

# Regulation Overdose

Reviewed by David R. Henderson

## LEVIATHAN'S DRUG PROBLEM: Federal Monopoly of Pharmaceutical Regulation and its Deadly Cost

By John R. Graham

49 pages; Pacific Research Institute, 2009

## OVERDOSE: How Excessive Government Regulation Stifles Pharmaceutical Innovation

By Richard A. Epstein

283 pages; Yale University Press, 2006

Traditionally, one reviews books when they have been out for only a few months. But that tradition was likely due to the fact that if a book did not sell much in the first few months, it was hard to find in bookstores. The web and Amazon have changed all that. Now there is a long tail — many books that will sell in small numbers but are relatively cheap to inventory. It makes sense, therefore, to review books that, for whatever reason, did not sell well but should have. Thus my review of Richard Epstein's 2006 book *Overdose*.

Epstein, the University of Chicago law professor, is a delightfully unusual scholar in that he not only covers the legal issues thoroughly, but he also is an exceptional microeconomic thinker. He has that rare ability to take an issue, apply some basic microeconomics combined with some careful assumptions about various magnitudes and, *voilà*, reach a conclusion that may surprise and will certainly illuminate. Indeed, his virtuosity at this is reminiscent of his retired University of Chicago colleague, economist Sam Peltzman.

Epstein displays all of these skills in

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*Overdose*. In it, he defends patent law in the drug industry while criticizing various proposals to change the law, and also argues against the extreme regulation of drugs that the FDA has engaged in for decades. I found his case for strong patent law in the pharmaceutical industry persuasive, despite my libertarian view that patent law is essentially an arbitrary assignment of monopoly power by government. If there is ever a case for patents, the drug industry is the one for which that case is strongest. Possibly more important, he makes a devastating case that the FDA should not have the power to prevent new drugs from being brought to market. That is not all; Epstein also analyzes the problems with our current tort law system for drug liability and suggests some ways out.

**Drug Prices** Take the old bromide about how advertising and marketing costs of drugs increase the price that drug companies must charge. Seems obvious, right? It is also incorrect, and Epstein effectively explains why. He points out that the cost structure in the pharmaceutical industry is extreme: high fixed costs — potentially in the hundreds of millions of dollars — to produce the first pill that can be legally marketed, but then low marginal costs for subsequent pills. Without large expenditures on marketing, the market will be too small to generate enough revenues in excess of variable costs to cover the fixed costs. Drug company executives, looking forward and seeing this fact, will not develop new drugs. And a nonexistent drug has, in effect, an infinite price. But if spending this money on marketing can multiply the size of the market, then the

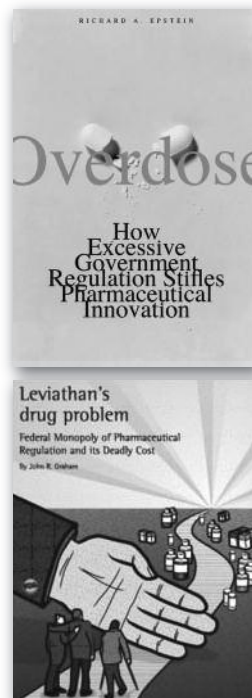
expected revenues will be enough to make developing the drug worthwhile.

Epstein uses a numerical example to clinch this case. Assume, he says, that a new product costs \$1 million to produce; thus, without marketing, it must sell at least 10,000 units at \$100 per unit. But assume further that at that high \$100 price, only 8,000 people want to buy it. Revenue to the firm: \$800,000. Result: the drug does not get produced. But now assume that for an additional \$200,000 of truthful and accurate advertising (in a separate chapter, he handles ads that are not in this category), the firm can sell 100,000 units at \$20 a pop. The result: the firm makes revenues of \$2 million. Assuming that its variable costs are \$500,000, the firm will net \$300,000. The drug has been produced, and marketing has made

its price fall from infinity to \$20. Scale up these numbers by a factor of 100 (except for the price) and you have a fairly plausible, possibly even common, scenario in the drug industry.

Epstein's analysis of the law and the economics of the drug industry is outstanding on many levels. To give them all their due would require a small monograph. So I will focus on four: the nature of competition between "me-too" drugs, extreme FDA regulation that prevents or slows the introduction of new drugs, the issue of "reimportation," and the liability system for drugs.

