor. Fortunately, Henry also taught courses that I did like, including ancient political thought and logic. He welcomed students who dropped by his office to discuss some difficult text or logic problem, enjoyed conversations over between-class cigarettes and after-class glasses of wine, and kept a public list of double-entendres for grad school recommendation letters (“I wish I could say more about this student’s promise…”). If you were lucky, you would catch a glimpse of the Bugs Bunny tattoo on his arm—another product of his time in the Marines.

Henry shuffled off this mortal coil last July at age 82. Before passing, Rowman & Littlefield’s Lexington Books published his final book, Against Individualism, as the first in a series on Philosophy and Cultural Identity. In it, Henry challenges the concept of the autonomous individual as well as the Western ethical systems, libertarian philosophy, and capitalist economic system that “foundational individualism” supports.

His aren’t the arguments of a faculty lounge Marxist stereotype; Henry impatiently dismisses collectivism in the prologue and elsewhere in the book. Instead, he advocates a Confucian understanding of the person as a replacement for Western individualist ideas and values.

As a tribute to my late teacher, let’s consider his critique of the ideas that many of us readers of Regulation cherish.

Individualism and the West / Western philosophy, he writes, is grounded on the notion that the person is an autonomous, rational, persistent self that has intrinsic moral worth. According to Henry:

The idea of the individual self, based on self-awareness that entails rationality, is one of the most deeply rooted constructs in the history of Western
intellectual history. From its origins in ancient Greece in the tripartite nature of the soul, through the Judaic-Christian unitary version thereof, it has played a major role in shaping our sense of who and what we are, and how, therefore, we ought to live our lives, interact with our fellows, and shape the institutions in which we live together.

Under this view, infringing on individual autonomy is wrong and people’s freedom is morally limited only by the obligation that they not impose on others’ autonomy. Any further human commitments and constraints upon the individual must be voluntarily accepted in order to be morally acceptable. This leads to the idea that government legitimacy rests in the social contract, under which citizens agree to surrender some autonomy in exchange for government-provided benefits. No other justification for government is acceptable under these precepts, writes Henry:

If we are indeed free, rational, and autonomous, why should we want to surrender our freedom to a state that will claim a monopoly on the use of coercion to secure compliance with its dictates?

He argues that all versions of Western moral and political thought are grounded on foundational individualism, whether Immanuel Kant’s deontology or the various versions of utilitarianism, or even Marxism, communitarianism, and feminist care ethics. The perfect form of this Western philosophy, he writes, is libertarianism, which he describes as “a coherent, consistent, and not, by logical standards, an unreasonable moral code and political position.”

He credits foundational individualism with having provided great benefit to humanity:

Americans have long been proud of the constraints the Bill of Rights places on the government to interfere in the lives of its citizenry, and rightly so; would that all governments the world over were similarly constrained. ... Millions of people have benefited from the idea that human beings should be seen as free, rational, autonomous individuals, and the resultant gains in human dignity it has brought about are to be celebrated, and should not be lost.

However, he argues, world conditions are changing and the West’s individualist philosophy is no longer the positive force it once was. Natural resources are strained by population growth, wealth is increasingly distributed unequally, poverty threatens a greater percentage of humanity than ever before, and people are increasingly unhappy and angry. Foundational individualism is contributing to these ills, he claims, by advancing a false conception of human value and by obstructing corrective “social justice.”

Challenging the self / What’s so wrong with the concept of a morally valuable, rational, autonomous self? Henry makes two criticisms: experientially it exists have little support, and morally it leaves much to be desired.

Concerning the former, he invites readers to investigate themselves to evaluate the self. Strip away the physical body, the societal and familial roles, the various external and internal physical and mental stimuli, and memories, and what’s left? According to Western thought, Henry argues, this should be like peeling a peach: remove the skin and flesh, and one should be left with the pit—or in this exercise, the self.

However, he continues, when he strips away those facets of himself, he finds he’s left with nothing at all. Instead of a peach, the exercise is more like peeling an onion and finding there’s no core beneath the layers. He writes:

We seem incapable of describing the self we all supposedly possess, are hard put to describe what makes us a unique individual apart from others, or what criteria to employ in deciding whether another is the same individual over time; do not have strong intuitions or criteria for how to handle seemingly anomalous cases (Alzheimer’s patients, split personalities, extreme physical disfigurement, cases of self-deception, amnesia, etc.); or how to answer Hume’s logical question of what experience the experiencer can possibly have of the experiencer. All of this suggests, at the least, that the idea of autonomous individuals is at best a confused one. (Henry’s emphases.)

But this problem is not his biggest concern; the “self” could be a useful fiction if it yielded a fully satisfactory morality. The deeper problem for Henry is that foundational individualism results in an incomplete and even detrimental morality.

If individual autonomy is the supreme moral value, then that value does not motivate an obligation to help others. People can (and many do) voluntarily aid the poor, injured, and other unfortunate, but they apparently are motivated by something other than foundational individualism. Further, a libertarian polis cannot obligate itself to help the unfortunate through compulsory redistribution of wealthier citizens’ property; doing so would violate those citizens’ right to their property. As a result, the libertarian state has limited means to improve the lives of the weak and poor: it cannot pursue social justice.

Henry finds this constraint unacceptable. He writes:

Herein lies a fundamental conflict in all contemporary discourses on human rights grounded in the concept of the autonomous individual: To whatever extent we may be seen to be morally and
Henry claims, morally harmful, because it coming of libertarianism, but outright defends selfishness on the part of the well-to-do. He goes so far as to quote rebukes from John Kenneth Galbraith and The Post columnist Ian Fletcher:

John Kenneth Galbraith put a similar point succinctly when he said, “The modern conservative is engaged in one of the oldest exercises in moral philosophy; that is, the search for a superior moral justification for selfishness.” More recently, a popular critic of libertarianism described it as “a notoriously selfish philosophy.”

He reserves his sharpest criticisms for capitalism. Like the concept of autonomy, he credits capitalism with historically benefiting humanity by encouraging productivity and growing “the economic pie” so as to provide everyone with “a larger slice.” But there is a limit to those gains, he claims, and humanity is increasingly exposed to the darker side of capitalism:

Based supposedly on competition, even at its best, capitalism must generate losers as well as winners. And as the winners win more, they grow fewer in number, while the losers increase.

This leads to an unfair distribution of the “rights” that libertarians cherish:

Those with a great deal of money to buy things will have far more “rights” with reference to real property, material goods, and services, than those persons living in abject poverty: “Freedom of the press,” the journalist A.J. Liebling once noted, “is guaranteed only to those who own one.”

The division between winners and losers leads to privation and violence, to the detriment of society, he claims:

Poverty, inequality, environmental degradation, hatred, violence, and more ... cannot even be addressed properly, much less resolved, within the confines of a capitalist system.

And:

The growing maldistribution of wealth both within and between nations becomes starker, and as the policies and actions of the United States, adamant in pressing an unfettered capitalism on the rest of the world, are doing more to exacerbate than alleviate the gross inequalities that contribute measurably to the violence in so much of the contemporary world. Indeed, I believe the ongoing growth of poverty is not the sole, but certainly a major, cause of such violence.

And,

We all live in extant states characterized more or less by inequality, injustice, poverty, violence, and more, all of which seem to be clearly on the rise today.

And—well, you get the idea.

Economists reading this review are likely already pointing out the empirical and other problems with these claims—problems that I’ll discuss below. I was a bit disappointed to read my former teacher leveling criticisms that could be cribbed from any Bernie Bro’s blog (and more than a few Trumpists’). Fortunately, these are only a few sentences in a book that is generally thoughtful and intellectually charitable—and more reflective of the person I knew.

So let’s take seriously Henry’s criticism of individualism and capitalism, which he better expresses as follows:

When individual freedom is weighted more heavily (valued more highly) than social justice—defined broadly as a fair allocation of resources for everyone—the political, legal, and moral instruments employed by the rich and powerful in defending and enhancing that freedom virtually insure that social justice will not be achieved, and hence poverty not alleviated.

This criticism, he believes, cannot be made against libertarianism by other Western moral and ethical theories without their violating their own axiom of foundational individualism. On this point, credit him with having greater insight into the ideas of libertarianism’s Western critics than they do:

[Libertarianism] is simply this concept of the free, rational individual self taken to its logical limit, and thereby worthy of our close attention because all of us more or less pay allegiance to a similar vision of human beings. ... I have not been impressed by any of the few [Western-grounded] supposed refutations of libertarianism I have heard or read thus far, no matter which specific individualist ideology is employed. If the libertarian claim to a moral high ground is to be denied, it will have to be done in a non-individualist way.

Confucius / To make this non-individu alist challenge, Henry draws on the Confucianism that was the focal point of his academic career. So who was Confucius and what is Confucianism? Here is my thumbnail-sketch understanding:

The Chinese sage who we Westerners call Confucius was born Kong Qiu in the year 551 BCE in the Chinese state of Lu in the district of Zou, which lay directly across the Yellow Sea from today’s South Korea. The name “Confucius” is a Latinization of the honorific Kong Fuzi, meaning “Grand Master Kong”; in the East he is more commonly called Kongzi, (or, in
an older Westernization, Kong-Tzu) which means “Master Kong.”

His father, a local military commander, died while Qiu was very young, leaving the family impoverished. Yet Qiu was well educated in the district’s commoner schools, which taught the classic texts, arts, martial skills, and mathematics in an effort to graduate “perfect gentlemen.”

Perhaps sparked by that education, he became a lifelong student and teacher of Chinese history, ritual, and social/moral philosophy. In essence, Master Kong was a conservative because he looked to tradition to discern how life should be lived. He also was a worldly, humanist sage; though he observed and advocated religious rites, his studies and teachings focused on how people can live well in this mortal world.

Even as he pursued his studies, Master Kong also worked his way up through public administration in Lu. The state was awash in political intrigue, officially under the jurisdiction of the ruling family of Zou but really controlled by three local aristocratic families. Those families periodically battled each other and dealt with infighting. Master Kong nonetheless was broadly respected for providing good service to the people of Lu, offering sound counsel to the rulers, and nurturing better relations between the three families. He rose in rank to become a sort of prime minister, and his reputation as both a sage and political adviser spread throughout Zou.

Ultimately, Master Kong broke with the flawed leader of the chief Lu family, following his own doctrine that if an adviser can’t improve the ruler’s virtue then the adviser should step aside so that someone else may try. He went into self-imposed exile, touring neighboring states. He returned to Lu late in life, spending his final few years teaching. He died in 479 BCE; his venerated tomb is in the modern city of Qufu in Shandong Province.

From ancient times until 1949, Master Kong’s teachings and those of his followers were widely revered in China, though they did wax and wane in influence as political rule shifted from one dynasty to another. Following the Communist revolution, Confucianism’s importance has been at an especially low ebb.

