IN REVIEW

Education as an Emergent Phenomenon

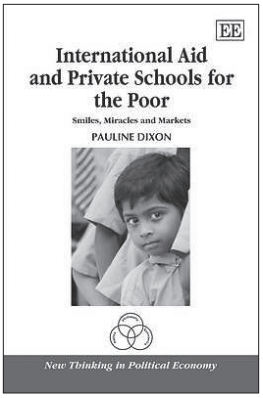
REVIEW BY ART CARDEN

How do we make poor people rich? If you ask many Western humanitarians, you might get answers ranging from direct relief ("give them food") to ideas for development-oriented projects that become the stuff of specific development projects, holiday-season humanitarian appeals, church mission trips, and "alternative spring breaks" for college students. Dig wells. Buy them water filters, sewing machines, or goats. Build schools.

There might be merit to a lot of those proposals, but I think we need to look beyond our good intentions and see the world's poor people not as an abstract lump of benighted and poverty-stricken humanity, but as people with minds, with goals, and with capabilities. Indeed, we need to see them as people who act, rather than people who are acted upon.

This is the approach taken by Newcastle University senior lecturer Pauline Dixon in her new book, *International Aid and Private Schools for the Poor*. In it, Dixon argues that, around the world, low-cost private schools are succeeding in very poor areas where governments are failing. She quotes Milton Friedman, noting that it is a "gratuitous insult" to the poor to think that we can know better than they do how to educate their children. The book shows us how poor people are providing low-cost, private alternatives to government education—and low-cost alternatives that do as well as or better than the government on many margins.

Dixon's book is a refreshing and inspiring contribution to the debate over how to help the least of these among us. She writes: "The accepted wisdom is that the poor need free government schools to educate them. This accepted wisdom is misguided." It's appropriate that this book is part of the Edward Elgar series "New Thinking in Political Economy" and featuring an insignia of a Venn diagram intersecting politics, philosophy, and economics. It would also be appropriate if it showed someone shooting a sacred cow because there are few cows as sacred to what the economist Daniel Klein calls "the people's romance" between polities and states as government-financed, free-and-compulsory education. That education is the government's job is an article of faith among many. Dixon breathes new life into the case for market-provided education, particularly in very poor countries.



International Aid and Private Schools for the Poor: Smiles, Miracles, and Markets

By Pauline Dixon

208 pages; Edward Elgar Publishing, 2013

Government and schooling / Throughout the book, Dixon shows that private schools generally beat government-run schools at their own game: they provide better facilities and their students do better when all is said and done. She begins with a brief review of the literature on development aid that will likely be familiar to readers of *Regulation*. Put simply, it doesn't work. She moves on to a brief history of British imperial adventures in India and what that meant for Indian schools. The results were not good, and they have so far left indigenous entrepreneurs and caring parents to pick up the pieces left by reformers with good (and in some cases, not-so-good) intentions.

In addition to surveying the empirical literature on low-cost private schools, Dixon brings the reader up to speed on the history of government involvement in schooling. She works at the E. G. West Centre at the University of Newcastle, so it is appropriate that she discusses West's path-breaking work on the role of government in education. The conventional wisdom is that people were wallowing in ignorance and poverty before enlightened governments stepped in and provided them with schooling. This wasn't the case. Summarizing West's work, Dixon notes that near-universal literacy preceded government involvement in education, and she notes that West's explanation for the expansion of state control of education was due to concerns about what the "lower orders" were reading: "What West believed the English government wanted to do was to prevent the spread of political literature among the poor." She continues, "To stifle the reading of such potentially damaging publications, public reading rooms were closed down and licenses withdrawn from coffee houses, public houses, and inns where certain newspapers were received and read."

I suspect that an enthusiast for government schooling will claim that this just illustrates how desperately underfunded schools are in India and other poor countries. This brings us to a running theme in Dixon's book: enthusiasm for govern-

ART CARDEN is an assistant professor of economics at Samford University in Birmingham, Ala., a senior research fellow with the Institute for Faith, Work, and Economics, a research fellow with the Independent Institute, and a senior fellow with the Beacon Center of Tennessee.

ment-run schools in poor countries is likely the product of an ideological conviction as much as or more than it is the product of carefully done empirical assessment. Schooling is either something governments should do for moral reasons, or government schooling is a good idea based on incomplete understandings of what economists mean when they talk about public goods and externalities. Schooling may generate positive spillovers, but as James Buchanan and William Stubblebine argued many years ago, it isn't clear that these spillovers matter at the margin. If there are spillovers to basic numeracy and literacy, which might be acquired by eighth grade, and everyone is schooled through at least 10th grade, then the spillovers are already reflected in the amount of education people receive.

This helps us understand why government schools can be so bad. In the tradition of "New Thinking in Politics, Philosophy, and Economics" that follows the work of James Buchanan, Dixon also explores how government provision leads to dysfunctional incentives in very poor countries. Centrally planned schooling will be limited in its efficacy by the dysfunctional incentives and by the knowledge problem. First, compensation for the teachers in these schools is not linked to performance and the schools are likely run for the benefit of politically powerful and influential labor unions. Second, Dixon discusses how Indian schooling can be evaluated on the basis of inputs. A "good school," from this perspective, or one worthy of a government license, is one that has the right playground equipment and approved technology in the classroom. It is conceivable that these inputs will lead to better educational outcomes, but detailed regulation of educational inputs ties the hands of potential innovators and entrepreneurs.

At its heart, Dixon's study is a study of pathological institutions and their role in preventing economic development. Unfortunately, development experts and practitioners have come to view institutions the way they used to view physical capital and human capital: as yet another treatment that can be applied to countries in the same way that doctors prescribe medicine. (Deirdre McCloskey made this point in a roundtable discussion of her work.) To use another metaphor, they are asking which switches to throw and which buttons to push in order to get development.

Clearing the way / For a long time, economists have indulged them by saying, at various points, that more capital or more human capital or better institutions would do the trick. The problem, though, as is evident from F. A. Hayek's work, is that there may not be any buttons to push or switches to throw. It may be that we are groping and hulking about blindly in a cavern looking for a light switch that isn't there and all the while getting in the way of poor people who are working to start their own fires and light their own ways. Dixon quotes C. K. Prahalad's excellent *The Fortune at the Bottom of the Pyramid*: "If we stop thinking of the poor as victims or as broken and start recognizing them as resilient and creative entrepreneurs and value-conscious consumers, a whole new world of opportunity will open up." This, perhaps, might be the best advice for those of us interested in alleviating the plight of the world's poor. *R*

The Fruits of Gridlock

REVIEW BY IKE BRANNON

Innovations spread through an economy in complicated ways, especially when we look beyond the private sector. For instance, economists have noted that the surprisingly slow adoption of leading-edge medical practices across the United States mirrors the glacially slow propagation of hybrid crop seeds a half-century ago.

In this new book, Brookings Institution researchers Bruce Katz and Jennifer Bradley celebrate American metropolitan leaders of the last decade whom they consider forward-thinking and innovative politicians. To a degree, it's hard to argue with their choices. For instance, they laud both Rudy Giuliani and Michael Bloomberg, which seems appropriate given the remarkable transformation of New York City in the last 20 years, with crime rates down by over two-thirds, public schools improving after hitting rock bottom, and tangible improvements in transportation. Along with various other developments, these efforts add up to a greatly increased quality of life in the city, and the government helped to achieve that. It's hard to look at today's New York City and not give Giuliani and Bloomberg some credit for these changes, concluding that effective government can make a difference.

But not all metropolitan areas have been as innovative and successful as New York City, and some of the innovations trumpeted by Katz and Bradley may not work elsewhere—or even in New York. For instance, in the last two years the city held a competition among several universities to award the winner a sizeable parcel of land on Roosevelt Island, along with $100 million in infrastructure support, in return for the winner using the parcel to establish an innovative applied sciences campus in the city. Cornell won the contest, thanks in part to an alumnus coughing up $100 million in project support to push them over the top. Bradley and Katz trumpet this investment as laying the groundwork for a new high-tech era in the New York economy, with the promise of helping the city insulate itself from its dependence on the finance industry for jobs and tax revenues.

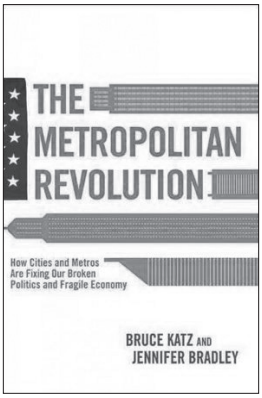
More engineering students are probably a good thing for society. And employing

IKE BRANNON is a senior fellow with the George W. Bush Institute and president of Capital Policy Analytics, a consulting firm based in Washington, D.C.

an underused parcel of land to get an Ivy League school to make a major investment in the city is probably a far superior use of that resource than the usual things that cities do with land. But New York's future as a science hub is far from a sure thing: while young computer programmers and electrical engineers may like living in Brooklyn, expecting that some sort of economies of agglomeration will develop because of this investment is dicey.

New York's supremacy owes itself to many things, and it has re-invented itself myriad times. These days, finance drives the city's economy, although it is not impossible to envision a world where Wall Street plays a much smaller role in the global economy—or even New York's economy—than today. Regulatory overreach, greater global competition shrinking finance's outsized profits, or technology lessening the need for central financial districts could all shrink Wall Street's footprint. The city's desire to diversify away from finance is laudable, but chasing the sexy geek jobs every other big city desires may not work, especially when the city has no comparative advantage other than being a hip locale.

But being a place where people want to live is nothing to sneeze at. In fact, improving a community's livability is probably the best thing a mayor or city council can do to attract jobs. Entrepreneurs also like living in places with good schools, low taxes, and clean streets. In the long run, the Brooklyn brand as a hip, fun place to live and work will lead to more jobs created in New York than Cornell's tech campus. Government isn't very good at knowing what sorts of jobs those will be, and is even worse at influencing what sorts of jobs those will be.



The Metropolitan Revolution: How Cities and Metros Are Fixing Our Broken Politics and Fragile Economy

By Bruce Katz and Jennifer Bradley

300 pages; Brookings Focus Press, 2013

'Investment' going awry / Governments that spend money to attract or retain new businesses have myriad motivations for doing so, some noble and some more base. And even the most noble of intentions can result in the state wasting taxpayer money.

When I was an economics professor in Wisconsin, I wrote an article for a Milwaukee newspaper criticizing the state's penchant for using tax breaks and subsidies to entice new businesses to enter the state or (more commonly) encourage businesses already in the state to remain. It was a fool's game, I argued, thinking that politicians know how to allocate scarce capital in a way that produces anything close to an economically optimal result.