One of the charges leveled by critics of the pharmaceutical industry is that it invests too much in so-called "me-too" drugs. Some have even gone so far as to say that a new drug that competes with an old one should not be allowed unless it is superior to the old one. In various speeches, I have criticized this view by pointing to an industry in which virtually everyone recognizes the value of a "me-too" good: the auto industry. You could call a Toyota Camry a me-too Honda Accord. But does anyone doubt that con-



sumers get a better deal on Accords because Honda must compete with Toyota's Camry?

Epstein addresses the argument that drugs are too differentiated from each other to give consumers the benefit of competition. He responds: "[T]his definition of competition is too narrow for its own good: it excludes cases in which substantial but imperfect competition is present across broad product classes." Epstein points to the wine business, which is intensely competitive, but nevertheless there are distinct differences between various brands and varietals.

In the chapter titled "FDA Versus the Individual," Epstein points out something obvious but profound:

If the FDA decides to let a drug onto the market, no one is obliged to use it. Any mistake to permit the sale of a drug is therefore subject to downstream correction by individual users. But a decision to keep the drug off the market is impervious to downstream correction by individual users.

He gives an example of someone who might have a 91-percent chance of dying without taking an action, but a 90-percent chance of dying by taking the action. If the action is surgery, notes Epstein, then the FDA has no say. But if the action is to take a drug, the FDA is involved and might forbid the one-percent solution.

Epstein also notes that by placing its emphasis on the average effects of drug use in evaluating drugs for approval, the FDA "ignores the variation in individual responses." The fact that a drug does not perform as well as a placebo, the kiss of death for approval, "shows that most people should not take the drug, not that it should be banned from the market."

What is the appropriate solution for the problem of price controls that other countries' governments impose on drugs? Epstein argues that the ideal private solution is for a drug company "to attach conditions of sale forbidding any drug sold overseas to be resold for consumption in the United States." That way, arbitrage is limited and a drug company that sells in the lucrative U.S. market can still earn monopoly profits on its patent — profits that encourage it to innovate. A seller that breaches its contractual obligation would then be liable for damages. But Epstein

notes that contract remedies "are difficult to come by in this international setting." What to do? The next-best strategy for drug companies is to "restrict the supplies sold in foreign markets to the estimated level of their domestic consumption to minimize the surplus available for reimportation by foreigners." Charley Hooper and I noted this in a February 24, 2004 *Washington Times* op-ed entitled "Hidden Drug Reimport Potential":

If many people in the United States are allowed to buy from Canada, drug companies will certainly notice. They don't want their U.S. pricing policies undercut because the U.S. market, relatively free of price controls, is the most lucrative drug market in the world. There is only one way not to have their prices seriously undercut: They will choose to limit supplies to Canada.

Unfortunately, there has been pressure from the U.S. Congress to require American firms to sell to foreign distributors in select countries whatever quantities of drugs they want to buy at a price equal to the price charged — often by government order — in the local market. Epstein points out the problem. To require these firms to sell unlimited quantities at an often-government-controlled price, quantities that could then be arbitrated to the U.S. market, would allow "foreign nations to set the prices for domestic (and foreign) sales of American drugs without any attention to whether drug companies receive a permissible rate of return once those restrictions are put in place." Epstein, always on the lookout for a government "taking" without just compensation, spots one here.

**Drug R&D** My fourth and final highlight from Epstein is his devastating critique of the current liability system for drugs — both in the abstract and by reference to actual legal cases, especially Vioxx. (The Vioxx discussion alone is worth the price of the book. Indeed, had I written the book, I would have led with this discussion because it shows just how dysfunctional the liability system is and how the *New England Journal of Medicine*, in particular, helped set up Vioxx's producer, Merck.) Instead of summarizing his complex views on the issue, I will hit the high points.

Epstein points out that the *NEJM*

helped create suspicion of Vioxx by publishing an "expression of concern" about an earlier study of Vioxx that the journal had run. He explains, "[E]xpression of concern' is a technical term that is tantamount to a charge of scientific fraud." He points out that the *NEJM* had published only three expressions of concern in its history and that, in this case, it did not take the more-normal route of referring the matter to the home institutions of the article's authors. He goes into great detail, concluding that, at most, there was evidence of procedural error, not scientific fraud.

Moreover, consider the civil case against Vioxx, in which Robert Ernst's widow was awarded \$253 million. Ernst had all the indicators of someone with a high probability of dying of a heart attack *whether or not he took Vioxx*. Epstein writes, "Just this logic should have propelled Merck to an easy win." Moreover, because little in the current legal system "allows for the coordination of awards across different cases," even if Merck did over-promote its product, we would have been closer to the mark had the case never been brought.