Role-bearing morality / Confucianism’s teachings are rooted in ancient texts that Master Kong consulted for moral enlightenment, as well as collections of his own insights and those of his early followers. These works do not analytically define a system of thought grounded in foundational axioms, Henry explains, but instead offer adages, short parables, and rituals intended to nurture virtue in readers and help them live better, more fulfilled lives. In essence, Confucianism follows Aristotle’s advice: If you want to become a good person, start by studying and replicating what good people do.

A central concept in Confucianism is the importance of properly fulfilling reciprocal relationship roles (shu). The most prominent of these are between a parent and child, between spouses, between older and younger siblings, between friends, and between ruler and subjects. Henry proposes replacing foundational individualism with this concept of the person as a role-bearer who should fulfill his roles well and who finds satisfaction in doing so.

Henry notes that people often switch ends of these reciprocal roles at different times in their lives and in different settings. For instance, the parent nurtures the child, but later in life the grown child will care for the parent; the teacher educates the student, but the student can then educate others. Importantly, for Master Kong these roles should not be fulfilled purely out of a sense of obligation (though the person who is attempting to become good may start with this sole motivation). To righ-teously fill a role, the role-bearer should want to graciously provide or appreciatively receive the benefits of the role. Just as important, the participants in these relationships must recognize that each particular relationship is distinct; a person should fulfill his duty to his spouse, or a teacher to his student, in a manner tailored to the specific spouse or student.

Concerning the government relationship, Henry explains that Master Kong believed that good governance should be both paternalistic and authoritarian—provided that the ruler is virtuous. According to Master Kong:

To govern means to make right. If you lead the people uprightly, who will dare not be upright? Employ the upright and put aside the crooked; in this way the crooked can be made upright. Go before the people with your example, and spare yourself not in their affairs. He who exercises government by means of his virtue may be compared with the North Star, which keeps its place and all the stars turn toward it.

Beyond the notion that the ruler and his advisers should be virtuous and benefit the citizens, Master Kong’s teachings offer few specifics on government policy. To sketch out a Confucian programme, Henry turns to two prominent Confucian disciples, Mencius (371–289 BCE) and Hsun-Tzu (298–238 BCE).

Both—and Confucians generally—believed that the state should provide for the basic welfare of people who are unable to provide for themselves. According to Master Meng,

Old men without wives, old women without husbands, old people without children, young children without fathers—these four types of people are the most destitute and have no one to turn to for help; the good ruler will give them first consideration.

Likewise, Master Hsun teaches:

In the case of the handicapped and helpless, the government should gather them together, look after them, and give them whatever work they are able to do. Employ them, provide them with food and clothing, and take care to ensure that none are left out. ... The government must also look after orphans and widows, and assist the poor.

Master Hsun also believed government
must engage in industrial policy for vital industries, telling rulers:

If you encourage agriculture and are modest in expenditures, nature cannot impoverish you. If you provide everyone with the goods they need and demand their labor only at the proper time, nature will not afflict them with illness. ... [But] if you neglect agriculture and spend lavishly, nature cannot enrich you; your people will starve even when there are no floods or droughts, and will suffer sickness even before great heat or cold come to afflict them.

Henry praises such ancient Chinese policies as

governmental measures to accomplish [important tasks] such as rebuilding dikes and levees across long distances after harsh winters [and] seeing to the transfer of goods and seeds from a bumper crop area to one struck by flood or drought. ... Well-organized social cooperation could lead to the recalcitrant East Asian earth surrendering a bounty sufficient to nurture the population and provide some material embellishments to human life as well.

Arguably, Henry over-reads the degree to which Confucians endorsed government intervention. Master Hsun advocated public labor “only at the proper time” and instructed government to be “modest in expenditures” My Cato colleague James Dorn recently told the story of Confucians’ opposition to government monetary authority during the Western Han Dynasty of 206 BCE–9CE (“Monetary Freedom: Lessons from the Western Han Dynasty,” Cato at Liberty, Oct. 17, 2017). Still, Confucians are more optimistic about the potential good that can come from government intervention than the Chinese sage who is better known among libertarians, Lao-Tzu (7th–6th century BCE).

However, beyond welfare and social coordination activities, and a discussion of how truth and reconciliation commissions can serve as a model for addressing some justice issues, Henry offers little on what government policies he desires or what specific political system should implement them. There is no description of a Confucian environmental policy, or a Confucian economics to replace capitalism, or a system of checks and balances to control evil or incompetent rulers, or a discussion of how virtuous rulers can be identified and empowered.

Reclaiming the self / Henry offers a bleak appraisal of the self, libertarianism, and capitalism. But are matters in the United States and the rest of the individualist West as grim as he claims?

Let’s start with the self. Economists and Westerners in general conceive of the individual as incorporating much more than a person’s societal roles; at the very least, each person has a distinct bundle of preferences, beliefs, values, expectations, risk tolerances, and other characteristics. These can evolve and even change entirely, but each person seemingly has a unique set of them—as underscored by the difficulty of trying to reach consensus on even the most innocuous of decisions that affect multiple people.

These aspects of the self seem to be more fundamental to the person than his or her relationship roles. Indeed, it’s difficult to conceive of how people can fulfill their 


shu


without incorporating these parts of themselves. Nearly every role I fill results from my choosing—that is, my preferring—to accept that role, and how I fill all of my roles is shaped by my preferences, risk tolerances, values, etc. Put differently, I am not my relationship roles; rather, I exhibit myself through the relationship roles I assume and how I fulfill them, as well as my many other activities.

Life in the libertarian West / Even if the self exists, that doesn’t mean Henry’s criticism of foundational individualism fails. But do Western morality and economics produce the evils and misery he claims?

Empirically, it’s difficult to make his charges stick. Contrary to his explicit claim otherwise, not only has the rate of people living in extreme poverty fallen since the dawn of the Industrial Age according to World Bank data, but so has the number of those people even as the world population has grown seven-fold. This decline has been especially sharp since the 1970s, contemporaneous with a surge in economic freedom as measured by such organizations as the Fraser Institute and the Heritage Foundation.

Homicide rates and other violent crime rates in the United States and other developed countries (i.e., countries with developed capitalist economies) have been falling since at least the 1990s according to data presented in Harvard psychologist Steven Pinker’s The Better Angels of Our Nature (Penguin Group, 2014). In Europe, those declines are just the latest in a long downward trend dating back at least to the 15th century. Globally, war deaths, genocides, and internal displacements have plummeted since the end of World War II and are practically unknown in the developed world, again according to Pinker’s data. And, as has often been noted, liberal, capitalistic democracies and trading partners seldom go to war with each other.

Life expectancy has surged since the Industrial Revolution, especially in the West, according to data presented in UCLA economist Deepak Lal’s Poverty and Progress (Cato Institute, 2013). Childhood mortality has been declining since at least the 1960s according to World Bank data, with the developed world having the lowest rates. The number of undernourished persons around the globe has fallen since the 1990s according to the United Nations’ Food and Agriculture Organization, and in the developed world—especially the United States—obesity is a far greater health concern than hunger. Air and water quality have been improving in the United States since at least the 1990s, and economists have long noted the positive correlation between market-provided wealth and improving environmental quality.

By these and many other measures, human well-being around the globe is advancing in direct correlation with the
expansion of economic freedom and the spread of foundational individualism. That well-being is highest in the world’s most libertarian, capitalist countries. (A collection of these data and commentary can be found on the Cato Institute’s HumanProgress.org website.)

So how can Henry’s argument go so wrong? Because Against Individualism assumes a false premise that undermines the book’s entire economic discussion and its broader worldview.

Beginning in the prologue and repeated elsewhere in the book, Henry characterizes market capitalism as necessarily having “losers as well as winners. And as the winners win more, they grow fewer in number, while the losers increase.” But market capitalism by definition is a system of voluntary exchange. People seldom volunteer to lose. Rather, they search for exchanges in which they best benefit, and as a result both participants in an exchange “win.”

In the West’s market economies, the pursuit of better exchanges has incentivized dramatic improvement in agricultural productivity, medical innovation, housing supply, transportation efficiency, and countless other advances. As a result, life expectancy has soared in the capitalist developed world, and developing countries like India and China are increasingly turning to markets to the benefit of their underclasses. Even Henry, after repeatedly charging in the book that capitalism leads to poverty, tacitly concedes the opposite is the case when he laments that “an increasingly wasteful and life-numbing materialism [has] become ingrained in people’s lives, especially in the developed world.” (Also worth noting: people in developed nations tend to fare better on happiness surveys and measures of well-being than people in less-developed, less-capitalistic nations.)

The pursuit of better exchanges not only yields materially better outcomes, but often morally better ones—at least, better than some exchanges that supposedly exhibit “social justice.” Consider just one example: social justice advocates’ support of ever-stronger minimum wage laws. The empirical literature shows that raising the minimum wage reduces employment, and those reductions fall disproportionately on the poor and other disadvantaged groups. (See p. 8.) Further, unemployment has long-lasting negative effects on a person’s wages when he does work. Repealing minimum wage laws and letting the labor market operate freely would thus benefit the poor and disadvantaged, yet social justice advocates continue to defend and demand stricter minimum wage laws.

A problem for Henry, and one for us / But even if life in the capitalist West is much better and more just—and improving—than Henry claims, that doesn’t mean his advocacy of Confucianism is misplaced. Humanity could greatly benefit from Master Kong and his followers’ teachings on the obligations of parenthood, marriage, friendship, and political leadership.

But those teachings could also help lead people astray. As Henry acknowledges in the book, Confucian morality is primarily a family- and tribe-centered morality, elevating duties and faithfulness to kin and kith above others. Consider this from the Analects:

The Governor of She, in conversation with Confucius, said, “In our village there is someone called ‘True Person.’ When his father took a sheep on the sly, he reported him to the authorities.” Confucius replied, “Those who are true in my village conduct themselves differently. A father covers for his son, a son covers for his father. And being true lies in this.”

The troubling lesson is that a son’s moral obligation to his thieving father takes precedence over concern for the village or the crime victim. This tribe-first belief is only a brief leap away from the belief that one should advance one’s tribe by harming out-groups, perhaps while chanting “America First” or “Build the Wall” (or far more nefarious slogans from the 20th century). Confucianism’s lack of a foundational principle that each person has moral worth allows for some horrid—though unintended—applications of Master Kong’s teachings.