A couple days later the governor's office invited me to a meeting in Madison with some of the governor's staff and a few economists from Madison to talk about the state's economy. The purpose of the meeting, it turned out, was to tell me to shut up. The various economic Pooh-Bahs informed me that they knew quite well how to allocate government money and the only reason that some of the state's investments failed was that the data they used to make their decisions were incorrect or incomplete. The governor and his team of economists were on their way to making the Madison–Milwaukee corridor a biotech hub—or maybe an engineering hub, they hadn't yet made up their mind—by thoughtfully allocating various tax breaks and subsidies, or so they told me.

But the reality was that most of the state's "investments" went to large manufacturing concerns already in the state, ostensibly to entice them to remain, although many of them had no real intention of going anywhere. That occurred because short-term political exigencies and cronyism invariably outweigh any long-term investment plans made by any government.

In the late 1990s, state and local governments in Wisconsin financed a new baseball stadium and a renovated football stadium for teams that had no real options to move. It handed tax breaks to Miller Brewing Company and Midwest Airlines, both of which were subsequently purchased and moved elsewhere, along with a soon-to-close Chrysler factory and any other entity employing enough blue collar workers earning union wages. Yet the state received no discernible returns on its spending.

Moreover, Wisconsin never had much of a chance to be anything like a hub for biotech or information technology. The University of Wisconsin is a very good school, but it isn't in the league with Berkeley/Stanford, MIT/Harvard, or the Research Triangle, and central Wisconsin is in a far different league than Boston or San Francisco when it comes to attracting the top foreign entrepreneurial talent.

While a series of governors lusted for high-tech jobs and concomitantly spent public money to keep blue collar jobs, a water services industry quietly developed in the greater Milwaukee area, despite receiving no significant subsidies or tax breaks. Its development came as a result of the city's location, connections to a few long-established companies in the area, and some civic-minded (and profit-minded) activities by a few key entities.

Lessons for smaller burgs / While Mayor Bloomberg may be able to meet with other big city mayors and tell them how he managed to construct bike lanes or ban smoking, a lot of what he has achieved while in office is *sui generis*. Any observations he offers will be of little value to growth-hungry politicians in Dallas or Chicago.

Or, for that matter, Peoria, Ill., a city of 115,000 (and nearly a half-million in the metropolitan area) where the schools continue to deteriorate but no mayor or city council has the fortitude or desire to wrench control of them away from the succession of mediocrities the school board appoints to run things. Central Illinoisans have responded to this by voting with their feet, and middle-class families with children either move to the suburbs or send them to Catholic schools—or leave the area altogether. What D.C. or New York did is of no particular interest to the city's government.

The gridlock in Congress has cut off the urban grant spigot in Washington, pushing metropolitan governments to do more. That is something that believers in small government ought to celebrate, even if we don't agree with everything those city governments do. The value of federalism has been utterly forgotten in recent years, with no one bothering to pay even lip service to it. Having a couple hundred governments trying new things and seeing what works—and what doesn't—and watching those lessons propagate through the country is the *sine qua non* of Jeffersonian democracy.

But we need to temper our enthusiasm by realizing that there are limits to what a hundred blooming flowers can achieve. What succeeds in dense urban centers may not work in prairie metropolises, navigating the shoals of public unions takes a lot of effort and political talent, and change is hard. The mayor of Omaha, Neb. may get inspiration from what Mayor Bloomberg achieved, but it's not clear what else can be taken from his tenure.

Small-town snobbery / My favorite *Andy Griffith Show* episode is "Andy's Rich Girlfriend." It takes place before Helen Crump comes to town and becomes Andy's steady girl. In the episode, Andy meets a wealthy, attractive, and nice woman from the big city (Raleigh in this case). He takes her on a series of dates designed to test her comfort level with small-town living—fishing and pheasant-hunting trips among them—before she finally calls out Andy for being a small-town snob, prejudiced against big-city people.

There's a lot of that in the country, I think, and I was guilty of that for much of my life until I wound up living in a big city and enjoying it. That sentiment infects Congress as well: the very structure of the Senate ensures that rural residents get disproportionate representation in Congress, as well as a disproportionate share of government largesse. If you would assume that New York City would get a greater per-capita allocation of mass transit dollars than Mobile, Ala. or Oshkosh, Wisc., then you don't know Congress.

Yet the lack of such largesse isn't a negative for the big metropolises. Bradley and Katz are spot-on in declaring that the neglect cities receive from the federal government is a blessing and that cities across the country are tackling big problems on their own. More neglect would be even better: fewer regulations, fewer tax dollars going from big-city residents to subsidize the lifestyle of corn farmers, and fewer strings on the dollars that the federal government does deign to return to the local level would improve things.

The deal of the fix / Innovations in government travel slowly and often translate poorly from one locale to the next. For a community to attract a new business or an entire industry, the formula is simpler than trying to identify a promising industry to develop. Creating a place where people want to live and work and raise a family is the first and foremost thing that can be done to attract people—and jobs. It is a more passive perspective than deal-making mayors are comfortable with, but such a perspective would circumscribe government activities in a healthy way.

Cities are certainly more important in the global economies today than they were a decade ago, with a majority of the world's inhabitants living in one for the first time ever. And the urbanization of humanity will only continue. However, convincing Chicagoans that the city needs to invest first and foremost with an eye toward foreign cities that Mayor Rahm Emmanuel sees as its competitors is a tough sell—save for the livability aspect of it.

Devolving power to cities and metropolitan areas is a development that we rightly ought to celebrate, as Bradley and Katz do. There's still more that could be done in this realm: abolishing the federal government's role in allocating transportation funding would be a reform that would allow state and local governments to be even more creative in how they fund and provide transportation, for instance. The next logical step in the progression would be for U.S. cities to emulate other foreign cities and begin devolving more services to the private market—but that's grist for the next generation of mayors. *R*

Overcome by Complexity

REVIEW BY RICHARD L. GORDON

Pollution control involves ambitious goals based on tenuous information about the benefits and costs of abatement. The vast economic literature on the subject, which includes this new book by economics professors Nicholas Muller (Middlebury College) and Robert Mendelsohn (Yale University), nearly universally recognizes that problem, but equivocates on its implications. The dominant view is that environmental threats are so clear that, even with the uncertainties, it is desirable to reduce emissions and improve enforcement. (Perhaps surprisingly, many adherents of this view are comfortable suggesting policies that explicitly consider the benefits and costs of abatement.) More skeptical critics suggest that pollution impacts are so complex that little basis exists for setting optimal policies and that existing policies extend control far beyond clear major threats.

RICHARD L. GORDON is professor emeritus of mineral economics at Pennsylvania State University.

Impediments to good analysis / How should we reconcile standard economic theories of optimal pollution control, the information available to implement control, and actual pollution regulation? A critical and widely recognized problem is that both the Clean Air Act and Clean

Water Act deliberately employ dangerously loose significant-impact criteria that rule out explicit consideration of the costs and benefits of abatement, thus seemingly mandating pollution suppression regardless of cost. Literal application of the two laws would be both economically and literally fatal because eliminating all health-damaging pollution stops all economic activity and thus provision of basic sustenance. In practice, the EPA typically mandates the use of "best available" pollution suppression, which at least limits controls to what is supposedly technologically feasible and commercially available.

A second, also-well-noted problem with pollution policymaking is that purported pollutants are emitted from many sources, travel and transmute, and then settle someplace. This produces enormous problems of unraveling impacts. At best, impact measurement would require undertaking elaborate studies of the continuous actual exposure of representative samples of human populations to pollution and all other influences upon their health. At worst, ethically indefensible dose-exposure laboratory tests might be undertaken. Unfortunately, the looser standards actually used allow reliance on far less precise measures.

Given our lack of adequate knowledge, how does the EPA follow presidential and congressional orders to measure the benefits and costs of pollution control? While many supporting studies are considered, the benefits always are predominantly the reductions of premature mortality from decreased exposure to small particles. To estimate those benefits, the EPA leans heavily on just two one-time, non-random-sample surveys with highly atypical characteristics. (See my "The EPA's War on Coal?" Spring 2013.) Updates are made only to examine the subsequent mortality experience of people originally sampled. The consequence is that, for whatever purpose a rule is proposed, the calculated side benefits from reduced mortality almost always vastly exceed the costs. To make matters worse, the EPA regularly warns that its impact studies have nothing to do with policy design.

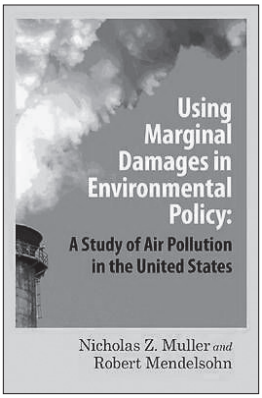
In addition to the looseness of its damage criteria, pollution policy has political defects as well. The first is the enormous inertia inherent in lawmaking. The U.S. Congress characteristically badly sketches objectives, delegates the implementation to a regulatory agency, almost never returns to reevaluate its legislation, and when it does, reacts to failures from overreach by adding complications advertised as fixes that universally worsen the situation. Thus, the laws keep adding new goals and control requirements—all of dubious merit.

The laws and basic constitutional principles correctly make rule implementation an extremely complex, time-consuming process. The EPA must undertake extensive studies to justify actions and then solicit extensive comments about proposed regulations. After the agency issues rules that respond to the external comments, judicial review occurs. The complexities make for extremely slow decisionmaking.

Thus, any desire to introduce benefit-cost analysis into pollution control faces the double problem of legal prohibition of such quantification and lack of the knowledge needed to set a correct pollution-control level or charge. That ignorance also implies that any control rule, including all those now in use, has inadequate justification. This leads to difficulties that are universally finessed in suggesting pollution control improvements. (See "Uncertainty Can Go Both Ways," Summer 2013.) Clearly, in the absence of satisfactory knowledge of the benefits and costs of emission control, no discipline can provide uncontroversial policy advice.

Implications for environmental policy analysis / Given the lack of health effects knowledge and the prohibition on the consideration of costs in environmental statutes, much more skepticism should be shown about what concerns are worth regulating. We are far from knowing how to set the levels of optimal charges or limits that textbook economic theory suggests should prevail, and the enforcement milieu precludes the steady adjustments to error that are essential.

Any study of pollution control should have some recognition of those limits. That is true for government reports, pure scholarly research, and especially for efforts such as Muller and Mendelsohn's—presumably designed to influence public policy debates. Their book moves relentlessly and too rapidly. At every point where common sense and the literature suggest warning flags, Muller and Mendelsohn move on.