Epstein cites and defends the estimate of Joseph DiMasi of Tufts University and his colleagues that the cost of bringing a new drug to market is \$802 million or more. The Naderite organization, Public Citizen, criticized this study. Epstein points out that one of their main criticisms is that the estimate mistakenly included the cost of capital. Epstein argues, as would virtually any economist, that the cost of capital is a relevant cost.

Two of the drug industry's chief critics, critics who want more, not less, pharmaceutical regulation, are Arnold S. Relman and Marcia Angell, both former editors of the *NEJM*. Epstein criticizes other thoughts they have, but Angell and Relman's touting of Public Citizen's criticism is worth quoting if only because these two critics are well respected, at least by some. In "America's Other Drug Problem" (*New Republic*, December 16, 2002), they write:

The authors [DiMasi et al.] seem to justify this interesting account maneuver on the grounds that from the perspective of investors, a pharmaceutical company is really just one kind of investment, which they chose among other possible invest-

ment options. But while this may be true for investors, surely it is not true for the pharmaceutical companies themselves. The latter have no choice but to spend money on R&D if they wish to be in the pharmaceutical business, so they have no “opportunity costs.” To add the investors’ opportunity costs to the company’s out-of-pocket cost of developing a drug seems rather odd. DiMasi assures us that this calculation conforms with standard economic thought and accounting practice, but recent events on Wall Street make such reassurance less comforting than it might once have been.

Wow! I mean, wow! Don’t Relman and Angell understand that drug companies, to raise capital to be in the business, must give investors a return at least as high as they can earn elsewhere? And, as for “recent events on Wall Street,” by which they were presumably referring to Enron, did anything that happened suggest to careful observers that companies in any business have a zero opportunity cost of capital? Relman and Angell are flailing at best.

**Drugs and the FDA** John R. Graham is a health economist with the Pacific Research Institute (not to be confused with John R. Graham, the financial economist at Duke University). In his new monograph *Leviathan’s Drug Problem*, he does an excellent job of analyzing Food and Drug Administration regulation and summarizing the research on the high cost of that regulation.

Graham quotes Richard Miller Jr. and H.E. “Ted” Frech’s finding (in their 2004 AEI Press book *Health Care Matters*) that in 1990, the lifetime cost of pharmaceutical spending to add one year of life expectancy was \$15,952 for a 40-year-old woman and \$14,486 for a 60-year-old woman (with comparable numbers for men). This is well below the threshold of cost effectiveness that most health economists use to measure value for money, suggesting that pharmaceuticals offer a very good deal.

Graham also gives evidence that the FDA, by delaying and preventing the availability of drugs, kills far more people than it saves. He points out that the Prescription Drug User Fee Act (PDUFA), by charging drug companies large fees to have their drugs considered by the FDA, has reduced the drug lag. (See “How Have User Fees

Affected the FDA?” Spring 2002.) But he also argues that PDUFA is not enough. He quotes the finding of the Abigail Alliance for Better Access to Experiment Drugs — which consists of families who have lost loved ones who were prohibited from taking experimental drugs — that every drug for which it advocated use as an experimental drug was later approved by the FDA.

Graham’s solution? Competing approval agencies. For instance, drug certification could be undertaken by a private nonprofit approval agency, just as Under-

writers Laboratories now does with thousands of products and the Snell Memorial Foundation does with helmets. But wouldn’t a nonprofit be a monopoly just like the FDA? No. That is not how UL, for example, works. Although UL does not need to make a profit, it does need to attract customers and it must compete with other standards organizations. A middle ground, notes Graham, is to allow Americans to use a new drug as soon as a regulator in any developed country grants approval to that drug. **R**

## The Living Dead

Reviewed by George Leef

### THE TYRANNY OF DEAD IDEAS: Letting Go of the Old Ways of Thinking to Unleash a New Prosperity

By Matt Miller

272 pages; Times Books, 2009

**M**att Miller, the author of the recent book *The Tyranny of Dead Ideas*, is a senior fellow at the Center for American Progress, communications consultant, and host of the public radio show *Left, Right, and Center*. He positions himself as a “centrist” who favors government intervention in markets, differentiating himself from influential liberals whose notions would crash the nation onto the rocks of economic stagnation and egalitarian envy, and from free-market purists whose advocacy of downsizing government he fears will lead to diminished public welfare.