That said, Henry still has the overzeal criticism for us libertarians: foundational individualism may give each person moral worth, but that conflicts with the seemingly meritorious idea that government should redistribute some wealth from the rich and powerful to the poor and weak. We libertarians can respond that people are free to—and should—help the poor privately. We can also note that some of the most prominent libertarian theorists—e.g., John Locke, Adam Smith, Friedrich Hayek, Milton Friedman, Robert Nozick—supported some form of public aid to the poor. The libertarian West does have many safety-net programs—the United States alone spends roughly $1 trillion a year on various government welfare programs—and there is no significant political movement to abandon them. (A visit to Cato’s webpage finds much more attention given to improving the safety net’s efficiency and incentives, than to ending it.) But these responses only beg Henry’s question: if foundational individualism is the West’s paramount value, can it be reconciled with a morality of social justice, especially in the public sphere?

There are, of course, libertarian philosophies that are not grounded in foundational individualism, and there are libertarian efforts to advance social justice using foundational individualist premises. (See, e.g., University of San Diego philosopher Matt Zwolinski’s “Bleeding Heart Libertarians” work.) And there are plenty of deontological, utilitarian, and other Western arguments for some ethic of common provision. But Henry can fairly argue that, as noble as these efforts are, they have not yet conclusively reconciled foundational individualism with social justice.

I take this as my former teacher giving us libertarians an assignment. Does foundational individualism require us to wholly abandon social justice? Do we relegate social justice to only the sphere of private morality? Or can libertarianism support a public ethic of social justice? Struggling with these questions would be a fitting memorial to Henry’s life and work.
Buchanan’s Big Idea

REVIEW BY ART CARDEN

From publishing trends in 2017, it seems like James Buchanan might be the official “recently deceased economist” of The Age of Trump. He was the villain in Nancy MacLean’s fundamentally flawed conspiracy tract Democracy in Chains (see “Buchanan the Evil Genius,” Fall 2017), and his misadventures with the administration at the University of Virginia figured prominently in David Levy and Sandra Peart’s Escape from Democracy (see “The Discontented Animal,” Summer 2017).

Given the breadth, depth, volume, and multidisciplinary importance of his contributions, it stands to reason, perhaps, that there would develop a field we might call “Buchanan Studies.” Buchanan’s student and then longtime colleague and collaborator Richard Wagner is—with the possible exception of Geoffrey Brennan—the scholar most qualified to contribute to those studies. In James M. Buchanan and Liberal Political Economy, Wagner explores some of Buchanan’s most important ideas and how they are relevant to 21st century political economy.

It is important to state at the outset what this book is and what it is not. It is a discussion of Buchanan’s ideas and why they might be relevant or useful to active scholars. It is not an “intellectual biography” of Buchanan in the strict sense, and Wagner is clear on this. He makes much of Buchanan’s influences, but he offers a topic-by-topic discussion of his ideas rather than a chronological account of their development, and his approach is fundamentally analytical. The book also discusses the ideas’ place in intellectual history and 21st century political economy. It draws from Wagner’s intimate knowledge of Buchanan the man and the scholar, as well as the collaborative work Wagner and a generation of younger scholars have done developing what Wagner calls “entangled political economy.” It is, as he puts it, his “interpretation of the contemporary meaning and significance of Buchanan’s oeuvre, as filtered through my 50-year association with him as a student, colleague, and coauthor.”

Political economist / This book is not an exegetical exercise, but it is still relevant to how we understand Buchanan as a product (or not) of the time in which he wrote and his broader cultural influences. This takes on importance, even urgency, in light of MacLean’s thorough misunderstanding of Buchanan’s overall program. MacLean makes much of Buchanan’s classical liberal sympathies, Tennessee upbringing, and career spent mostly in Virginia. To her, Wagner might respond with this passage:

Buchanan was a classical political economist who entered the scholarly world during the heyday of the neoclassical period of economics. Consequently, he was often misconstrued as a neoclassical economist with right-wing ideas. That view is wrong; it reflects the common tendency of people to interpret other people and events in terms of the main currents in play at the time. While Buchanan worked during the heyday of the neoclassical period in economics, he was a classical political economist in the style of Frank Knight and not a neoclassical economist of post-war Chicago vintage.

This is a key insight if we are to understand Buchanan with reference to the intellectual and political world he inhabited. Buchanan the classical political economist was squarely outside the mainstream of economics but squarely inside the mainline of economics stretching back through Friedrich Hayek to Adam Smith, to use George Mason economist Peter Boettke’s characterization. He made use of equilibrium constructions, but Buchanan’s political economy was largely classical rather than neoclassical, emphasizing economics as a science that studies exchange and social processes rather than resource allocation and the efficiency properties of equilibria. Buchanan won the Nobel Prize in 1986 for this work, the most important application of which was in the development of Public Choice Theory, a body of theory and evidence that treats “politics as exchange” and that makes the same assumptions about political action that analysts typically make about commercial action.

Wagner goes on, then, to explore the major themes in Buchanan’s intellectual system and the ways in which people have and can apply them today. It is important to note that while public choice can be pithily summarized as “economics applied to politics,” public choice as Buchanan did it was not simply neoclassical economics applied to politics. It was, rather, a resurrection of classical political economy and a marriage between it and Italian public finance, which emphasized the political underpinnings of governments’ taxing and spending choices. Buchanan’s public choice emphasized social processes, the institutions of exchange, and the incentives facing political and bureaucratic actors. Wagner refers to “Virginia Political Economy as Classical Political Economy Italianized,” and writes that “The Virginia
IN REVIEW

theorists to a man focused on process and coordination, and not on resource allocation.”

One big idea / Buchanan’s was fundamentally an anti-elitist paradigm, which is ironic given MacLean’s charge that his system is but a thinly veiled reaction against racial egalitarianism as embodied by the Brown v. Board of Education decision. Toward the end of the book, Wagner juxtaposes the egalitarianism of Buchanan with the elitism of John Maynard Keynes and notes that Buchanan’s ideas lend themselves to a politics of “genuine liberalism” as opposed to the “guided or controlled liberalism” of Keynes.

To the extent that Buchanan was “reacting” to anything, it was “the presuppositions of Harvey Road”—the conceits of Keynes and his coterie who thought themselves intellectual aristocrats positioned to make “the really important decisions” on everyone’s behalf. Buchanan, by contrast, put no faith in experts and argued, for example, that the Council of Economic Advisers, which had been established by the 1946 Full Employment Act, should be disbanded.

Wagner characterizes Buchanan as a “hedgehog,” borrowing from Isaiah Berlin’s The Hedgehog and the Fox (Weidenfeld & Nicolson, 1953). Hedgehogs, to Berlin, are thinkers with One Big Idea, while foxes are thinkers with lots of small ideas. He bases this characterization on the pattern set by Buchanan’s first paper, a 1949 article in the Journal of Political Economy titled “The Pure Theory of Government Finance: A Suggested Approach.” If Buchanan was a hedgehog, though, he was a foxy hedgehog, applying his One Big Idea about the importance of rules and groups to numerous settings. To Buchanan, we cannot treat a state as an independent unitary actor immune to incentives, and we have to peel back the layers of the onion in order to really get at what is meant by a “self-governing” polity.

There are Adam Smith scholars, Friedrich Hayek scholars, Karl Marx scholars, John Maynard Keynes scholars, Marcel Proust scholars, and a whole host of scholars who have dedicated their careers to exploring and understanding a single thinker’s breakthrough insights. As a leading representative of the mainline tradition in the late 20th century, Buchanan is as good a candidate as any to draw the attention of specialists in intellectual history, constitutional economics, political theory, and social philosophy. For scholars seeking to acquaint themselves with his ideas, James M. Buchanan and Liberal Political Economy is an indispensable starting point.

Occupational Licensing Reform

**REVIEW BY GEORGE LEEF**

M y word processing program objects: “bottlenecker” is not a word. But the authors of this book think it should be and I agree. A “bottlenecker” is someone who tries to get government officials to enact laws or regulations that obstruct new competitors from entering the market. Just as the neck of a bottle restricts the flow of liquid, so do such rules restrict the flow of rivals. Occupational licensure is a favorite tactic, but not the only one. This book details the ugly tactics that bottleneckers use to get their way and recounts numerous legal battles that have been waged against them.

The book’s subtitle conveys the big message: people often try to game government for power to exclude competitors, thereby gaining private profit. Those efforts, when successful, drive up costs for consumers and destroy entrepreneurial opportunities for individuals who want to get ahead. It is basic public choice theory that interest groups will attempt and often succeed in getting friendly politicians to minimize competition, but what Bottleneckers does especially well is put that theory into stories sure to hit the mark with ordinary readers.

Authors William Mellor (an attorney who co-founded the Institute for Justice) and Dick Carpenter (director of strategic research there) begin with the dismaying fact that while back in the 1950s occupational licensure was rare with only around 5% of American workers subject to licensing, today roughly 33% of workers face the requirement. Moreover, the ratchet keeps moving upward as more and more groups get politicians to impose licensing. Professional groups often wage multi-year campaigns involving top-notch lobbyists when they want a bottleneck in their field. Initiatives to de-license occupations are almost unheard of.

Scare stories / Consider, for example, the interior design profession. Most Americans would scoff at the idea that anyone should have to obtain a government license to be allowed to work as an interior designer, but to those who are in the business, keeping down the number of newcomers is important. The American Society of Interior Designers (ASID) has been fighting for many years to get state legislatures to enact at least “titling acts” (which prevent anyone who hasn’t passed the required exams from advertising his or her services as “interior design”) or, better yet, “practice acts” (which make it illegal for an unlicensed person to do any work that is deemed interior design). Annoyingly enough, the ASID wheedled a $13,000 grant from the National Endowment for the Arts to develop its model legislation.

With this and many other examples,
Mellor and Carpenter demolish the notion that licensing stems from public demand for protection against incompetent or unethical practitioners. The impetus for licensing always comes from the group itself, and one of the standard arguments is that all the group’s members really want to do is protect the public.

The authors tell the story of the push for interior design licensing in Florida, where the proponents argued that tragedies could ensue if unlicensed people were allowed to do their work. For instance, they said, unlicensed designers might use carpeting that isn’t fire-resistant. Indeed, Florida had experienced such a tragedy in a nursing home, but it had nothing to do with an “incompetent” designer choosing the carpeting. Never mind the facts, though—lobbyists won’t let a good scare story go to waste.

Another revealing aspect of the ASID story is how states waste resources in policing their laws. We learn, for instance, that the Florida Board of Architecture and Interior Design hired a law firm to investigate and root out the supposed danger of unlicensed individuals doing design work. The authors write, “Every year, the firm initiates proceedings against hundreds of citizens and businesses both in Florida and outside the state, in most cases for nothing more than simply using the terms ‘interior design,’ ‘interior designer’ or even ‘space planning’ without the board’s permission.” So it isn’t just consumers who suffer from higher prices when they deal with interior designers; taxpayers also suffer when state resources are diverted into nothing more than cartel protection.