Using Marginal Damages in Environmental Policy: A Study of Air Pollution in the United States

By Nicholas Muller and Robert Mendelsohn

150 pages; American Enterprise Institute, 2013

Their work illustrates a chronic problem in contemporary economics of encouraging elaborate formal analysis without concern for the feasibility of actual implementation. Critics of economic policy analysis argue that publication in prominent journals is overemphasized and the journals favor form over substance. While those criticisms are overdone, Muller and Mendelsohn do provide an example of empty formalism. The book's origin as an expansion of an *American Economic Review* paper is a further indication of problems. (An irony is that Muller is now a colleague of David Colander, a leading critic of the stress on overly abstract journal articles.)

Sophisticated formalism and its defects / The authors argue that existing knowledge allows the calculation and imposition of specific-source optimal taxes on multiple pollutants. The bulk of the book is devoted to sketching and utilizing a model to measure optimal taxes. Scattered through the book are a few sensitivity analyses. All of those tests suggest strong reasons to doubt the validity of the proposed pollution con-

trol taxes. Yet, the authors slide past those warnings and argue their modeling serves as the practical basis for better pollution-control approaches.

The formal analysis starts with mathematical derivations of the standard rules of optimal pollution control, presents the "simplified" air pollution dispersion model used, rushes through listings without evaluating the equations used to quantify the impacts of the pollutants, and summarizes the results of about 60,000 calculations of the marginal damages of six pollutants at almost 10,000 sites. It shows the sensitivity analyses run on four power plants, moves on to argue that Muller and Mendelsohn's model shows how to improve the sulfur dioxide quota-trading program under the 1990 Clean Air Act Amendments, and proceeds to provide purported indicators of priority areas for regulatory reform. The book then offers three chapters on the total damages from pollution.

Every step cries out for further discussion and qualification, which are not provided. The omissions include the overwhelming practical questions about the generation, transmission, and effects of pollution, the applicable laws, their implementation, the insuperable problems of satisfactory quantification, and the extensive criticism that governmental environmental policy and its purported quantified justifications have inspired. The most basic omission is recognition of the statutory reasons why the EPA does not stress economic efficiency.

The methodology uses a simpler emissions dispersion model than the EPA uses and tests whether the simplification is an adequate approximation of the EPA model. The EPA model is left unexplained; the approximation used is represented by two largely unexplained equations. Predictably, a good fit between the approximation and the more complex model is used to justify the simplification. The authors fail to consider the possibility that the larger model is defective.

The sensitivity analysis is a narrow mechanical exercise. After piling on a host of assumptions about the underlying data, Muller and Mendelsohn undertake multiple random samples from the data relating to four different actual power plants to simulate the distributions. Despite often finding that the standard deviations exceed the means by such large amounts that negative benefit values are highly probable, the authors express confidence the means estimated are useable.

A serious defect of the book is the superficial, fragmented treatment of mortality damages. On p. 4, we learn that mortality damages "comprise the bulk of air pollution damages." On p. 44, in the impact-measurement description offered in Chapter 3, the book indicates that, for estimates of the numbers of mortalities, it relies on the same studies that the EPA employs in its cost-benefit analyses. Only on p. 111 are the calculated mortality effects shown. A sensitivity analysis on p. 117 discloses that Muller and Mendelsohn used mortality-evaluation methods radically different from the EPA's, which means the authors used lower values for lost lives and they adjusted the values for the age of the decedents. The EPA estimates were 630 percent higher.

The only methodological concern addressed in Chapter 3 is rejecting objections to valuing lives. This is detrimental to the authors' argument because so many of the sources they use to determine that value are defective. Muller and Mendelsohn rely on the same American Cancer Society (ACS) health effects study that provides the basis of the EPA's work. The EPA also sponsored a Health Effects Institute (HEI) review of both the ACS study and an even less satisfactory one by the Harvard School of Public Health. The HEI study clearly indicates the fragility of the impact estimates. (Muller and Mendelsohn have cited the HEI study in the online appendices of two of the journal articles that are precursors to this book. My "EPA War on Coal?" article reviews the study's defects.)

Given those knowledge gaps and the nature of the EPA, Muller and Mendelsohn should have exercised more caution about proposing practical use of their pollution-abatement methodology. Questions arise first about the wisdom of replacing the EPA's model of pollution dispersion with an approximation. What suffices for an academic enterprise seems inadequate for policymaking. Even the EPA model may have limitations about what it does measure and necessarily ignores that people are sheltered from outside air most of the time.

The next concern is whether the EPA or any public agency should be trusted to select the best estimates of health impacts. Moreover, the Muller-Mendelsohn abatement-benefit calculation approach inspires skepticism. Their method is to add one ton of each pollutant at each site 60,000 times to calculate all the marginal benefits. It strains credulity that any model is precise enough to produce reliable estimates of the change in value. Moreover, no consideration was given to the costs of enforcement.

Their discussion describes the emission-trading element for sulfur dioxide in the 1990 Clean Air Act Amendments and then introduces a problem with the trading scheme that they claim to remedy: that the location and not just the magnitude of damages affects the benefits. Calculations are made first of the benefits of attaining the emissions target set by the amendments through shifting to quotas reflecting locational differences in damages. Then an estimate is made of how benefits are further increased by shifting to the much stricter emission limits that their model alleges is efficient. This is simply repetition of the EPA's standard contention that any reduction in particulate emissions produces large benefits.

The book then offers four chapters summarizing aspects of the calculations. The first stresses pointless calculations of the largest gaps between marginal abatement benefits and marginal abatement costs. In this chapter, they note but ignore that both the size of the gap and the size of emissions determine the importance of different emissions. The calculations supposedly are to assist some unnamed regulator free to set priorities without recognition that an act of Congress is needed.

The next three chapters present calculations of the total cost of pollution disaggregated in several ways. The estimates rely on underlying valuations of the cost by pollutant and source. Each marginal damage figure is multiplied by the quantity of pollutant emitted to produce the value of damages by that pollutant at that source. Many aggregations are possible, and several are shown. Below, only those seeming particularly important are noted.

The first aggregation is by pollutant and type of damage. It shows that premature mortality is the dominant harm: $90 billion out of a $109 billion total. The authors add estimates, derived from another author's figures, of damages from carbon dioxide. A dubious set of sensitivity analyses is provided. Four of those analyses deliberately produce much higher damage estimates—three involve assuming higher values to lives saved and the fourth employs another epidemiological study beloved by the EPA because the study reports much higher mortality effects than the other available study. (The HEI review found that the second study was unacceptably unreliable because it only covered six "cities.") A clear explanation of the data sources used is lacking here and in the next two chapters.

The remaining calculations are of the damages by sectors of the economy. The first covers all of the 20 broad sectors into which the EPA divides the total economy. Carbon dioxide figures are given for the coarser five-sector subdivision used by the emissions data source, the U.S. Energy Information Administration. Since the EPA cannot assign transportation uses to user sectors, Muller and Mendelsohn provide an alternative sectorial breakdown that disaggregates transportation into several sectors, aggregates industry into two, and adds agriculture and residential. This discussion, unlike the initial breakdown, covers all emissions measured. Chapter 10 then presents tabulations of the damages caused by subsectors that produce high damages, such as coal-fired electric power plants. The tables show both their valuations and those arising from adopting the EPA's assumptions about mortality.

Despite the wild differences in results arising from changing the cost-of-mortality estimate, the authors claim "we demonstrate that it is possible to provide reliable measures of pollution in national accounts." (The pollution cost of coal generation of electricity is estimated to be between $18.7 billion and $142 billion.)

The book concludes with a reiteration of the authors' basic premise that their efforts produce a useable method to move closer to the "textbook" rules of efficient pollution control.

Conclusion/ Change in air pollution regulation is desperately needed. The cure is better recognition in the underlying law of the vast uncertainties involved and the great difficulty, if not impossibility, of resolving them. Those supposedly worried about excessive intervention should not support the pretense that some giant computer model can overcome these defects easily. Everything in the book reinforces preexisting skepticism about such claims. Thus, this effort at practical reform serves as an illustration of the barriers to improvement. *R*

Appreciating the City, and the Suburbs

REVIEW BY WILLIAM A. FISCHEL

The Environmental Advantages of Cities provides a thorough and convincing argument for something I was already convinced of: urban areas are, on balance, a good thing for the environment and offer mostly benign environs to their residents. In the book, author William B. Meyer, who teaches geography at Colgate University, systematically sets up and shoots down what he calls "commonsense antiurbanism." Calling many of the arguments against cities "commonsense" seems overly generous, but Meyer adopts the term in order to include a wide variety of popular arguments besides those made in scientific papers.

Correcting poor analysis/ Some of the antiurban arguments fail because they do not think in per-capita terms. A map of greenhouse gas emissions in Milwaukee revealed that the central areas were the worst offenders. But, as Meyer points out, that's because it was calculated on emissions per acre, not per household. A map based on the more logical per-household basis shows that the city-dwellers produce the least amount of greenhouse gases. Meyer rightly insists that critics not simply criticize places and the people who live there; he wants to know where those people would live if not in cities and what impact that change would have on both the people and the environment. It's not unlike the economic idea of opportunity cost, exemplified by the jokey repartee, "How's your spouse?" "Compared to what?"

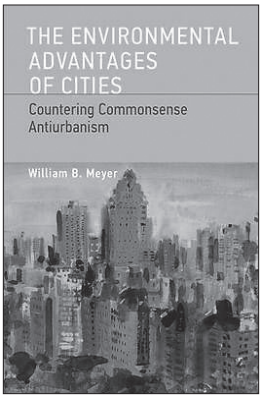
Another common error that Meyer exposes is inappropriate statistical comparison. A United Nations study of the supposed evils of urbanization in the developing world compared the well-being of "slum dwellers"—itself a tendentious term—to all other urban residents and all rural populations. The appropriate comparison, of course, would be some subset of rural populations, since some rural folks are doing just fine while many others are a lot worse off that those who live in "slums."

And so it goes throughout the book. Meyer demolishes statistical and logical

WILLIAM A. FISCHEL is the Hardy Professor of Legal Studies and a professor of economics at Dartmouth College.

fallacies about the comparative evils of water pollution (much safer in cities), natural hazards like tornadoes (easier to spot and shelter in cities), technological hazards like automobile accidents (congestion has its benefits), and infectious diseases. Concerning the last, I was unaware that the Bubonic Plague was considerably worse in rural Europe.