In the book, Miller argues that the only intelligent course is to make government bigger but also smarter. The problem, he claims, is that reform and expansion are blocked by “old ways of thinking” on both Miller’s left and right. If that thinking can be overcome, then America can “unleash a new prosperity.”

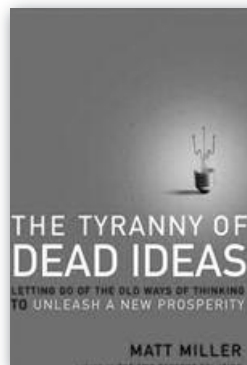
So what are these “six dead ideas”? In a nutshell:

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**Rising Standard of Living?** Miller contends that the age-old belief that each generation of Americans will enjoy a higher standard of living is no longer true. The reason for this, he says, is globalization. Global competition “puts an effective wage cap on large swaths of employment, even if jobs do not actually move offshore.” Therefore, he says, we must face the reality that there will be a huge gap between the relatively small percentage of Americans who earn very high incomes and the badly lagging middle and lower classes. Miller’s prescription is increasing income redistribution and government intervention in markets.

It is difficult to embrace Miller’s concern, given that just about every recent American generation has been told that “times have changed” and that their generation will be the first generation to not live as well as their parents did. To date, none of those gloomy pronouncements — often made by learned individuals citing all sorts of compelling reasons — have proved true. Who knows — perhaps Miller will be the first.

But if he is, then I have little confidence that his prescription of government intervention and redistribution will save us from such a decline. From milk marketing orders, to Regulation Q, to Essential Air Service, there are heaps of examples of government intervention that misallocates scarce resources away from high-



value uses, not toward them. Likewise, redistribution can lead to misallocations of labor and lessened incentives for the accumulation of skills. There is good reason to worry that bigger government will perpetuate and expand such misallocations, which will not improve living standards, but will lower them.

**Free Trade Is Always Good?** The second “dead” idea that Miller decries is the notion that the United States should be an ardent supporter of free trade. He argues that the era of globalization changes the old calculus of specialization and gains from trade, because today each country’s productive capabilities are not fixed. Rapid changes in other countries result in too many American workers being hurt by trade and, again, the government needs to step in.

To be fair to Miller’s position, I stress that he is not a protectionist. He accepts the benefits of trade, but he wants government to ease the transition costs when domestic workers lose their jobs because of foreign competition (not, however, if technological change is the cause). I appreciate that point, but it seems that there are many programs already in place for this (e.g., unemployment insurance, retraining subsidies, welfare-to-work programs). I worry that, instead, Miller’s call will be a conduit for protectionism.

**Employers Should Take Care of Employees?** Miller claims that industrial capitalism’s “brutality and insecurity” in the 19th century led to the idea that workers should look to their employers for protection against life’s major risks. As a result, health insurance and retirement income are often provided by employers. The problem is that the cost of these benefits is (supposedly) becoming too onerous for business. Miller recommends putting government, not employers, in charge of overseeing workers’ health care and retirement income.

As we all know, it was an historical accident that health insurance came to be a fringe benefit of employment in the United States rather than something individuals bought on their own. Likewise, traditional pensions came about as a way for employers to defer some of their compensation to workers, and at the same time

create a pension fund that could be used as an emergency fund by the employer if it found itself in dire financial straits.

Undoing the historical accident and removing any inappropriate incentives for traditional pensions would ultimately benefit public welfare. However, I am not so sure that shifting responsibility for health care and retirement income from employers to government is the best way to help workers.

**Taxes Are Always Bad?** The fourth “dead” idea is that high taxes are always economically harmful. Miller observes that, given the federal government’s high level of current debt plus the unfunded liabilities posed by Social Security and Medicare (not to mention similar liabilities on the state level for Medicaid and state employee pensions and benefits), there will need to be a considerable increase in government revenues if those obligations are to be fulfilled. Miller believes the economic drag produced by all these unfunded liabilities outweighs any short-term economic gains from lower taxes today, and he attacks Republicans and conservatives for using current tax rates as a political wedge issue.

I fully appreciate the significance of the unfunded liabilities that federal and state governments face over the coming decades. However, in simply embracing tax increases, Miller ignores the fact that higher revenues do not necessarily mean reduced unfunded liabilities. It seems likely to me that, after raising taxes, lawmakers will do what they always do: direct the new money toward new spending, which they will label “investment.” Neither starving the beast nor feeding it seems to make it go away.