Frustrating fight | In each type of bottlenecking they discuss, Mellor and Carpenter describe the legal challenges that have been brought against the laws. Some suits have been successful; others have not. In the battle over interior design licensing, the most conspicuous case has been in Florida, where designer Eva Locke, a Cuban refugee, filed suit against the state’s licensure law. The Florida statute included both titling and practice regulations.

The district court ruled that the titling regulation was a violation of the First Amendment because it prohibited Locke from speaking to people about the nature of her work. But the court also ruled that the practice aspect of the law was legal, despite strong evidence that no public interest was served by restricting interior design work to those licensed by the state. When Locke appealed that decision to the Eleventh Circuit, the result was a depressing instance of judicial deference. The judges said they wouldn’t “second guess the legislature’s judgment as to the relative importance of the safety justifications.” That ruling exemplifies the main barrier to legal action against bottlenecking: the deeply ingrained idea among judges that they should “let democracy work” rather than intervene against patently absurd regulations stemming from one of democracy’s weak spots: its openness to special interest manipulation.

Making a killing | Perhaps the most distressing of the stories Mellor and Carpenter tell is about the funeral industry’s use of licensure to prevent competition that would save people money at a time when they’re particularly vulnerable to pressure. There is a lot of money to be made from the death of loved ones, and the soft-spoken, compassionate people who tell the bereaved that they only want to bring them solace turn into ferocious dragons whenever someone threatens to diminish their profits.

The initial threat to those profits came from the Federal Trade Commission. In 1972, the FTC undertook an investigation of the funeral industry and found that funeral directors routinely pressured families into purchasing high-cost caskets; misrepresented legal, cemetery, and crematory requirements; and even performed services without permission from the family—billing them, of course.

The investigation led the FTC to propound the “Funeral Rule,” meant to restrict unethical practices in the industry. Funeral directors fought the rule with intense lobbying in Congress and legal challenges. Not until 1984 did the Funeral Rule finally take effect. When it did, a market for lower-cost burial goods emerged. To stifle that competitive threat, the funeral industry turned to state regulation. Specifically, they argued that only licensed funeral directors should be permitted to sell caskets.

One man who ran into this regulatory minefield was Pastor Nathaniel Craigmiles of Chattanooga, TN. His Baptist church had mostly poor and uneducated members. After his mother’s death, he discovered how inordinately expensive funerals were and decided to save his parishioners from needing to “mortgage their homes to pay for a decent burial.” He started up a small business selling caskets at much lower prices than what funeral homes in Chattanooga were charging. Craigmiles secured the necessary local business permits, but he didn’t obtain a funeral director’s license because, of course, he wasn’t running a funeral home. Then an official from the state funeral board informed him that without the license, his casket sales were illegal. “You don’t have to buy a car from a mechanic. Why should you have to buy a casket from a funeral director?” Craigmiles asked.

Obtaining the required license was far too costly for him to consider. Instead, he filed suit against the state board, arguing that its licensing rule was an unconstitutional deprivation of his right to earn an honest living. In court, the funeral industry tried to defend the anticompetitive regulation by claiming that it was necessary to
protect public health and safety. Craigmiles countered that those arguments were bogus because it was legal for Tennessee residents to use homemade caskets and bodies could be buried without one. The judge rightly saw the funeral board’s arguments as utterly self-serving and ruled that the licensing requirement was invalid.

Astoundingly, once Craigmiles was allowed to resume his business, he found himself threatened with bodily harm, his store windows broken, and his caskets damaged after being delivered to funeral homes. Even after his store mysteriously burned down, he would not give in to the intimidation and instead opened two new stores.

The funeral industry wasn’t throwing in the towel, however. It appealed the judge’s decision against its anticompetitive regulation to the Sixth Circuit. But the higher court was having none of the appellant’s arguments, concluding the Tennessee legislature’s “measure to privilege certain businessmen over others at the expense of consumers is not animated by a legitimate governmental purpose.” That was an example of engaged rather than deferential judging.

Don’t think that we have a free market in caskets nationwide. In other states, the funeral industry has prevailed, thanks to shameless lobbying to sway legislators and deferential judges on other courts. For example, Oklahoma’s identical regulation against casket sales by anyone other than a licensed funeral director was upheld by the Tenth Circuit in 2004.

Conclusion / Other instances of bottlenecking that Mellor and Carpenter cover involve food trucks (where local politicians say they’ll support you in exchange for keeping competition out of their business. Every one of these stories will raise the blood pressure of Americans who believe in free enterprise. As the authors say: “Breaking open bottlenecks is about more than economic growth. It is also about creating a just society built, in part, on the right to earn an honest living free from arbitrary and unnecessary government encroachment.” This is an issue where free market advocates should be able to make common cause with progressives, since both camps presumably dislike the abuse of government for private profit.

Patriotism as Stealing from Each Other

In his new book Clashing over Commerce, Dartmouth College trade economist and economic historian Douglas Irwin “explores the economic and political factors that have shaped the battle over U.S. trade policy from the colonial period to the present.” The book divides American trade history into three periods: from the War of Independence to the Civil War; from the Civil War to the Great Depression; and from the Depression until today.

Founding to 1865 / Irwin presents the first broad period as characterized by a view of tariffs as a mere tool for raising government revenue. Until the creation of the income tax in 1913, tariffs provided the federal government with most of its money.

The founders, writes Irwin, “favored free and open commerce between nations and the abolition of all restraints and preferences that inhibited trade.” Like Adam Smith, they opposed the mercantilist—that is, protectionist—theories of the time. But that opposition was counterbalanced by some exceptions that Smith himself identified. One was concerns over national defense. Another was a desire for reciprocity—that is, equally open and nondiscriminatory trade with other countries—and possibly to retaliate through trade barriers in order to foster reciprocity (although Smith himself doubted that retaliation would work). After Independence, the British government discriminated against American exports. The adoption of the Constitution was due in part to the perceived necessity of negotiating trade reciprocity between the 13 states as a group and the British government.

A tension between free trade and protectionism appeared early in the Republic. In 1791, Treasury Secretary Alexander Hamilton produced his Report on the Subject of Manufactures, which proposed tariffs and subsidies to foster domestic manufacturing given the “numerous and very injurious impediments” from Europe. As time went by, however, Hamilton’s Federalists became more free-trade, while the Republicans became more protectionist.

At the request of President Thomas Jefferson after clashes with the British Navy, Congress imposed a trade embargo against

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Britain in 1808–1809. Jefferson, who had written in 1787 that “a little rebellion now and then is a good thing,” adopted an uncompromising law-and-order attitude regarding the enforcement of the embargo. At the peak of the enforcement effort, American ships could not leave port, even for domestic destinations, without official clearance. “It is important,” he instructed his treasury secretary, “to crush every example of forcible opposition to the law.” Although Irwin does not put it this way, that was an early instance of Leviathan’s mission creep.

Figure 1 (p. 68) reproduces Irwin’s graph showing the evolution of the average tariff (or duty) on total imports (which include the free-entry list) and on dutiable imports. In both cases, the tariff increased from less than 15% in 1790 to about 60% in 1830, after the 1828 “Tariff of Abominations.” Tariffs were raised on raw materials (such as wool, hemp, and flax) and, to protect domestic producers of goods made from those materials, on similar imported consumer goods. Intervention begets intervention.

These tariffs sowed discord between the North, where manufacturers benefited, and the South, which consumed protected manufacturing goods while exporting cotton and tobacco. Tariff tensions led to threats of secession from South Carolina and the nullification crisis of the early 1830s.

The figure shows how tariffs were reduced from then on until the onset of the Civil War, “a quarter-century of gradually declining tariffs” under the Democrats. In 1859, the average tariff was less than 20%. Thus, according to Irwin, the idea that tariffs were a cause of the South’s secession is indefensible.

1865 to 1932 / The Civil War “brought about a major shift in U.S. trade policy,” launching a second broad period in American trade policy. The “temporary” tariffs imposed during the war “became the new status quo.” As shown in Figure 1, the period from the Civil War to the Great Depression was generally characterized by high tariffs on dutiable imports (about 40% to 50%). What pushed down the average tariff on total imports is that in 1873 Congress put coffee and tea on the duty-free list. The Underwood–Simmons tariff law of 1913, under the Democratic administration of Woodrow Wilson, dramatically reduced tariffs, but they were pushed back up in 1922 by a Republican Congress. As during the 19th century, the Republicans remained the party of protection.

Many economists (perhaps most of them) believe that tariffs did not contribute to the rapid industrialization of the United States in the 19th century. One prominent argument for this was made by Frank Taussig in his renowned Tariff History of the United States, which went through several editions between 1889 and 1931. Irwin argues that the large, diversified, and free internal market, with well-protected property rights, was sufficient to generate competition and growth. Moreover, open immigration compensated for the high post-bellum tariffs. Productivity showed especially fast growth rates in non-traded sectors such as services, including transportation, utilities, and communications. Add to this plentiful natural resources such as iron ore, copper, and petroleum, and we have more than enough explanations for the rapid development of America.

By the early 20th century, the United States was the world’s leading manufacturer and had been a net manufacturing exporter for a decade. By that time, America’s per-capita income quite certainly exceeded Britain’s by a substantial margin. “Between 1890 and 1913,” explains Irwin, “real wages increased roughly 30 percent because labor productivity increased by about 30 percent.”

The Democratic administration of Woodrow Wilson presided over tariff reductions during the 1910s. But even when they controlled the federal government, the Democrats were divided and, at best, lukewarm anti-protectionists. At any rate, they could not break the Republican old guard and the interests of the protected manufacturers it represented. The Republicans raised tariffs again in 1922. The infamous “antidumping” measures—a perfect excuse for protectionism that has survived until today—appeared in the 1922 tariff law. In the 1928 election (which made Republican Herbert Hoover president), the difference between the two parties shrank as the Democrats became more protectionist.

The debates of the 1920s illustrated a frequent conflict among industrial interests. Western ranchers wanted high duties on hides, while shoe manufacturers from Massachusetts did not. The chemical industry wanted an embargo on dye imports, while the textile industry did not. And so forth. Protectionism is always sectional and conflictual.

Perhaps the most infamous protectionist measure in U.S. history was the Smoot–Hawley tariff of 1930, which took half of its name from Rep. Reed Smoot of Utah. A committed protectionist, Smoot was after “internationalists who are willing to betray American interests and surrender the spirit of nationalism,” as he himself declared. The law increased the average tariff by about 6 percentage points, which the deflation of the Great Depression doubled (because specific tariffs translated into higher proportional tariffs as import prices decreased).

Economists broadly opposed Smoot–Hawley, with 1,028 of them signing a formal petition against it. According to Irwin, today’s consensus among economists is that the Smoot–Hawley tariff played only a small role in exacerbating the Great Depression, although it did provoke retaliation from many foreign countries.