Meyer's next-to-last chapter, "Human Habitat," is actually his best and I would urge readers impatient with his leisurely introductory material to start there. In it, he deals head-on with the argument that cities are just bad for people, inconsistent with human nature and our evolutionary needs. The antiurbanists' most dramatic and persistent story is the "rats study," published in *Scientific American* in 1962. Common rats were placed in an enclosed space of fixed dimensions, given plenty of food and water, and allowed to breed indefinitely. They eventually became annoyed with their overly close neighbors and developed pathologies that antiurbanists attributed to densely populated human cities. Meyer notes that Lewis Mumford, the famous critic of city bigness, opined that the rats in the study "exhibit the same symptoms of stress, alienation, hostility, sexual perversions [circa 1968], parental incompetence, and rabid violence that we now find in Megalopolis."



The Environmental Advantages of Cities: Countering Commonsense Antiurbanism

By William B. Meyer

248 pages; MIT Press, 2013

The first response by the tribe of economists to these arguments would usually be revealed preference. Billions of people generally do not move to cities unless they expect their lives to be better than in nonurban places. Urbanization is a worldwide phenomenon. With few exceptions, people were not compelled to move from rural to urban areas. Unlike rats in a box, most humans have the option of leaving if they don't like local conditions. Indeed, the most notable compulsory urban policies were undertaken by dictators who forcibly removed people *from* cities (e.g., Pol Pot's evacuation of Phnom Penh) and by the authoritarian governments of Russia and China, whose internal passport systems keep many citizens from moving to cities in order to better their lives—and perhaps demand better governance.

Interestingly enough, revealed preference is Meyer's first argument, too, even though his tribe is that of geography. The antiurbanists who condemn Megalopolis sound like the supposed saying of Yogi Berra: the place is so crowded that no one goes there anymore. (Meyer actually uses the line.) This is not to say that big cities lack environmental problems, but, as Meyer points out, the close proximity of people in urban areas produces a local political climate that can manage collective problems before they turn into the rat-like disasters that animated Mumford's imagination.

Suburbia / The more problematic aspect of the book is that Meyer cannot decide whether suburbs are a legitimate part of cities. He often alludes to cities as entire metropolitan areas, which would include suburbs. But at other times he sees suburbs as somehow antiurban, something whose growth should be condemned as "sprawl" that chews up the environment. He is dismissive of the work of Robert Bruegmann, whose *Sprawl: A Compact History* punctured the myths that suburbanization is historically recent, peculiarly American, and bad for cities.

It is fine to be ambivalent about American suburbanization. I have argued that unchecked local zoning and federal tax and expenditure policies have made American cities excessively spread out, causing too much commuting and undermining the benefits of proximity. But even without those policies, it is likely that American metropolitan populations—and those of most other high-income societies—would mostly live in suburbs. Shlomo Angel and colleagues have demonstrated in a remarkable project, *The Atlas of Urban Expansion*, that almost every city in the world is spreading out spatially while becoming less densely populated.

The reason for worldwide suburbanization is fairly straightforward: Personal incomes are rising in nearly all cities, in large part because urban agglomeration economies make workers more productive. Most people with more disposable income want some additional living space, both indoors and out, and the suburbs are the cheapest place to get it. It is revealed preference all over again.

The hazard of neglecting this benign explanation for suburbanization is that defenders of urbanization don't know where to stop. They seem to think that if some density is good, higher density must always be better. This is the main rationale for urban containment policies such as those in Portland and Seattle, which restrict suburbanization and aggressively promote infill policies. To my mind, metropolitan infill policies are usually helpful insofar as they sweep aside parochial land-use policies that unreasonably limit redevelopment. But if infill projects are good enough to attract residents downtown, there's no reason to forbid suburban development for those who want it, provided developers are willing to pay for the infrastructure costs that accompany it. City life can compete with suburban life without forcing people to choose high-rises and public transit. Perhaps Meyer's next book should address the "commonsense" arguments that see suburbanization as the dysfunctional appendage of urbanization rather than a natural complement of successful city growth.

Conclusion / In the meantime, I hope the present book gets the attention it deserves. I predict it will not, though. Among the famous environmental thinkers that Meyer criticizes are Lester Brown and Paul Ehrlich. Meyer writes, "In 1976, Lester R.

Brown predicted that cities could never house a majority of the human population (as in fact they now do) because the world's resource base could not meet what he called 'the additional energy costs of urban living.'" Ehrlich is called out as one of those who erroneously used the Black Death of medieval Europe as a precursor to runaway diseases in modern cities.

Meyer is actually too kind to Brown and Ehrlich. They are so often off base in their predictions of environmental and human catastrophe that one would expect them to be hiding under rocks. To the contrary, both have received "genius" grants from the MacArthur Foundation and both are the recipients of numerous honorary degrees and other public honors. In the field of environmental commentary, it seems, it's a lot more profitable to be furious and fanatical than, like Meyer, sound and sensible. R

Perverse Incentives in the Financial World

REVIEW BY DAVID R. HENDERSON

Advocates of free markets and deregulation are often accused of being apologists for big business. The main reason for this seems to be that we defend the rights and accomplishments of big businesses that achieve great things under economic freedom. But we have always been careful to defend economic freedom, not big business per se. If I were to recommend one book to disabuse people of the idea that being pro-freedom necessarily means being pro-big business, that book would be Jonathan R. Macey's *The Death of Corporate Reputation.* But that is only one of many things that recommend the book.

Macey, a professor of finance at Yale University, is a long-time observer and analyst of both corporate finance law and actual finance as practiced on Wall Street. He has written profusely on the topics covered in this book. His broad claim is summarized in the title of this book and in the subtitle: *How Integrity Has Been Destroyed on Wall Street.* Macey is a harsh critic of both government regulators and private financial actors. He argues that government regulation has failed and that perverse regulation, combined with changes in technology and information costs, has reduced the value of reputation in financial markets. He makes his case sector by sector, taking on accounting firms, law firms, credit rating agencies, stock exchanges, and the Securities and Exchange Commission. He sometimes overstates his case. At times, I found his evidence better than his theoretical argument, and one piece of evidence—on the legendary junk-bond king, Michael Milken—actually undercuts his argument. But his big-picture reasoning and conclusions are broadly convincing and his case gets stronger as the book progresses.

DAVID R. HENDERSON is a research fellow with the Hoover Institution and an associate professor of economics at the Graduate School of Business and Public Policy at the Naval Postgraduate School in Monterey, Calif. He is the editor of *The Concise Encyclopedia of Economics* (Liberty Fund, 2008). He blogs at www.econlog.econlib.org.

Does reputation matter? / Macey begins by pointing out the received economic wisdom on the importance of reputation. Companies have an incentive to establish a reputation for quality and honesty whenever their product is hard for consumers to judge. That works with businesses ranging from the local dry cleaner to the largest auto company. When companies' reputations suffer, the companies suffer. That's what gives them the incentive.

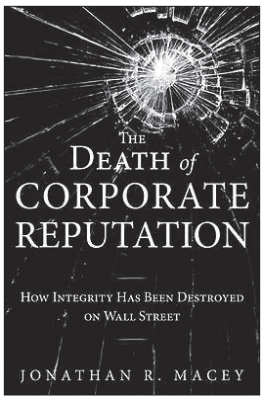
Macey gives the example of Bankers Trust, a financial company that, as its name implies, built its business by earning its customers' trust. But that changed in the 1990s when Bankers Trust took advantage of two of its clients, Gibson Greeting Cards and Procter and Gamble (P&G). Bankers Trust made complex financial derivative deals with those clients, deals that it understood better than the clients did. In the P&G deal, P&G ended up paying interest rates over 14 percentage points above the market. In the discovery process, after P&G sued Bankers Trust, a document was found describing a conversation between two Bankers Trust employees in which one said that P&G would "never be able to know how much money was taken out of that [swap by Bankers Trust]," and her colleague responded, "That's the beauty of Bankers Trust." Although Bankers Trust settled, it ultimately lost in the marketplace because its reputation was damaged.

Fast forward to a 2010 lawsuit that charged Goldman Sachs with behaving unethically. Goldman had claimed in its 2007 annual report that "[o]ur reputation is one of our most important assets" and that "[i]ntegrity and honesty are at the heart of our business." In defending itself, Goldman claimed that no one should have believed those claims because they are simply "puffery"—that is, subjective opinions used in sales and advertising that people are not supposed to take literally. In other words, Goldman Sachs itself was claiming that its own reputation didn't matter. That seems like Macey's smoking gun for his claim that reputation matters much less today than it used to.

The financial stakes in many of today's deals are even higher and so one might think that reputation matters even more. So why does reputation matter so much less? Macey argues that precisely *because* the stakes are so high, individuals in a firm can cheat a few times and, even if their reputation is damaged as a result, live luxuriously on the interest from their ill-gotten gains. Also, he writes, because the cost of getting information about particular individuals in a firm is so low, individual reputations have become unhinged from firm reputations. That means that individuals in a

firm have much less incentive to monitor the behavior of other people in the firm.

Even if he is right that individual reputations matter more and firm reputations matter less, that still means that reputation matters. His account of the 1980s Milken case illustrates that. Macey shows that Milken did great work for his firm's clients, helping companies finance takeovers and expansions using high-yield, or "junk," bonds. But an ambitious prosecutor, Rudy Giuliani, got favorable publicity by going after Milken viciously for minor trading violations. Macey points out that the Milken case shows that "being sued and pleading guilty, even in a criminal case brought by the federal government, was no longer a death blow to one's reputation." Exactly. But that does not mean that reputation doesn't matter. On the contrary, it means that potential clients could see through Giuliani's thuggish behavior and judge Milken on what really mattered: good value and honest dealing.



The Death of Corporate Reputation: How Integrity Has Been Destroyed on Wall Street

By Jonathan R. Macey

287 pages; FT Press, 2013

But surely accountants who audit companies' financial statements must worry about their own reputations and, therefore, have a strong incentive to root out financial misdoings in the companies they audit. Not so, argues Macey. His argument is twofold. First, the move in the accounting industry from general partnerships to limited liability partnerships means that a partner in an accounting firm does not have the same financial stake he used to have in monitoring his colleagues' work. Second, accounting firms often also do lucrative consulting for the firms they audit, setting up an inherent conflict of interest.

What about lawyers? Macey argues that "improved information technology, the passage of the securities laws, and the increase in both in-house counsel and specialization of lawyers' functions have decreased lawyers' incentives to monitor their colleagues and, by extension, their firms." All true. But there are two things to note: First, the securities laws that he discusses were passed in 1933 and 1934, so it's hard to argue that those laws are responsible for any *recent* decline in the reputation of law firms. Second, as he himself admits, whatever is true about law firms, an individual lawyer's reputation still matters for that lawyer.

Nor, writes Macey, can we depend on credit rating agencies. The reason: regulation. In 1975, the SEC designated only two agencies, Moody's and Standard & Poor's, as "nationally recognized statistical rating organizations" (NRSROs). Later, a third firm, Fitch, was designated as an NRSRO. (A few "boutique" firms have subsequently been named NRSROs, but the original three dominate the market.) It was only a matter of time before the SEC and state and local regulators required that bonds get a seal of approval from one of those three firms before banks, money market funds, pension funds, and other fiduciary organizations could invest in them. That not only created a cozy cartel, but also diminished the incentive of those three firms to care about quality: when someone has to buy your product anyway, there is less incentive to produce a good product. Macey argues that the credit agencies' ratings are virtually worthless. Still, he notes, investors pay attention to them. Why? He attributes it to a "lemming" effect. But wouldn't we expect market players with millions of dollars at risk *not* to pay attention to worthless information, especially when they have had years to realize how little value the credit rating agencies create? I would have thought that Macey, with his deep understanding of markets, would think so.

Government reputation / One of the most important chapters contains Macey's explanation of the incentives facing SEC employees. I have always wondered why the infamous Bernie Madoff got away with his Ponzi scheme for so many years, despite six warnings to the SEC by knowledgeable people who suspected such a scheme. After reading Macey's masterful chapter on the SEC, I wonder no more. Macey writes, "The SEC has few incentives to investigate the simple but effective sorts of fraud schemes that Bernard Madoff masterminded because there are few career payoffs to doing so." Macey points out that the big, well-known financial firms, where many of the SEC enforcers ultimately want to work, would never engage in Ponzi schemes. So there is no reason for SEC enforcers, from a narrow career viewpoint, to pay attention to such schemes.

Lawyers at the SEC formulate complex regulations that have little to do with protecting the investing public. They will then be expert at helping firms comply with the regulations. Macey does not just speculate about this. He points out three instances in which lawyers at the SEC have gone on to lucrative positions with major Wall Street firms. One former SEC director of enforcement, writes Macey, "is a partner in the giant law firm of Davis, Polk & Wardwell, which represents many clients before the SEC." That person's predecessor at the SEC "is the general counsel at JP Morgan Chase." And this latter's predecessor left the SEC to become general counsel at Deutsche Bank. Unfortunately, neither Macey nor the source he cites on those facts actually names the three people involved. Given that this book is about reputations, including those of individuals, the absence of that important detail is disappointing.

I shouldn't end this review without mentioning the horror story of a firm called Egan-Jones. The firm was a small rating agency that had the effrontery to downgrade the U.S. government's debt in July 2011 from AAA to AA+, well before Moody's and Standard & Poor's downgrade. Within three months, Egan-Jones received notice from the SEC that it would be the target of an SEC legal action. Officially, the action had nothing to do with the downgrade; rather,

the firm was charged with failing to meet a technical SEC requirement that ratings of bonds be "disseminated publicly." But Egan-Jones' well-known business model was to charge bond buyers, rather than sellers, for its ratings—a practice that protects the firm from the perverse incentive of issuing ratings to please the sellers. If the company disseminated its information publicly, why would anyone pay? The good news is that, according to Macey, "The SEC's campaign against Egan-Jones harmed the SEC's reputation more than Egan-Jones's reputation." Who says reputation doesn't matter?

Macey ends on what is, at best, a semi-hopeful note. Regulation, he points out, is not a good substitute for reputation, so one important step is to deregulate. He understands, as many people do not, that the 1990s and early 2000s were not the golden era of financial deregulation, but rather a time of fairly heavy regulation. Deregulation, he writes, "will help to reestablish incentives for firms to invest in reputation." Fortunately, with this book, he has done his part in trying to get reputation to play a more important role on Wall Street. R

Political Bubbles and the Elite Fundamentalist Free Market Conservatives

REVIEW BY VERN MCKINLEY

Since 2009, there have been dozens of books published on the recent financial crisis. Some of the most popular are the comprehensive blow-by-blow accounts written either by journalists undertaking old-fashioned shoe-leather reporting or government insiders leveraging their advantage of asymmetric information. These books are popular because they reveal previously unknown details of the crisis.

Another category of books focuses on a narrow aspect of the crisis, such as a single financial institution or an aspect that the author(s) thinks has been ignored in other crisis-related books. *Political Bubbles* falls in the latter category, detailing the political aspects of the buildup and response to the crisis. Political issues are certainly addressed in small doses in other books, but I am not aware of any other book that is almost completely dedicated to the issue. The promotional materials for this book confidently note that it "reveals how politics are responsible for financial disasters."

The book's introduction gets off to a promising start on who gets the blame for the crisis:

> We focus on the national government in Washington, D.C. To be precise, we put much of the responsibility for the crisis and the failure to undertake genuine reform of the American financial system squarely on members of Congress, on Presidents Jimmy Carter, Ronald Reagan, George H. W. Bush, Bill Clinton, George W. Bush, and Barack Obama and on those they chose to serve in their cabinets and in the Executive Office in the White House and to run regulatory agencies, including the Federal Reserve and the Securities and Exchange Commission.... [Political actors] allowed the crisis to develop and inhibited response after the crisis was front and center in the public eye.

This sounds good, but it becomes clear as the book advances that, although the authors state that they see "policy errors of commission and omission," they think a more activist and draconian interventionist response cooked up in Washington was called for: "Policy makers could have avoided the crisis by closely regulating or even prohibiting the [housing finance] products."

Definitions / One of the first tasks the authors tackle is to define political bubbles:

> [Political bubbles are] a set of policy biases that foster and amplify the market behaviors that generate financial crises. Political bubbles are pro-cyclical. Rather than tilting against risky behavior, the political bubble aids, abets and amplifies it. During a financial bubble, when regulations should be strengthened, the political bubble relaxes them. When investors should hold more capital and reduce leverage, the political bubble allows the opposite. When monetary policy should tighten, the political bubble promotes easy credit.

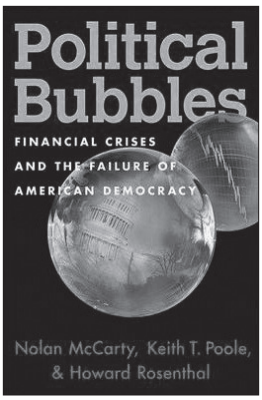
What this definition misses is that political bubbles are most likely to flourish in sectors where the government intervenes and, in the process, distorts decisionmaking by incentivizing certain behavior (i.e., homeownership in the case of the recent housing bubble).

The book's authors then go to great lengths to define a political model based on three factors ("The Three I's") that they argue have been impediments to successful policymaking regarding financial regulation: *ideology* (Chapter 2), *interests* (Chapter 3), and *institutions* (Chapter 4). *Ideology* is a rigid set of beliefs about how the world works and what is right and wrong (in contrast to pragmatism). The authors demonstrate that the U.S. political system has become more polarized, ideology is more important, and there is no ideological overlap between the parties. *Interests* are the efforts of those that impede regulation by seeking government relief or attempting to influence political decisionmakers by mobilizing constituencies, financing campaigns,

VERN MCKINLEY is a research fellow at the Independent Institute and author of *Financing Failure: A Century of Bailouts* (Independent Institute: 2012).

and providing information to legislators or lobbying them. The authors demonstrate that banking, financial, and real estate interests have outsized influence in preserving their interest. Finally, *institutions* are those government structures—such as regulatory agencies, the courts, the Senate (filibuster), and the president (veto power)—that act as a roadblock to regulation and reform. The authors argue the influence of "free market conservatism" has exacerbated those roadblocks.

This initial discourse regarding the concept of a political bubble and the elements of the authors' political model takes up the first 115 pages or so of the book (over 40 percent of the book's narrative). Much of it reads like an undergraduate text in political science, with ideology scores and bar charts analyzing by party some of the key votes during the run-up to the crisis. I consider myself to be interested in the finer details of politics, but I found it difficult to read the detailed discussion of the various models of politics set forth by the authors and I believe most readers will be in that position. This material could have been addressed in a briefer manner and integrated into the narrative about the financial crisis.



Political Bubbles: Financial Crises and the Failure of American Democracy

By Nolan McCarty, Keith T. Poole, and Howard Rosenthal

356 pages; Princeton University Press, 2013

Deregulation? / The next chapter (Chapter 5) begins the meat of the discussion, as its focus is on the political bubble of the crisis of 2007–2008. The chapter gets right the causes and properly blames Democrats and Republicans alike for pushing government policy toward increased homeownership. It illustrates this point with two on-point quotations from our back-to-back two-term presidents (Clinton and Bush 43) extolling the virtues of rising homeownership and taking political credit for the phenomenon. The quotations perfectly capture the interventionism of the pair, both of them seemingly unaware of the financial bubble that they are creating in the process.

The quotes segue into a chart showing the result of their interventionism as the overall homeownership rate was unnaturally driven from the mid-60 percent range in the early 1990s up to a bubble-producing level near 70 percent and then, as the bubble burst, back down to where it was in the mid-1990s. This chart allows the reader to visualize the wrenching angst our economy and financial system went through over this 20-year period of failed housing policy, leading the authors to conclude, "In broad categories of American society, no group benefited from the policies of the Clinton and Bush years." Elsewhere the authors succinctly summarize the political reasons for the housing bubble, giving an example of one of their "Three I's": "In short, a variety of government policies favor housing. Interests fight for these policies."

However, the logic of the chapter deteriorates into a critique of the deregulation "bogeyman." At the core of the authors' argument is their claim that about a dozen pieces of legislation or other regulatory actions enumerated at the end of the chapter (so-called "deregulation") combined with housing policy to produce the bubble. Rather than dedicate an entire chapter to a detailed analysis of each of those actions (which seems logical), there is merely a superficial analysis of the earliest two cited legislative acts, while the many other acts are not thoroughly addressed or explained in detail.

The conclusion from the review of the two legislative acts is clear: "interest rate ceilings and usury laws represent a form of social insurance for the poor," and "adjustable rate mortgages" prey on "unsophisticated borrowers." The argument comes down to a form of paternalism ("financial naiveté of many borrowers") that I would summarize as the poor are not very smart and can easily be taken advantage of, so we have to impose price controls and other restrictions on the mortgage market. The authors even admit the likely consequences of their prescription: "Of course, this rationing may hurt the poor, but there are far better policy responses to poverty than promoting credit and debt."