1932 to today / In Irwin’s periodization, the third broad phase starts under the administration of Franklin D. Roosevelt. FDR was less suspicious of free trade
IN REVIEW

than many of his precursors. He seemed to understand that solving the Great Depression required more international trade—even if, paradoxically, he tried to limit domestic free trade.

Irwin describes the period from 1932 until today as a quest for reciprocity—that is, the reduction of American trade barriers as a bargaining chip for other countries to do the same. In a sense, it was a return to the first period of American history.

One important pro-trade development early in this period was the adoption of the Reciprocal Trade Agreements Act (RTAA) in 1934, which empowered the president to negotiate lower duties with the governments of other countries. The RTAA reduced the capacity of special interests to push their protectionist causes in Congress. Irwin also underlines the influence of a few pro-trade individuals such as Cordell Hull, a congressman from Tennessee who became Roosevelt’s secretary of state. Sen. Paul Douglas of Illinois later wrote of Hull, “Thus, the shrewd, hillbilly free trader and militia captain from the Tennessee mountains outwitted for beneficent ends the high-priced protectionist lawyers and lobbyists of Pittsburgh and Wall Street.” Everybody, however, seemed to go out of their way to emphasize that they were not proposing free trade.

The same protectionist fears were expressed then as today. In 1945, Republican Rep. Harold Knutson of Minnesota asked rhetorically, “Please tell me how you are going to provide jobs if you transfer our payrolls to Czechoslovakia, France, the United Kingdom, China, Germany, Russia, and India?” I wish we had more hillbilly free traders.

In 1941 Hull declared that, after the war, “extreme nationalism must not again be permitted to express itself in excessive trade restrictions,” and promoted negotiations toward that goal. John Maynard Keynes, who was a trade negotiator for the British government, thought that free trade would be replaced by economic planning and balked at what he saw as the State Department’s belief in “the virtues of laissez-faire in international trade.”

The international negotiations resulted in the adoption of the General Agreement on Tariffs and Trade (GATT) in 1947 under President Harry Truman. American tariffs on dutiable imports were reduced by 21% on average. Combined with the increase in import prices caused by post-war inflation, this resulted in the average dutiable tariff declining from more than 30% in 1944 to 13% in 1950.

As shown in Figure 1, tariff reductions continued with new rounds of GATT negotiations. Writes Irwin, “The early postwar period brought about the most momentous shift in U.S. trade policy since the nation’s founding.” Many factors contributed, including a change in the Republicans’ protectionist absolutism, favorable public opinion even among trade unionists, and foreign policy concerns.

By the mid-1960s, however, more intense international competition—partly as a result of the container revolution that cut the cost of sea shipping—led to protectionist tensions resurfacing in America. In 1970, over a protectionist bill requested by President Richard Nixon and introduced by Democratic Rep. Wilbur Mills of Arkansas, Republicans and Democrats finished switching sides, the Democrats replacing the Republicans as the party of protection. Democratic Party constituents, including organized labor, felt more affected by import competition. The U.S. government imposed import restrictions to protect the apparel, shoe, and steel industries—often against GATT rules.

The Trade Act of 1974 made antidumping complaints by domestic companies easier. In 1976, by some calculations, the U.S. market was more protected by nontariff barriers than the European Economic Community and Japan, although exports were less subsidized in America. A severe double-dip U.S. recession from 1979 to 1982 combined with the significant appreciation of the dollar (from monetary policy) to squeeze domestic producers of traded goods, particularly in manufacturing. Despite his professed faith in “free trade”—which at least he dared call by its name!—Ronald Reagan and his administration made many compromises to protect producers of automobiles, steel, textiles, apparel, and some other goods, even invoking an “unfair surge in imports.” Japan was considered the big bad wolf of the times, much like China is today.

It was calculated that American consumers’ annual cost from textile and apparel protection amounted to more than $100,000 per job saved, several times the average wages in those jobs. A more active opposition from American purchasers of intermediate goods such as textile and steel helped contain the protectionist pressures.

The 1990s saw major initiatives to roll back trade barriers, including the conclusion of the North American Free Trade Agreement (NAFTA), the completion of the Uruguay Round of GATT, the creation of the World Trade Organization (WTO), and the welcoming of China into the world trade system. Despite his party’s protectionist drift, Democratic President Bill Clinton opposed protectionism and contributed much to the adoption of NAFTA. Public opinion also seemed to move away from protectionism but, as we would soon see, not irrevocably so.

In the 2000s, protectionist pressures rose up again with the so-called “China shock” after China joined the WTO. Partisanship and division started growing again, reaching their peak (thus far) with the election in 2016 of perhaps the most protectionist president in U.S. history. Figure 1 suggests that the reduction in tariffs has plateaued, but note that these data do not incorporate the increasing use of so-called “trade remedies” or special duties to compensate for alleged dumping and foreign subsidies.

FDR seemed to understand that solving the Great Depression required more international trade—even as he tried to limit domestic free trade.
At some point in the 19th century, political battles organized around partisan lines, even though both the Republican and Democratic parties were generally mildly interventionist, more or less protectionist, and rather devoid of philosophical foundations. The big difference is that the Republicans were protectionist because they defended the special interests of their electoral clienteles, such as manufacturers in the Northeast, and that the Democrats were less protectionist because they represented different electoral clienteles, such as the exporting South. A Republican congressman summarized the position of the two parties after the Civil War by saying that “the Democratic doctrine is a tariff for revenue with incidental protection, while the Republicans advocate a tariff protection with incidental revenue.”

All of this should remind us that free trade is free trade. The essence of protectionism is the state’s forbidding its own citizens or subjects to import what they want at conditions that they have individually determined to be the best available, and to forbid them to invest in foreign countries as they want, given the conditions they get there. Foreign interference should not be a reason for the government of a free country to submit its own citizens to more coercion. In a free country, free international trade should be a no-brainer, just like domestic trade.

Clashing over Commerce illustrates many elementary economic errors made by the protectionists. The Republicans’ 1908 presidential platform included the plank, “The true principle of protection is best maintained by the imposition of such duties as will equal the difference between the cost of production at home and abroad, together with a reasonable profit to American industries.” As Irwin notes, this idea of equalizing costs of production ignores the fact that differences in the (comparative) cost of production constitute “the very basis for international trade.” If two parties can produce the same things at the same costs, there is no benefit to be derived from exchange.

Clashing over Commerce illustrates the problem of collective action in trade policy. Producers’ benefits are concentrated, while consumers’ costs are diffuse. The cost of the textile and apparel protection for the average American household was $63 per year from the 1970s until the early 2000s. Consequently, while producers (capitalists and workers) lobbied the government, no consumer had a sufficient incentive to participate in lobbying and protests, even if the sum of the producers’ benefits was much lower than the total cost imposed to millions of consumers. Left unconstrained, the state develops into a coalition of producers, not an association of consumers.

International trade rules and institutions (like GATT and the WTO) can compensate for this bias. Another note of optimism is that trade integration leads importers of intermediate goods and large retailers to counterbalance the concentrated interests of import-competing industries. We see this phenomenon in the current debate on NAFTA, where many corporations side with consumers.

The worst in politics / When the demands of special interests are channeled through a welcoming political process, logrolling (that is, political horse trading) on a grand scale engulfs politicians. In 1909, Theodore Roosevelt chose to drop his push for tariff reform in exchange for Congress allowing him to expand the Interstate Commerce Commission. A more dramatic example: the so-called “dirty compromise” adopted by the 1787 Constitutional Convention saw the Southern delegates grant the federal government the right to regulate international commerce in exchange for continuation of the slave trade (plus a prohibition on export taxes). A common form of logrolling was for a congressman to trade his approval of some tariff pushed by another congressman in return for the latter voting for the former’s own preferred tariff. During the 2005 congressional debates on the Central American Free Trade Agreement (CAFTA), Rep. Robin Hayes of North Carolina’s 8th District announced, “I am flat-out, completely, horizontally opposed to CAFTA.” But Republican Speaker of the House Dennis Hastert persuaded Hayes to...
switch his vote by telling him: “In return for your vote, we will do whatever is necessary to help the people in the 8th District.” Gordon Tullock, the famous public-choice theorist, explained how this logrolling can produce policies that few people really want and impose a net cost for each citizen. (See Government Failure: A Primer in Public Choice, Cato Institute, 2002.)

David Wells, a protectionist nominated by Congress as special commissioner of the revenue in 1866, was shocked to discover how private interests operated in Congress. He admitted in private correspondence, “I have changed my ideas respecting tariffs and protection very much since coming to Washington.” There was nothing rational in the way that Congress treated protection demands; political greed was the motive.

Although Irwin may not go that far, Clashing over Commerce shows how protectionism brings out the worst in politics. For example, many congressmen secretly approved the accession of China to the WTO, but did not want to be seen voting for it if they knew it would otherwise pass. U.S. Trade Representative Charlene Barshefsky remarked that “the vast majority of members know this is absolutely the right thing for us to do,” but that “doesn’t necessarily mean ... they will vote affirmatively.” When Congress discussed tariff bills in detail, members tried to include so-called “jokers,” that is, intentionally obscure formulations and convoluted definitions in order to sneak in the protectionist measures they wanted.

Protectionism dresses in the clothes of nationalism. James Swank, a driving force of the American Iron and Steel Association formed in 1864, wrote that “protection in this country is only another name for Patriotism,” and that “it means our country before any other country.” “I am an American, and therefore I am a protectionist,” proclaimed Samuel Randall, a Pennsylvania Democrat and House Speaker in the late 1870s. Donald Trump claimed that foreigners are “stealing our companies,” which is a nationalist fabrication.

In the 1870s, Rep. Samuel Cox of New York identified the thieves better. He understood that protectionism favors parts of the country at the expense of other parts. He declared (in a quote that by itself is worth the price of Irwin’s book):

Let us be to each other instruments of reciprocal rapine. Michigan steals on copper; Maine on lumber; Pennsylvania on iron; North Carolina on peanuts; Massachusetts on cotton goods; Connecticut on hair pins; New Jersey on spool thread; Louisiana on sugar, and so on. Why not let the gentleman from Maryland steal coal from them? True, but a comparative few get the benefit, and it comes out of the body of the people.

Protectionism leads to incoherent if not absurd results. In 1962, the European Economic Community doubled its tariff on imported poultry, leading to what was dubbed “the chicken war.” The U.S. government retaliated with higher duties on other goods, including a 25% tariff on light trucks. The chicken war has long subsided, but the truck tariff persists to this day. The Organization of Petroleum Exporting Countries (OPEC) was formed after the U.S. government imposed an import quota on oil in the late 1950s, and the same OPEC imposed an oil embargo on America in 1973!