Democracy? / Much of the remainder of the book traces the response to the crisis. One questionable line of argument is that delays in responding to the financial crisis were largely attributable to "American democracy." This ignores the power and role that the financial supervisory agencies possess in the modern regulatory state. These agencies have wide-ranging powers, but in the early stages of a crisis they were consistently in denial regarding the extent of the problems because of their unwillingness to recognize their own inadequacies in their role as an early-warning system for problems in the industry. The classic Bernanke quote of "we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system," and of James Lockhart (the regulator of Fannie Mae and Freddie Mac) maintaining until weeks before the two housing giants melted down that they were "adequately capitalized," are two clear examples of this phenomenon.

The authors reveal their political biases throughout the book in comments that at times degenerate into snarky name-calling. The object of their derision is variously described as "free market conservatism," "fundamentalist free market capitalism," and an "extreme form of free market conservatism," and they use such labels as "ardent advocate of free market conservatism," "extreme conservative," "extreme libertarians," "elite fundamentalist free market conservatives," "pack of ideologues," "fundamentalists," "antigovernment ideologues," and "free market ideologues." The authors lay most of the blame on political followers of these philosophies for politi-

cal bubbles and the financial crises that follow: "But the belief structure most conducive to supporting political bubbles is what we term free market conservatism," which in its simplest form is the belief that "government intervention in the economy is bad per se, no matter what."

However, the authors only come to this conclusion by wrongly conflating crony capitalism with those that truly extol the virtues of the free market: "The crony capitalism of the 1980s, shrouded in the virtues of free market conservatism, led directly to the blowup in 2008," and "crony capitalists and free market ideologues would later bond." A case study of Fannie Mae and Freddie Mac, which are discussed extensively throughout the book, is a perfect example of the distinction. "Crony capitalists" were the beneficiaries of government housing policy that saw Fannie and Freddie as a free lunch, while those truly extolling the "free market" saw the pair as a rigged system of political and industry favoritism combined with excessive leverage that was bound to implode during a housing crisis. True advocates of a free market in mortgage finance, such as Peter Wallison at the American Enterprise Institute and many a scholar writing for the Cato Institute, had been advocating for the destruction of Fannie and Freddie's government-sponsored status as far back as the early 1990s. In a Venn diagram, true free market advocacy (or any number of the other descriptors the authors use) does not overlap with crony capitalism.

So to return to the claim that the book "reveals how politics are responsible for financial disasters" and to judge the book on that basis, at times it meets this lofty goal and other times it falls short. The book is at its best when its arguments are well conceived, laid out, and supported with relevant quotes by policymakers and explanatory charts and tables. It falls short when it strays from that approach and resorts to name-calling and lapses in logic. *R*

It's Lousy Being You (Unless You're Rich)

REVIEW BY IKE BRANNON

Tyler Cowen is not optimistic about the future of the American economy. And that is reason to worry, for the man is usually spot-on. Cowen's 2011 book on the state of the economy, the popular *Great Stagnation*, set forth why the economic growth we saw in the decades prior to the 2008–2009 recession is unlikely to return anytime soon.

Average Is Over picks up on that cheery message and suggests that even if steady 3 percent annual growth in U.S. gross domestic product were to magically reappear, it probably wouldn't help Americans all that much anyway, unless they happen to be members of the intellectual elite whose skills are enhanced—and not replaced—by computers. That class of Americans is smaller than what most people seem to realize, Cowen avers.

Here's hoping he isn't as prescient as he was with *Great Stagnation*.

In reality, the new book isn't a litany of solely ill tidings. It focuses on explaining how he sees the world changing and how his readers can make sure that they're not the ones punished by the economy's transformation. But taken together with *Great Stagnation, Average Is Over* seems to say that only a few of us have careers that will survive the culmination of the information technology revolution. The college degrees that so many of us assumed would keep us in good stead 20 years ago may be millstones around our necks, it turns out.

Or maybe not. Cowen is taking a trend that's been occurring for decades—an increasing demand by employers for skilled, talented workers—and positing that this "taste for talent" has become much more refined of late, meaning that only some skilled workers will be in strong demand in the future. Despite his marshaling of an impressive litany of anecdotes manifesting this trend, I'm not yet convinced that his dire thesis is right. After all, it's a thesis that's been advanced in previous downturns in the business cycle, but then dismissed when those cycles turned upward.

Job-displacing technology isn't new /My first college class—back in 1983—began with my economics professor asking the class why a majority of people managing shoe stores had college degrees when, a generation before, degreed shoe-store managers were virtually unheard of. He argued that the job hadn't changed all that much over the intervening 30 years and that the high school graduates of the 1950s managed to hire workers, keep the books, and sell wingtips just fine. What skills did four years of college confer on today's shoe store manager to make him more productive?

Yet the use of degreed employees to fill jobs formerly performed well by high school diploma holders has continued unabated in the era of the personal computer. Today nearly all retail managers have college degrees. Is the post-computer trend different than what my professor discussed? I think Cowen would say that these shoe-store managers are simply victims of a stagnant labor market and of technological transformations that have rendered their training worthless. Worse, they'll soon be joined by more of their baccalaureate-holding ilk, doomed to be under-employed for the duration of their career.

I have a qualm with this supposedly grim picture: who's to say what is and isn't

IKE BRANNON is a senior fellow with the George W. Bush Institute and president of Capital Policy Analytics, a consulting firm in Washington, D.C.

an occupation appropriate for a college-educated worker?

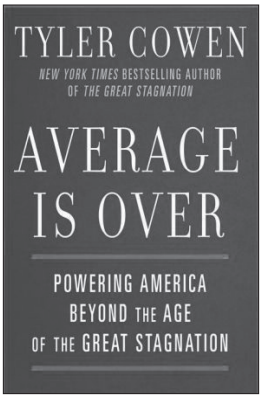
Much of what has happened in the last five years is that some college graduates have taken jobs that, in earlier decades, were taken by their less-educated brethren. It's unclear whether this trend will reverse—not because higher-skill jobs in this economy never fully absorb the ranks of the educated, but because the owners of such businesses may conclude that college graduates are sufficiently more productive and thus worth paying the higher wages necessary to keep them around. In other words, these jobs become higher-skill jobs and employers are willing to pay the premium for a college graduate when a better labor market imposes one.

A few years ago, a friend of mine abandoned his nascent Chicago business career and returned to his small-town home to take care of a dying parent. As part of the move, he took a low-paying job near his family home for a relative pittance, managing the loading dock at a big box store. After his parent passed away the following year, he made plans to return to Chicago and resume his better-paying career, but his manager realized that having an "over-educated" worker had worked out quite well. Negotiations ensued and a formerly blue-collar job was turned into something that paid akin to a white-collar salary. My friend remained with the company. So in Cowen's world, is this outcome bad or good?

Underachieving college grads / Of course, there are plenty of sad stories about college grads "slumming it" in today's labor force. The head of physical plant maintenance for Indiana University, located in the idyllic slacker paradise of Bloomington, Ind., once told me that he could fill every janitorial job on campus with a college graduate and every supervisory position with someone with an advanced degree and still have plenty of applicants to choose from. That was 20 years ago, incidentally.

Cowen believes that any job formerly done by a non-degreed worker but now filled by a degreed worker is an unfortunate effect of technological change.

The plight of the overeducated is not a new concern. When Arjo Klamer, while preparing his book *Conversations with Economists*, asked Nobel laureate Robert Lucas his thoughts on the apparent under-employment of an accountant who drove the cab that had delivered Klamer to Lucas's office, Lucas remarked that if he was driving a cab he was a cab driver, not an accountant. It's facile to suggest that the growth in the number and variety of jobs for which a college degree is now preferred is solely due to a faltering economy that can't make "suitable" use of such well-educated workers. Cowen is correct that there are both cyclical and structural forces pushing college graduates into a wider variety of jobs; however, we're just arguing over the relative weights. I think cyclical factors dominated while Cowen suggests the opposite.



Average Is Over: Powering America beyond the Age of the Great Stagnation

By Tyler Cowen

304 pages; Dutton Adult, 2013

Cowen's perspective in the book is that any job formerly done by a non-degreed worker but now filled by someone with a college degree is an unfortunate side-effect of technological change. I'm not so sure that it is a side-effect or that it is necessarily unfortunate.

Back in my hometown near Peoria, Ill., one of my childhood friends told me, from kindergarten onward, that he aspired to be a sheet metal worker like his father. When he graduated high school, however, Caterpillar—the heavy equipment manufacturer that employed my friend's father (as well as the father of every other kid in my kindergarten class)—had fallen on hard times and had no jobs available on the line for newbies. My friend spent the next two decades working—earning workmen's wages—for a Caterpillar supplier while taking night classes at the nearby junior college. Twenty years after high school, Caterpillar offered him what was essentially his father's job, but it had morphed into something entirely different over the interim. Instead of crafting sheet metal by standing on the assembly line wearing jeans and a t-shirt, my classmate worked in an office at a computer screen, wore a collared shirt, and spent his nights finishing up an engineering degree.

The high union wages of my youth led to absurd outcomes, such as college engineering students postponing completing their degrees because they had gotten work on the assembly line, and then later discovering that the jobs they found with their newly minted engineering degrees earned them less than union workers. For three decades I lived in a time and place where unskilled blue-collar workers made more, on average, than their typical college-educated brethren. It is slightly amazing that this wage disparity lasted as long as it did; had it endured much longer (it took a long and bitter strike-cum-lockout in the early 1990s to end it), Caterpillar likely would have endured the same fate as Chrysler and General Motors and been whittled down to size during the Great Recession.

Productivity over the business cycle /In the book, Cowen is at his best when exploring precisely how computers can accentuate the skills of workers to increase productivity. His argument belies intuition at first, but he marshals considerable evidence to both explain and prove his thesis, especially when discussing (a little too in-depth, in fact) the advent of "freestyle chess," which he submits as an analogy for the *new* new economy.

He's on less firm ground, however, when making his argument that the Great Recession suddenly rendered "zero marginal product" workers unemployable forever. For instance, he interprets the jump in productivity in 2008, when firms began shedding employees wholesale, as evidence that the laid-off workers were completely unproductive (or actually pulled productivity *down* by their mere presence). He claims that these workers won't be getting their jobs back now that firms are newly constrained to be profit-maximizers—which apparently wasn't the case before.