Perhaps the best illustration of the consequences of compounding regulation is the sugar import quotas, which led farmers in Central America and the Caribbean “to stop producing sugar and start cultivating illegal narcotics that were smuggled into the United States, starting a war with drug traffickers,” Irwin explains. Or consider the U.S. government’s deficits in the 1970s and early 1980s, which pushed up the dollar (through foreign borrowing), stimulated imports, harmed American exporters, and fueled protectionist demands to the same government.

In the 19th century as today, economists who defended trade were attacked and ridiculed by populist politicians. Republicans rejected the theory of comparative advantage, described by one of them as “the refinement of reasoning to cheat common sense.” Sen. Henry Hatfield of West Virginia blasted academic economists: “Cloistered in colleges as they are, hidden behind a mass of statistics, these men have no opportunity to view the practical side of life in matters pertaining to our industrial welfare as a nation.”

Toward the future / I fear that the history of American trade policy does not augur well for the future of free trade. But I may be wrong, and I hope to be.

On one hand, it is true that the integration of supply chains has generated strong business interests against protectionism.

---

**Figure 1**

AVERAGE TARIFF ON IMPORTS, TOTAL AND DUTIABLE, UNITED STATES, 1790–2015

Perhaps organized interests will end up aligned with what economists have known since David Hume and Adam Smith: free international trade is in the interest of consumers and the vast majority of individuals.

On the other hand, the ideal of free trade does not seem to have become more popular. Irwin himself rings an alarm: “What used to be called ‘trade agreements’ in the 1930s became ‘free-trade agreements’ in the 1980s and then were labeled ‘partnerships’ in the 2010s due to the negative connotation that ‘free trade’ now has in many quarters.”

And “free trade” has become less free as “partnerships” are now expected to include labor and environmental requirements and even provisions regarding such matters as gender issues. “Fair trade,” which is trade according to the latest political fads, is not free trade. Irwin notes a very important point: the recent orientation of trade agreements toward regulatory harmonization has politicized them and rendered them more likely to provoke political resistance. And the outlook for free trade has further deteriorated with the current mercantilist administration in the United States.

American trade history has witnessed no great debate on unilateral free trade, the idea that whatever other governments do, ours should allow us the freedom to import and invest as we want (“us” meaning each individual or group privately). It is not far from the truth to say that the closest to trade freedom that Americans ever got was the truncated alternative between reciprocity and protectionism. That most other countries have been no better is hardly a cause for optimism.

Whatever predictions one may draw from two and a half centuries of American trade history, and whatever the points on which one might disagree with Irwin, Clashing over Commerce is a very impressive book. Besides a detailed history of trade policy, it provides a general picture of American political and economic history. It is more impressive a book than Taussig’s was a century or so ago. Let’s hope that like Taussig, Irwin will update this book and publish new editions as time rolls on.

A Mixed Bag

**REVIEW BY DAVID R. HENDERSON**

In 2014, French economist Jean Tirole, chairman of the Toulouse School of Economics and the Institute for Advanced Study in Toulouse, won the Nobel Prize in Economics. Although he is well known within the increasingly technical economics profession, Tirole is not well known to non-economists. This 500-plus-page tome may change that. Written for a general audience, it covers a wide range of issues, including those on which he has published professionally and those on which he has not but still has much to say. The topics include the effects of free trade, French unemployment, the role of the state, financial bubbles, the Greek economic crisis, and regulation of industries.

It’s hard to generalize about Tirole’s views. On the one hand, he understands the powerful role of incentives, understands why free trade is good for a country, thinks through the unintended consequences of legislation and regulation, and understands that the political system is filled with perverse incentives. On the other hand, he favors some highly intrusive regulations in the labor market, has too much confidence in the ability of economists and governments to improve on free markets, misunderstands how to judge the tightness or looseness of monetary policy, mistates the nature of externalities, and doesn’t seem to understand adverse selection in insurance markets.

**Value of markets** / To illustrate how thinking about incentives and unintended consequences can help inform good policy, Tirole considers a hypothetical case in which a nongovernmental organization (NGO) “confiscates ivory from traffickers who kill endangered elephants for their tusks.” The NGO can either destroy the ivory or sell it. Tirole points out that most people would advocate destroying the ivory. But he urges the reader to think further. Destroying the ivory means that the supply of ivory is lower than otherwise, making the price higher than otherwise. How does a higher price affect the incentives of poachers? That’s right: it encourages them to kill more elephants. Another example, which many economics professors use in class, is the perverse effects of price ceilings. Not only do they cause shortages, but also, as a result of these shortages, people line up to purchase the scarce provisions and thus waste time in queues. The time spent in queues wipes out the financial gain to consumers from the lower price, while also hurting the suppliers. No one wins and wealth is destroyed.

Tiroe, like most economists, is strongly pro–free market. He argues that French consumers gain from freer trade in two ways: it exposes French monopolies and oligopolies to competition; and goods imported from low-wage countries are cheaper. On the former, Tirole notes, “Renault and Peugeot-Citroen sharply increased their efficiency” in response to car imports from Japan. He estimates that the monthly gain from free trade per French household is between $1,400 to $4,200.

Incidentally, when economists refer to economics as “the dismal science,” they almost always get the origin of that term wrong. Tirole gets it right. He explains that Thomas Carlyle, in an 1849 publication calling for bringing back slavery, called economics the dismal science because the economists of the time strongly opposed slavery. The economists who dominated in 1849, although Tirole doesn’t mention this, were strongly pro–free market.

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Economists, including Tirole, have been very critical of the French government’s labor policies. Their regulations make it hard for employers to fire people, and this makes employers less likely to hire people in the first place. The result: unemployment in France has not fallen below 7% at any time in the last 30 years. This especially affects young people: the unemployment rate for 15–24 years old was a whopping 24% at the time Tirole wrote this book. Their employment rate—the percent of those in the age group who had jobs—was a dismal 28.6%, compared to the OECD average of 39.6%, Germany’s 46.8%, and the Netherlands’ 62.3%.

To solve this problem, Tirole advocates grandfathering job protection for current employees but getting rid of the regulations that protect newly hired workers from being fired. But he doesn’t stop there. He argues that because employees “are not responsible for and have no control over technological change or demand shocks faced by their employers,” they must “be insured against the risk that their jobs might become obsolete or simply unprofitable.” So he wants to maintain the current unemployment insurance system.

Nowhere in the relevant chapter does he suggest reducing France’s duration of unemployment benefits, which is now two years for people under age 50 and three years for people over age 50.

Tirole recognizes that the current system gives the employer an incentive to officially “fire” an employee who actually quits. The employee gains and the employer loses nothing by firing. His solution is to charge employers who fire employees an amount reflecting the cost that the unemployment insurance system imposes on French taxpayers. This would probably work better than the current system, but it is awfully intrusive compared to, say, reducing both the amount and duration of unemployment benefits.

**Government intervention** / Throughout the book, Tirole shows his understanding of basic public choice. He tells of a 1999 report by French economist Jean-Jacques Laffont to an audience of “senior officials, academics, and politicians” discussing the need to reduce obstacles to youth employment. The reaction was negative. One critic claimed that Laffont was likely to corrupt French youth. And what had Laffont said? Writes Tirole, “Politicians and officials respond to the incentives they face” and “the way government is organized should take this reality into account.”

Unfortunately, he himself fails to follow through consistently on this understanding. In the chapter on finance, he writes, “The role of the economist is to help mitigate market failures.” One can accept that there is one role of economists, but is it the role? To say so is to set up economists as critics of markets and not as critics of government policies. Fortunately, even though he says that is the role of economists, he shows in much of the rest of the book that he is also a critic of government intervention.

One type of market failure that most economists recognize is externalities. At one point, though, Tirole finds an externality where there isn’t one. He considers a bank that holds a risky asset whose value falls. When that happens, the bank’s shareholders lose, the bank’s creditors lose, and “perhaps also its employees and borrowers” lose. All potentially true. Then he writes, “This is a negative externality affecting all the stakeholders.” But consider all these “stakeholders.” First, shareholders suffer, but they invested in the bank knowing that there was a risk. Creditors may suffer, but they lent to the bank knowing that there was a risk. Employees may suffer, but they knew there was a risk when they decided to work for the bank. As for borrowers, divide them into current borrowers and potential future borrowers. Current borrowers may suffer if the bank calls their loans, but they knew that was a risk when they borrowed. Future potential borrowers may find themselves unable to borrow from the bank in the future if it’s in bad enough shape, but is it really an externality when a bank’s decisions limit its business with future customers?

Tirole does add, “Moreover, the bank might be able to continue borrowing despite the risk, if lenders think the government will bail out the bank if it gets into difficulties.” This is the problem and the government creates the externality. But the “Moreover” is misplaced. The government here is the sole source of the externality.

**Finance** / In his discussion of last decade’s financial crisis, Tirole puts part of the blame on monetary policy for creating a real estate boom. He gets it wrong, though, claiming that monetary policy led to abnormally low interest rates. Monetary policy cannot keep interest rates low for long unless it is geared toward creating low inflation or even deflation, thus reducing nominal interest rates by reducing expected inflation. The cause of the low interest rates—as former Federal Reserve chairman Ben Bernanke recognized and as Jeffrey Hummel and I described in “Greenspan’s Monetary Policy in Retrospect” (Cato Policy Report, November 2008)—was a surge of saving by Asian countries and elsewhere, resulting in more money available for lending and investment. Monetary policy did affect the financial crisis in the United States, but by not being loose enough. As Hummel wrote in “Explanation versus Prescription” (Cato Unbound, Sept. 21, 2009):

Beginning with the Fed’s creation of the Term Auction Facility in December 2007, nearly every dollar that Bernanke injected into financial institutions was sterilized with the withdrawal of dollars through the sale of Treasury securities. Not until September 17, 2008, did a panicked Fed finally set off a monetary explosion, doubling the base in less than four months.
In various places in the book, Tirole discusses financial bubbles. There is a question, even after the fact, about whether a bubble did in fact occur: was it a bubble, or did some subtle change in fundamentals lead to a reduction in value? Even if one grants after the fact that, yes, it was a bubble, can one identify a bubble in advance? That’s what really matters.

To his credit, Tirole doesn’t seem confident that one can. He does cite 2013 Nobel Prize winner Robert Shiller, who claimed before the fact that the real estate market was in a bubble. But he doesn’t point out that Shiller claimed that stock prices were in a bubble in 2000, when the Dow-Jones Index stood just below 12,000. It is now above 22,000. And that understates the gain from holding stocks because many holders reinvest the dividends. Had I sold my stocks in response to Shiller’s 2000 warning, I would be a much poorer man.

Tirole also mistakenly labels paintings by Picasso and Chagall as bubbles. The aesthetic value, he argues, “could be replicated for a few thousand dollars using modern technology,” which he believes shows the originals are overpriced. His claim ignores a basic fact from economics: values are subjective. By their willingness to pay millions for the original painting, people show that they do, indeed, value it highly. They would not value a copy as much.

**Industrial organization**/ Much of Tirole’s research is in the economics of industrial organization, and in his chapters on related topics he shows much insight. In writing about industrial policy, for example, he questions whether small and medium-sized enterprises need any special treatment from government and, instead, suggests removing obstacles that governments put in their way. He points out that when a French firm moves from 49 to 50 employees, it faces 34 additional legal obligations. Sure enough, in a chart in his book showing the number of enterprises with various numbers of employees, a spike occurs at 47 to 49 employees, and then the number of firms with 50 to 69 employees is much lower.

**Risk**/ In his discussion of insurance, Tirole displays a misunderstanding of adverse selection. Adverse selection occurs when insurers are not able to distinguish between degrees of risk and, therefore, don’t set premiums based on risk. When people buying insurance know their own risk better than the insurance company does, a large percentage of low-risk people find the insurance unattractive, while a large percentage of high-risk people find it attractive. The result: the selection of buyers is adverse to the insurance company. The straightforward solution is for insurance companies to reduce the asymmetry by getting more information about potential customers and then pricing accordingly. But, writes Tirole, “Information kills insurance,” meaning that costs won’t be borne equally by a large insurance pool of customers with different risk levels. But this doesn’t kill insurance; what does is government requirements that insurance companies not be allowed to price for risk.

Tirole also seems not to understand insurance pricing. He writes, “I can get a policy specifying a reasonable premium to insure my house because the chances that my house will burn down are about the same as the chances that your house will burn down.” He would be surprised if he saw the high premium I pay for insuring my Canadian cottage, whose structure is worth over $100,000, compared to the much lower premium I pay on my California house, whose structure is worth over three times as much. Clearly, those probabilities are not the same. One bad forest fire would wipe out my cottage; a forest fire near my California house is much less likely and, even if it occurred, is far less likely to do damage.

All of the discussion above is about Tirole’s thinking on economic analysis. What about his views on freedom? I’ll end with a hopeful note. While he is no libertarian, he does have a pro-freedom streak. He opposes the condemnation of behavior “that has no identifiable victim.” Presumably his opposition to condemnation would lead him to oppose government regulation of that behavior. It seems from context that he does.
Corporate Investment


Criticism of U.S. corporations for focusing on short-rather than long-term investment returns dates back to at least 1980 when Harvard Business School faculty members Robert Hayes and William Abernathy wrote in a landmark article, “By their preference for servicing existing markets rather than creating new ones and by their devotion to short-term returns and management by the numbers, many of them have effectively forsworn long-term technological superiority as a competitive weapon” (“Managing Our Way to Economic Decline, Harvard Business Review 58 (July–August): 67–77). In this paper, Steven Kaplan marshals evidence that, in recent decades, firms generally have not fallen prey to corporate short-termism. First, corporate profits as a percentage of gross domestic product are near all-time highs and have been rising for the last 30 years, suggesting they are doing well at exploiting market opportunities. Second, if existing companies underinvest, then venture capital (VC) investors would fill the gap and be very profitable. But VC as a percentage of the total stock market has fluctuated in a relatively narrow range of 0.1 to 0.2% over time. VC returns are a bit above general stock market returns, but not by much. Private equity funds have a similar record, with a little blip for the internet boom of the late 1990s. That performance suggests firms are not passing up on promising investment opportunities.

Kaplan concludes with other stylized facts that are also inconsistent with the short-termism argument. The internet stock boom of the late 1990s was based on high long-term expected cash flows, which of course did not occur, but the dot-com investors were long-term oriented. Companies are increasingly less profitable at the time of their initial public offering. Amazon and Tesla have high values but no profits (in the case of Amazon, until recently), facts not consistent with short-termism. Some 180 biotech companies went public between 2013 and 2016, and only 4% were profitable. Finally, hydraulic fracturing technology to tap into natural gas reserves—fracking—was developed over recent decades despite long periods of negative cash flows.

—Peter Van Doren

Health Insurance


Economists have long argued that traditional rate-of-return public utility regulation reduces the incentives of regulated firms to control costs. If a firm earns a guaranteed rate of return on capital investment, then the firm will be inclined to overinvest in capital because it is protected from downside risk.

In this paper, Steve Cicala and colleagues argue that the same logic applies to a provision of the Affordable Care Act. The act requires health insurers in the “fully insured” market (those insurers who bear financial risk rather than just administer claims for large self-insured employers) to spend 80% of their premium income on medical care and mandates rebates to consumers ex post if this does not occur. This provision was added to the law by consumer advocates and their political supporters who argued that some insurers retain too much premium income, make too much profit, and are stingy in approving coverage of medically necessary procedures.

Much like traditional rate-of-return regulation, this rule creates incentives for insurers to spend more on medical care rather than to reduce premiums. The paper estimates a difference-in-differences model in which firms that spend less than 80% of their premiums on medical expenditures are compared with firms that are in compliance with the rule. In the year before the rule was implemented, 52% of consumers in the individual market were in plans that spent less than 80% of premiums on medical expenditures and thus would not have been in compliance.

The paper concludes that the average effect of the rule on treated firms (those that previously had been spending less than 80% of premiums on medical claims) was to increase their medical expenditure outlays by about 7%. There was no reduction in premiums.

—PV.

Environmental Regulation


Between 1990 and 2000, the real value of U.S. manufacturing output grew by a third while emissions of the six regulated air pollutants (carbon monoxide, nitrous oxide, particulate matter, fine particulate matter, sulfur dioxide, and volatile organic compounds) fell by 35%. From 1990 to 2008, those emissions fell by 60%. Why did this occur?

Three possible explanations have been offered. The first is trade, i.e., the United States offshored pollution-intensive industries, while U.S.-based industry shifted toward less polluting products. The second is improvements in productivity that expand output while reducing the use of polluting manufacturing inputs such as fossil fuels. The third is environmental regulation. The paper concludes that almost all of the reduction in emissions over time stems from changes in emission intensity within very narrowly defined manufacturing products. And that reduction, in turn, was not the result of trade-induced composition change nor productivity improvements. Instead, stricter environmental regulation resulted in the reduction of emissions.

—PV.
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Employment Effects of the ACA


Health insurance coverage under the Affordable Care Act increased by 4.2 percentage points in states that expanded Medicaid and 2.6 percentage points in states that did not in the first two years of the ACA’s coverage mandate (2014–2015). For households with incomes between 100% and 400% of the federal poverty level, subsidies were available if the households purchased coverage from the health insurance exchanges created by the ACA. Many economists, including those from the Congressional Budget Office, predicted that because those subsidies depended on household income rather than individual wages, second earners in households would reduce their labor market participation to allow their households to qualify.

The authors of this paper found no change in the level or trend of aggregate labor market participation after the ACA. But this aggregate result was the product of two offsetting trends. There was an increase in labor market participation in areas of the country in which the share of people who were uninsured and earning under the poverty line was larger and a reduction in labor force participation in areas in which the share of people who were uninsured and earning between 139% and 399% of the poverty line was larger. “These changes suggest that middle-income individuals reduced their labor supply due to the additional tax on earnings while lower income individuals worked more in order to qualify for private insurance,” the authors conclude. “In the aggregate, these countervailing effects approximately balance.” —PV.

Minimum Wage


I summarized some of the recent papers on the effects of minimum wage increases in the “Working Papers” section of the Fall 2015 issue and Ryan Bourne continues that discussion in this issue (“A Seattle Game-Changer,” p. 8). An important component of those discussions was a paper by Jonathan Meer and Jeremy West. They argue that changes in minimum wages do not cause an abrupt change in employment levels, but instead employers respond by slowing their future hiring and hiring higher-skilled workers, thereby reducing overall employment growth.

This paper analyses data on over 2 million hourly employees from over 300 firms for the years 2010-2015. It uses a difference-in-differences regression to compare six states that implemented a large (at least $7.50 per hour) increase in their minimum wage (California, Massachusetts, Michigan, Nebraska, South Dakota, and West Virginia) with states that didn’t pass such an increase.

For the treatment group of states, the fraction of employees earning less than $10 an hour declined 0.7% in the year following the minimum wage increase. But the fraction of workers making $10–$15 an hour increased. The overall result was that total employment didn’t really change. This is consistent with Meer and West in that the effect occurs in the form of slower hiring of the least-skilled rather than termination of existing employees because firing is costly.

—PV.

Airbnb and Housing Prices


Airbnb has reduced dramatically the transaction costs of renting housing on a short-term basis. Some critics have argued that this has reduced the supply of housing available for long-term renters, thus exacerbating the housing affordability problem in major American cities.

In this paper, data on Airbnb listings from 2012 through 2016 at the ZIP code level are regressed on Zillow housing price and rental price information. Fixed effects for ZIP code and city-level time trends are included. The authors control for time-varying factors by ZIP code with a variable that measures Google searches for Airbnb at the ZIP code level interacted with number of restaurants and hotels in a ZIP code reflecting underlying tourist demand. The expectation is that landlords in more “touristy” areas will be the most likely to convert long-term rentals to Airbnb and reduce long-term rental supply and increase the rents of remaining housing.

The authors find that a 10% increase in Airbnb listings increases housing prices by 0.65% and rents by 0.38%. The annual rent increase in their data was 2.2% and the average ZIP code experienced a 6.5% annual increase in Airbnb listings. Thus from 2012 through 2016, only 0.25% of the 2.2% increase in annual rent was explained by Airbnb. The Airbnb effect is not zero, but it is small.

Soda Taxes


The tax on soda in Mexico has been hailed as reducing consumption with likely long-term health benefits. The Mexican soda tax is large (9% of pretax average prices). Estimates of the reduction in consumption assume that the tax is passed through to prices and that consumers react to prices only by reducing the amount consumed using the standard (elasticity) estimates of −1 to −1.3. That is, a 1% increase in the price results in a 1% to 1.3% decrease in consumption.

But another response of consumers to a price increase is to
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change to a cheaper soda brand and keep the quantity consumed constant. For example, before the tax, Coca Cola was priced 15% above Pepsi. After the tax, the Coke price is still 10.8% higher. Thus a consumer could respond to the tax by reducing Coke consumption or simply switching to Pepsi. The authors’ estimate of the true elasticity for soda consumption adjusted for the substitution of cheaper brands is much smaller (–0.2 to –0.3).

According to survey data, average soda prices increased 11.9% between 2012 and 2014. But the average price of purchased soda increased by half that rate, suggesting that consumers purchased lower-priced soda. When the corrected elasticities are used, the 2–4 pounds-per-person predicted weight loss advanced by some academic papers becomes less than a pound.