However, I think there's a different story for the productivity spike: When an economic downturn begins, managers presumably don't know whether the decline in demand for their output is a temporary or long-term phenomenon. Since it is costly both to lay off and rehire a worker, the managers' first response to a diminution in demand usually isn't to lay off workers; rather, the remaining workload gets spread across more people and periods of idleness ensue. We call this "labor hoarding." This, I submit, was happening in 2007–2008. Less output spread over the same number of people results in faltering productivity. When it became clear that the recession was real and likely to be severe and long-lasting, surplus workers were laid off. Maybe the laid-off were zero productivity workers, but it's also possible (and practically speaking, far more likely) that they are capable workers who are no longer being hoarded during an enduring period of decreased demand.

When a company lays off one-fourth of all workers while producing the same amount of output, its productivity skyrockets. But that doesn't mean the now-dismissed workers had low capability. Because of labor hoarding, worker productivity is a poor measure of worker capability at various points in the business cycle. Yet, productivity is what Cowen examines when formulating his story. He's not the first economist to make that mistake—Nobel laureate Fin Kydland once wrote a paper blaming recessions on "negative technological shocks," one that he later repudiated once he realized the error of his assumptions.

Keep the shades on? / There are now very few unskilled workers getting primo wages because of union power. Some of those jobs have simply disappeared, having been replaced by machines. Or they are being done by a machine-cum-highly trained worker, like my friend the sheet metal guy. Cowen warns white-collar workers not to think we are immune from the technological revolution making our skills irrelevant to the new economy, too—unless we have the skills that the revolution complements rather than replaces. This is a message that economists of various ilks have delivered for centuries, but history repeatedly proved them wrong. However, Cowen is a far better thinker than those predecessors, and he makes a compelling (although not airtight) case that this time things are truly different.

The economy is going to grow more slowly than it used to, and your share of its riches is likely going to shrink, Cowen tells us. Here's hoping he's wrong, for a change.

The Value of Immigration

REVIEW BY GEORGE LEEF

Public opinion polls indicate that many Americans think we have a serious immigration problem. Immigrants, especially illegal ones, are thought to be stealing our jobs, degrading our culture, adding to our tax burdens, and refusing to assimilate. What we should do to solve that problem usually entails further regulating the flow of people into the country and especially restricting immigration only to those who have the high-level job skills that the American economy is said to need. Secure the border and keep out the undesirable, low-skill masses.

Those notions encapsulate the conventional wisdom about immigration, but Global Crossings by Independent Institute senior fellow Alvaro Vargas Llosa shows that they are badly mistaken. The author, a journalist who was born in Peru and who has worked on three continents, makes a compelling case that immigration is a natural economic phenomenon toward which *laissez-faire* is the best policy.

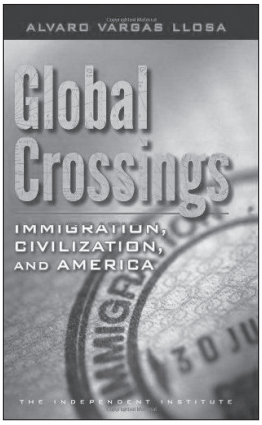
The book's key insight is that the movement of people across political boundaries is no different from the movement of natural resources or finished products. When the demand for labor is stronger in another country, some people will weigh the costs against the expected benefits and migrate from their native land if doing so seems likely to improve their standard of living. Those who make that calculation are rarely driven to leave by desperate poverty, but instead are motivated by a "get ahead" outlook. And if the advantages of working in the foreign country decline, those people often migrate back. We've seen that in recent years, as the strong flow of migrants from Mexico and Central America that prevailed for much of the last two decades has slowed to a trickle as the U.S. economy has gone stagnant.

Like other government interferences with economic phenomena, regulations that restrict or prevent the movement of people create far more problems than they solve—if they solve any problems at all. After reading this book, the arguments that immigration is creating economic and social problems for America seem to amount to nothing more than narrow-minded griping.

Xenophobia / To dispel the idea that there is anything unique about America's cur-

GEORGE LEEF is director of research for the John W. Pope Center for Higher Education Policy.

rent squabbles, the first part of the book focuses on the history of immigration. "Migration has been happening," Vargas Llosa writes, "in varying forms, for millennia, but it still elicits primal fear and distrust, and not just on the part of the 'receiving' country; communities from which people migrate often disapprove … and consider it treacherous." But immigrants, he shows, have almost always enriched the nation to which they move, through work, cultural infusions, and especially entrepreneurship. That is true even when the immigrants come from nations with similar cultural roots—for example, the influence that cooks from Peru and taxi drivers from Ecuador have in Spain. The book abounds with interesting tidbits from the author's extensive travels.



Global Crossings: Immigration, Civilization, and America

By Alvaro Vargas Llosa

353 pages; Independent Institute, 2013

It is also true that throughout history, immigrants have usually aroused distrust and hatred. In ancient Greece, outsiders were permitted to live in Athens, pay taxes, and (if need be) fight for it—but they could not become citizens. In modern times, some European nations, especially France, have struggled with the influx of unpopular, culturally different people from former colonies and other nations. Although many natives despise these newcomers for the cultural damage they will supposedly do, the immigrants nevertheless work, produce, and gradually fit in.

Immigrant contributions / Knowing that most of his readers will be Americans, Vargas Llosa devotes much of his effort to responding to the arguments that immigration opponents are making here. According to the opponents' narrative, in the 19th century U.S. immigrants were hard-working people who strove to assimilate into society. Today's immigrants, however, are more interested in collecting government benefits than working (but when they do work, they have the temerity to take "our" jobs) and are not much interested in assimilating. Accordingly, immigration opponents conclude, U.S. policy must change so that we admit only immigrants who have skills that are in short supply—engineers for example. Such people will add to the U.S. economy rather than impose costs, and they will readily assimilate.

Vargas Llosa counters those claims by pointing out that today's immigrants are little different from those of a century or more ago, and argues that the change we should make in our immigration policy is toward much greater freedom. With respect to work and welfare, he shows that very few immigrants do not work and that they are only slightly more of a welfare and public-services burden than "real" Americans are. True, immigrants are more apt to require emergency room medical care and Congress does appropriate around $250 million annually for the states to cover the cost of such treatment. Also, children of immigrants contribute substantially to public education costs, at least in some areas. Hearing about those and other costs associated with immigration, the nativists quickly demand that we secure the border and deport all the illegals.

That's superficial thinking, Vargas Llosa contends, for three reasons: First, immigrants on the whole contribute more to the nation's economy than they consume. Second, they save more than natives ("a habit sorely lacking in the country" he writes). Third, immigrants usually arrive in their most productive working years, a benefit for a country with an aging population with great numbers of people on the verge of retirement.

Moreover, immigrants have been and remain a tremendous source of entrepreneurship. They begin and often expand businesses that provide employment for many thousands of workers, most of whom are not immigrants. While many young Americans grow up with an entitlement mentality that makes the difficult work of starting a business from scratch almost unthinkable, that mindset is absent in immigrants. Thus, immigration helps to energize America with fresh injections of people who are creative and ambitious. We *need* that.

In sum, the case against immigration is based on a fixation with its short-run costs while overlooking both the immediate and long-run benefits.

Fitting in / What about cultural assimilation? Vargas Llosa writes that the "good old days" were not really as good as they are portrayed. Immigrants in the 19th and early 20th century were often slow to learn English, intermarry, and "fit in." The same complaints we hear today, such as the inconvenience of large pockets where the immigrants' native language predominates, were voiced in the past. (The inability to speak German was a considerable handicap in many towns and cities in the Midwest until the early 20th century.) More to the point, however, it simply is not true that today's immigrants are "worse" when it comes to assimilation than were the immigrants of yesteryear. Data show that they learn English and intermarry at about the same rates as in the past.

The case against immigration is based on a fixation with short-run costs while overlooking both the intermediate and long-run benefits.

To the minor extent that present-day immigrants may be slower to assimilate, Vargas Llosa argues that our political obsession with multiculturalism is to blame. Among other statutes and regula-

tions at fault, he particularly criticizes the Bilingual Education Act of 1967, which, he writes, "gave rise to policies that in time would lead many Americans to resent immigrants and view minorities as invasive." As is so often the case, federal efforts meant to help minority groups have been counterproductive. Assimilation used to be accelerated by employer insistence on using English while on the job, but today that can lead to trouble with the Equal Employment Opportunity Commission. If the anti-immigration crowd wants to complain, it should complain about our panoply of multicultural policies rather than about immigration.

Opening borders / In the book's closing chapters, Vargas Llosa sketches an optimistic argument that the ancient tribal fears that many people still harbor today against those who are "different" will give way to open minds, open borders, and a more harmonious world. There may come a time in humankind's evolution, he writes, "when deeply ingrained ideas about nationhood and the nation state, as well as the instinctive discomfort many people feel towards outsiders, will cede their place to more open, flexible, and globalized ideas of human existence, and less defensive attitudes." That is a striking vision, but the author does not believe it is mere wishful thinking. International trends, he maintains, are moving in that direction.

We already have substantially free flows of goods across borders and quite a few nations—the United States being an exception—have been moving toward a freer flow of people as well. Perhaps, Vargas Llosa suggests, a consequence of all the global crossing may be the dissolution of national bonds in favor of "bonds of economic involvement, social networks, and cultural identities." What if, as he puts it, "credo" comes to trump nationality?

If the movement of people across national borders brings that about, we would realize enormous benefits besides improved economic growth. It would dampen the dry kindling of nationalism that so often flares up into violent conflict. Demagogues have long exploited what Vargas Llosa calls "the fortress view of nationhood" to cement their hold on power, even at the cost of war. His optimistic view is that we will see less of that as people move more freely across national borders. Adam Smith famously remarked, "If goods don't cross borders, soldiers will." Our author takes that observation a step further: if goods and people cross borders, soldiers won't. Let's hope he's right.

Global Crossings is, in my view, one of the two best books available on immigration. (The other is Philippe Legrain's *Immigrants: Your Country Needs Them*.) Read both and you'll come away with a strong conviction that the free movement of people is just as vital to economic health as is the free movement of resources, ideas, and goods. R

Working Papers

BY PETER VAN DOREN

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

High-Frequency Stock Trading

"What Do We Know About High-Frequency Trading?" by Charles M. Jones. March 2013. SSRN #2236201.

High-frequency trading (HFT) uses automation to implement strategies that were previously performed by market specialists in exchanges. HFT has increased competition in market-making and reduced the price of capital. Bid-ask spreads have decreased over time and revenues to market-makers have decreased from 1.46 percent of traded face value in 1980 to 0.11 percent in 2006. And HFT reduces stock price volatility; when the temporary ban on short sales of financial stocks existed in 2008, the financial stocks with the biggest decline in HFT had the biggest increase in volatility.