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**Mortgages and the Financial Crisis**


The conventional explanation of last decade’s financial crisis is that credit growth from 2001 to 2006 was concentrated in the subprime segment of the housing market even though there was no aggregate income growth in that group. This unwise allocation of credit to people with poor probabilities of repayment was exacerbated by the Great Recession. The subprime holders of mortgages disproportionately lost their jobs and couldn’t maintain their house payments, according to this theory. The most prominent citation for this view is a 2009 paper by Atif Mian and Amir Sufi (“The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis,” Quarterly Journal of Economics 124[4]).

This paper argues that Mian and Sufi’s finding is the result of their decision to estimate borrowers’ credit status by using a 1996 ranking of ZIP codes by the fraction of residents below 660 credit score, along with their 1997 individual credit score. Low subprime scores are found disproportionately among young people with thin or nonexistent credit histories. Credit scores grow normally as people age and demonstrate success with paying bills on time. The research design used by Mian and Sufi conflates the normal life cycle growth in credit to those who were young before the boom with poor credit worthiness during the boom.

To avoid that problem, this paper uses individual-level credit scores calculated shortly before mortgage borrowing occurred rather than in 1996 or 1997. The more time-appropriate credit scores revealed that defaults among borrowers with low scores actually decreased during the Great Recession. The fraction of mortgage delinquencies accounted for by the lowest quartile of credit scores dropped from the normal 40% to 30% and the fraction of foreclosures from 70% to 35%.

Instead of credit growth to sketchy borrowers, this paper highlights the role of credit growth to “investors,” defined as those who hold two or more first mortgages. From 2004 to 2007, the share of mortgage balances held by investors in the middle quartiles of the credit score distribution rose from 20% to 35%. For investors, foreclosure rates did increase four-fold for the lowest quartile credit scores, but it increased 10-fold for the other three quartiles. The fraction of “investors” (those with more than one first mortgage) who became delinquent grew 30 percentage points for the lowest three quartiles and by 10 percentage points in the top quartile. For people with just one first mortgage, the foreclosure rate doubled in the lowest two quartiles and barely changed for the highest two quartiles.

The paper reproduces the Mian and Sufi ranking of ZIP codes by the fraction of subprime borrowers in 1999 and finds their result. Borrowers who resided in the top quartile of (subprime) ZIP codes in 1999 exhibited larger growth in per-capita mortgage balances. But the individual borrowers living in those “subprime” ZIP codes who were responsible for most of the credit growth actually were prime borrowers. This result reinforces the rule to avoid making inferences about individuals based on characteristics of aggregations.

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**Retirement Income and Expenses**


The “retirement funding gap”—the deficit between the amount of money needed to provide for future seniors in retirement and the public and private money actually set aside for them—is the source of considerable angst in the policy world. But not all analyses of this gap are gloomy. While many say this number is large and growing, Andrew Biggs, a senior fellow at the American Enterprise Institute, contends in a September 2017 paper for the Mercatus Center that the number of seniors in poverty who failed to save sufficiently for retirement has been greatly exaggerated. Penn Wharton Public Policy Initiative scholar Jagadeesh Gokhale has noted that the living standards for seniors are generally higher than the rest of society.

A central question in this literature is how much income do retirees need in order to maintain their standard of living. We know the answer is less than 100% of their employment income: when people stop working they no longer have commuting costs, they don’t need to buy work clothes, and they no longer have to eat their lunches out. What’s more, a significant proportion of retirees have finished paying off their homes, leaving them with one less expense to worry about. However, they do have higher health care...
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costs, and these costs tend to increase as they age. What’s more, about one in four people will spend significant time in a nursing home at some point in life, an expense that can be potentially ruinous to a family’s wealth. In a 2015 paper for the Employee Benefit Research Institute (EBRI), research associate Sudipto Banerjee attempts to determine how people’s spending changes after retirement. He uses data from the Health and Retirement Study (HRS) and the Consumption and Activities Mail Survey—a supplement of the HRS—to estimate patterns in retiree spending. His top-line finding is—as we expect and as is consistent with other research—that spending declines as age increases. In these data sets, annual spending fell 19% between ages 65 and 75, and 34% between ages 65 and 85. However, the decline slows over the latter part of that age range, and then begins increasing around age 85.

Banerjee offers a few explanations for this pattern. Concerning the decrease in spending, one contributor is a decline in the number of people in a retiree-headed household. When a spouse dies or divorces and leaves the household, spending falls. A small but growing proportion of retiree-headed households will also have children at home at the beginning of this span; their subsequent departure contributes to the decline in spending. However, there is a large fixed component to household spending that’s independent of the size of the household. Concerning the late-life rise in spending, it correlates with an increase in out-of-pocket medical spending and is concentrated at the top of the income distribution.

The survey breaks down consumption into seven spending categories: home, food, health, transportation, clothing, entertainment, and “other,” which includes charitable contributions and gifts. From these data Banerjee makes three broad observations. First, there is a large variation in spending across the country. Consumption is much lower in the South, for instance, than in the wealthier northeast. But on average, spending drops 5.5% in the first two years of retirement and continues to fall in the following years.

Second, housing comprises the largest component of total spending for households, even in retirement. Banerjee notes that households that pay off their mortgage do not necessarily see an immediate reduction in home spending; a common strategy is to channel payments that had gone to a mortgage into various home improvements such as a new furnace, new furniture, and the like.

Third, health expenses increase for senior citizens, although the rate of increase varies quite a bit across the country. Health care spending increases are much higher in the urban Northeast than in the South, a difference that may be driven by the relative shares of the population on Medicaid. On the other hand, transportation costs go down quite a bit as people retire, regardless of the locale.

Banerjee uses these data to offer a richer picture of spending in retirement. One realization: while the permanent income hypothesis (a manifestation of consumer rationality) would suggest that we should strive to keep our spending as constant as possible over our lifetime, the reality is that for most households consumption falls when we retire and our incomes fall, which implicitly repudiates the permanent income hypothesis.

This is not necessarily a troubling phenomenon. In retirement, our expenses fall and our potential leisure time increases, so we substitute more home production for buying things (like meals) from the market. Besides, some people do not reduce their spending when they reach age 65: fully 45% of all households see their spending increase immediately following retirement, and one-third of all households report higher spending five to six years after retirement. This increase is relatively even across the income distribution, suggesting that the increase is attributable to health issues.

These numbers raise the question of how much money people need for medical expenses in retirement. Investment firm Fidelity suggests at least $275,000, excluding long-term care costs. EBRI estimates that savings of $127,000 for a man and $143,000 for a woman would give a retiree a 90% chance of covering all health care expenses in retirement. For context, Banerjee reports that 46% of all senior citizens have had at least one overnight nursing home stay. On the other hand, only 23% of retirees had an out-of-pocket nursing home expense; in other words, half of all people who do have a nursing home stay manage to get out of the home before their 90 days of Medicare nursing home payments ran out.

Banerjee suggest that for a sizeable fraction of the elderly there is a real possibility that an extended stay at a retirement home or convalescent center could be financially calamitous without any long-term care insurance. He avoids making recommendations but one leaps from his pages: we should worry less about retiree income and more about health care costs.

One reason we shouldn’t worry so much about retiree income is that more retirees could make use of reverse mortgages, as Mark Warshawsky explains in a Mercatus working paper. Warshawsky, who earlier this year became the assistant commissioner for retirement and disability policy at the Social Security Administration, joins Gokhale and Biggs in believing that concerns over seniors running out of money in retirement are overstated. Previous research Warshawsky did with Gaobo Pang found a shortfall greater than Biggs, but still one smaller than what is generally assumed.

Warshawsky observes that analysts and the public often overlook the value of retirees’ houses when considering those retirees’ economic resources. This makes little sense because of the large amount of equity that seniors typically have in their houses, and because homeowners can use reverse mortgages to tap this wealth while remaining in their homes. He suggests that, like annuities, reverse mortgages are wrongly considered to be bad deals for homeowners. In this paper, he essentially investigates the broadest possible use of this product under some reasonable assumptions. Specifically he has in mind a Home Equity Conversion Mortgage (HECM) loan, which is both issued and insured by the federal government. He would like for the government to allow it to be marketed by the private sector, which he believes would greatly boost its popularity.

HECM became a federal program in the late 1980s. While few people availed themselves of it in the 1990s, it took off at the end
of the decade. There was no underwriting at first because the intrinsic value of the house made underwriting seem unnecessary, and the Federal Housing Administration did not worry about defaults. As a result, the federal government did take losses. The defaults caused some of the large banks, worried about their reputation, to stop offering the product.

HECMs are available only to seniors over age 62. They can get a lump sum, line of credit, or a monthly income flow, and they cannot borrow more than $640,000 or the value of their home, whichever is less. These are non-recourse loans; borrowers never pay back more than the value of the home when it is sold. They do not have to pay until the surviving spouse dies or moves out of the house.

HECMs are complicated, and the FHA requires counseling (at a cost of $150) prior to any purchase. The interest rate is LIBOR plus a 2.5% lender’s margin. Despite its complexity there is a market for this, Warshawsky has determined. There are 37 million households led by people over age 62, and 80% of them own homes. Just 2% of them have a reverse mortgage. Normally, Warshawsky notes in the paper, people are limited to withdrawing just half of the equity in a house with a reverse mortgage, which minimizes the risk of the lender not getting fully paid back after death.

If we exclude people in the bottom 30% of the wealth distribution, those with a home value under $100,000 (for whom the transaction costs would be too great to make a reverse mortgage worthwhile), and those in the top 20% of the wealth distribution (who won’t need such a product and would benefit more from a life annuity), we are left with approximately 14% of the population of seniors who could potentially benefit from an HECM.

So why aren’t many of these seniors using HECMs? Warshawsky notes that a reverse mortgage is relatively expensive, but there are other forces at work. Jonathan Skinner, a Dartmouth economist, says people consider their homes to be a wealth stock of last resort and are loath to touch home equity except in an emergency. And, of course, people have a bequest motive.

Thomas Davidoff at the University of British Columbia hits upon something else at play in this decision, noting that the ability of the elderly to use their home equity explains why there’s so little demand for long-term-care insurance. Warshawsky’s solution is to tighten up Medicaid eligibility rules for nursing home coverage, which would force more people to buy long-term-care insurance. Freed of that obligation, more seniors would see the advantage of tapping their home equity.

Warshawsky’s message is that the home is a valuable asset for many people and that more of them should tap some of its equity, and we should make it easier and less costly to do so. If we were to achieve that by spurring more families to buy long-term-care insurance, thereby lessening the burden on Medicaid, that would be a win–win outcome.

—Ike Brannon