Although most commentators recognize those benefits of HFT, they also believe that it makes financial markets more fragile. The "Flash Crash" of May 6, 2010, during which futures for the S&P 500 fell almost 10 percent in 15 minutes, is often cited as an example of the costs created by HFT.

In this paper, Columbia Business School professor Charles Jones argues that HFT behavior during the "Flash Crash" was initially stabilizing, but eventually high-frequency traders also liquidated their positions, exacerbating the downturn. He claims that even before HFT, market specialists also behaved similarly, buying initially when others were selling and thus reducing the effects of a panic, but then eventually selling themselves. He concludes that HFT does not appear to be any more destabilizing than market specialists were.

Many view HFT as an "arms race" (traders pushing technology for ever-faster trading and locating servers closer to exchanges to take advantage of millisecond differences in data transit time at the speed of light) that should be stopped by policy. Some have proposed a financial transactions tax, also called a "Tobin tax" (after its first proponent, Yale economics professor James Tobin). A Tobin tax, even a small one, would have large effects on stock values. A 0.25 percent tax would lower returns by that amount. If investors expect a 6 percent return, then a 0.25 percent tax would lower returns to 5.75 percent and stocks would have to drop in value by 4.17 percent (0.25 percent divided by 6 percent) to restore the 6 percent required return. Bid-ask spreads are now 1 cent for large cap stocks, but a 0.25 percent tax would add 12.5 cents to the spread for a $50 stock.

PETER VAN DOREN is editor of *Regulation* and a senior fellow at the Cato Institute.

Jones describes the Swedish tax experience as instructive. In 1984, Sweden imposed a 1 percent transaction tax, which doubled to 2 percent two years later. Some 60 percent of Swedish stock trading volume moved from Sweden to London. Swedish stock values fell by 5.3 percent and capital gains tax receipts actually fell by more than the amount of transaction taxes collected. The tax was repealed in 1991, but Swedish stocks continued to trade in London. Sweden never regained its role in financial markets.

Patent Reform

"Predatory Patent Litigation," by Erik Hovenkamp. August 2013. SSRN #2308115.

Non-practicing entities (NPEs) are firms whose sole assets are intellectual property that they have purchased the rights to, rather than developing themselves. The firms' main activity is suing other companies for patent infringement. They have been discussed in these pages before (see "The Private and Social Costs of Patent Trolls," Winter 2011–2012, as well as last issue's "Working Papers" column). Commentators seem to agree that NPEs are opportunists that exploit and illuminate flaws in overly broad information technology patents, and that they contribute little to economic growth—and may hamper it.

One proposal to reduce this opportunism is to increase the fees to renew a patent late in its life because mischievous suits seem to occur exclusively late in patent life. Another proposal is to shift the legal fees for patent infringement suits to the courtroom losers, thus increasing the costs of frivolous suits.

Northwestern University J.D./Ph.D. student Erik Hovenkamp offers a different idea: defendant mutual defense by contract. Predatory NPEs now attack firms one at a time. Defendant firms frequently settle rather than face the prospect of a financially catastrophic judgment. Hovenkamp proposes that manufacturing firms whose success is dependent on intellectual property form mutual defense associations analogous to treaty organizations among nations. The members would agree to share defense costs and to litigate to judgment rather than settle cases out of court. This, along with the shifting of legal fees to the losers as proposed by Mark Lemley and Douglas Melamed (discussed in last issue's column), would deter NPEs from litigating low-quality patent cases.

Unemployment Insurance

"Unemployment Benefits and Unemployment in the Great Recession: The Role of Macro Effects," by Marcus Hagedorn, Fatih Karahan, Iourii Manovskii, and Kurt Mitman. October 2013. NBER #19499.

Unemployment following the Great Recession has remained unusually high. One possible reason is the extension of unemployment benefits from their usual 26-week limit to a period as long as 99 weeks. The conventional wisdom is that such extensions have positive effects on the macroeconomy because they have very little effect on labor supply and also increase aggregate demand because unemployed workers have a large marginal propensity to consume any benefits they receive.

This view has been supported by low estimates of the effect of unemployment insurance extensions on labor supply. Economists have used the cross-sectional variation across states in extension initiation and duration to estimate the effect of benefit variation on the search behavior of the subset of the unemployed who receive benefits. For example, in a fall 2011 *Brookings Papers on Economic Activity* article, Berkeley economics professor Jesse Rothstein compared those unemployed who are eligible for unemployment insurance with those who are not, thus isolating the search behavior of those receiving benefits. He concluded that the increased duration of benefits has a very small effect on the duration of unemployment and concludes that only a small fraction of the increased unemployment in the Great Recession can be attributed to reduced worker job search effort.

The authors of this paper argue that Rothstein's research design underestimates the total effect of unemployment insurance extensions on labor supply because it does not include the indirect effects on labor demand, i.e., the posting of vacancies by firms. The effect of benefit extensions on labor demand arises because the existence of unemployment benefits *reduces labor supply*, which increases the wage that would-be employers have to offer, which in turn decreases firm expected profits and reduces the posting of vacancies.

To detect this effect on vacancies, one cannot simply regress the increase in benefits on wages, in general, because the wage data would include both the effect of reduced labor supply (less searching) that would increase wages as well as the effect of reduced labor demand (fewer job creations) that would decrease wages. The authors propose instead a regression of difference in wages against difference in benefits across time, but only for those workers who stay on the job. The differences in benefits arise through estimation on contiguous counties on opposite sides of a state border. The authors conclude that a rise in unemployment of 3 percentage points is the predicted result and that "unemployment benefit extensions account for most of the persistently high unemployment after the Great Recession."

Clearinghouses

"The Dodd-Frank Act's Maginot Line: Clearinghouse Construction," by Mark J. Roe. March 2013. SSRN #2224305.

Clearinghouses have become a standard response to the failure of troubled financial institutions in 2008. Proponents argue that if the credit default swaps created by American International Group (AIG) had been cleared rather than traded over the counter, the clearinghouse would have paid the capital and collateral calls of the counterparties holding credit default swaps for debt secu-

IN REVIEW

rities backed by pools of mortgages. This would have eliminated the fire sale of such assets to raise capital and the resulting decrease in asset market value that was at the heart of the financial crisis and the bailout of AIG. This thinking has become conventional wisdom and is embodied in the Dodd-Frank Act of 2010.

Regulation was one of the first to criticize such thinking in an article by University of Houston finance professor Craig Pirrong ("The Clearinghouse Cure," Winter 2008–2009). In this paper, Harvard law professor Mark Roe agrees with this criticism and argues that Dodd-Frank and similar proposals are severely misguided. Clearinghouses would not have stopped what happened in 2008: the reevaluation of the same assets by multiple institutions at the same time and selling them to raise cash. A simultaneous common failure or reevaluation of assets across financial institutions is not something that a clearinghouse is even designed to handle. Clearinghouses cannot prevent the effects of a downward asset price spiral from spreading, nor the negative information contagion about those assets. Proponents of clearinghouses seem to forget that the government bailout of AIG was $180 billion while the capital of the clearinghouse for the Chicago Mercantile Exchange is only $7 billion. If AIG had been a member of a clearinghouse, the clearinghouse would not have had sufficient capital.

Income Inequality

"Why Has Regional Income Convergence in the U.S. Declined?" by Peter Ganong and Daniel Shoag. March 2013. SSRN #2081216.

Income inequality discussions usually focus on the changing returns to skill, the role of trade, and measurement issues involving the growing role of health care benefits. A less commonly invoked explanation involves zoning. Migration to higher-wage cities is now much more difficult than in the past and may play an important role in increasing inequality.

From 1880 to 1980, incomes across states converged at the rate of 1.8 percent per year, according to Harvard economist Daniel Shoag and doctoral student Peter Ganong. Since 1980, that convergence has stopped. In 1940, per-capita income in Connecticut was 4.37 times per-capita income in Mississippi. In 1980, that ratio had decreased dramatically to 1.76. But since then no change has occurred; the ratio is now 1.77.

The authors' explanation for this is housing supply constraints. The difference in housing prices between rich and poor states has grown relative to income differences across states. The result is that from 1980 to 2010 there has been a large reduction in low-skill migration to those states with a high share of bachelors' degrees, but no change in high-skill migration to the same states. Had migration continued after 1980 at the same rate, wage inequality would have been 10 percent smaller.

Legal Services for the Poor

"The Cost of Law: Promoting Access to Justice through the Corporate Practice of Law," by Gillian K. Hadfield. December 2012. SSRN #2183978.

The most provocative advocate for the deregulation of the provision of legal services is University of Southern California law professor Gillian Hadfield. She has argued her position twice in these pages ("Privatizing Commercial Law," Spring 2001, and "Legal Barriers to Innovation," Fall 2008).

In this new paper, she notes that ordinary people often appear in court without legal representation. The legal profession has responded to this by requesting more legal aid. But in Hadfield's view, the problem arises from the economic regulation of the provision of legal services. In particular, state regulation of the corporate practice of law prohibits, say, Walmart and Target from providing legal services in their stores. And states forbid online legal-document companies from providing legal assistance. Those prohibitions prevent the development of lower-cost methods of providing legal services. R

Regulation CATO INSTITUTE

EDITOR
Peter Van Doren

MANAGING EDITOR
Thomas A. Firey

DESIGN AND LAYOUT
David Herbick Design

CIRCULATION MANAGER
Alan Peterson

PUBLISHER
John A. Allison IV
President, Cato Institute

Regulation was first published in July 1977 "because the extension of regulation is piecemeal, the sources and targets diverse, the language complex and often opaque, and the volume overwhelming." Regulation is devoted to analyzing the implications of government regulatory policy and its effects on our public and private endeavors.

Are you concerned about what America's college students are learning these days?

So are we!

The John William Pope Center for Higher Education Policy is a nonprofit institute dedicated to improving the nation's colleges and universities.

Concerns

We are concerned that:

- The intellectual life on campus is narrow, rejects traditional Western ideas, and belittles inquiry
- Faculty pay is rising, but faculty teaching workloads are declining
- Accountability is inadequate
- Taxpayers may be paying for inefficiency

Goals

Our goals for U.S. universities are to:

- Increase the diversity of ideas
- Encourage respect for freedom
- Improve students' learning
- Cut costs

To achieve these goals we:

- Inform the public about actual learning
- Promote classic texts and traditional curricula
- Tell taxpayers where their funds are going
- Make policymakers aware of our feelings

The John William POPE CENTER FOR HIGHER EDUCATION POLICY

For more information, visit popecenter.org