**Schools Should Be a Local Matter?** I took special interest in Miller’s fifth “dead” idea, which is that K–12 public schools should remain under local control. He argues, not without reason, that local control allows special interest groups, especially teacher unions, to get away with low standards and enormous inefficiency. He wants to bury this idea because other nations, by centralizing control of their schools, are said to be racing ahead of us in educating the young.

Let us give Miller a gold star for saying things about public education that liberals are loath to say. At many schools, stan-

dards and performance (by students and teachers) are dismal. Unions run school systems for their benefit, squeezing out tremendous amounts of money from taxpayers in exchange for work that usually is mediocre at best.

However, I cannot see how this can be remedied by centralizing education policymaking in Washington. The more centralized political control is, the more easily it is affected by special interests and the more difficult it is for ordinary citizens (especially a citizenry as diverse as the United States) to get the schools they want. Federalization is a dubious cure for inefficiency in anything.

The underlying flaw in Miller’s thinking here is that he does not understand that many of the problems in education are the product of regulations and policies that are sacred to the education establishment. Consider, for instance, teacher certification. Certification typically requires would-be teachers to show mastery and utilization of a particular approach to pedagogy. Yet as all good teachers know, different children respond differently to different pedagogies, and different teachers are effective at some pedagogies but not others. Effective education is the matching of student to teacher to pedagogy — a matching that is difficult enough on the family and local levels, and increasingly impossible as education policymaking becomes more and more centralized. Hence, the certification requirement, in its current form, serves to shelter specific pedagogical theories, not to provide the best educational setting for different children — but the former is what the education establishment wants. We also have teacher job security rules that make it nearly impossible to fire a poor teacher — and again, that is what the education establishment wants. Why would the education establishment want something different — or be less effective at getting what it wants — if education decisions are shifted to Washington, DC instead of state capitals and local school boards?

**Money Follows Merit?** The last of Miller’s “dead” ideas is that modern capitalism is a meritocracy where the level of one’s income reflects his economic contributions. That idea must be tossed aside, Miller says, so we can tax those who make gargantuan incomes and restore a sem-

blance of social justice.

As is the case throughout the book, there is a nugget of truth in what Miller writes. Over the past two decades, some individuals have pocketed prodigious amounts of money. More than a few of them have received this money not because of some feat of value addition, but because they knew how to game the system and had the right connections.

Miller claims to sense a brewing class revolt against the super-rich that will result in higher taxes. I think this is wishful thinking. But assuming he is right, will the revolt benefit the public? It seems likely that such a revolt would be against all richies, not just those who gained their wealth through mischief. But if all of the wealthy are attacked, that would weaken beneficial incentives for hard work and innovation, which would certainly not leave the public better off.

**New Ideas** In the second part of the book, Miller describes some of the new ideas that he wants to succeed the “dead” ones that he has trashed. Let us consider two of them.

First, Miller believes that government and business must work hand-in-hand in order for the nation to have a vibrant economy, declaring, “Only government can save business.” He is eager to justify his “new” idea that the state can and should take care of workers and claims that American businesses cannot compete internationally if they have to bear the health care costs for their workers.

“Legacy costs” such as retiree pensions and benefits, as well as benefits for current workers, have proven a heavy burden for some U.S. employers — but not nearly as many as Miller seems to believe. General Motors and the major airlines of the pre-deregulation era are examples of such troubled employers (though some of those airlines also exemplify how such burdens can be reduced), but my sense is that the overwhelming majority of firms are not in such dire straits. This is not to say that firms do not want to reduce their costs, but instead that they have managed their obligations prudently and been able to navigate difficult tradeoffs in their compensation packages. If suddenly the federal

government were to relieve them of these burdens (in exchange for increased taxes, of course), wouldn’t those employers then have to make difficult decisions about other forms of compensation?

Second, Miller believes that it is a “destined idea” that the United States will significantly raise taxes and thus “save the economy (and the planet).” He wants Americans to act “like adults” and accept the necessity of higher taxes so as to fund more government services. He calls for a “smarter” tax system with lower rates on business — thereby leaving them with more money to hire and invest in their operations — but higher taxes on individ-

### In his calls for bigger government, Miller writes as if Beltway inhabitants are paragons of virtue and knowledge.

uals through the adoption of a Value Added Tax and carbon taxes. (The latter, of course, is premised on the idea that lowering carbon dioxide emissions is crucial.) Miller believes that this change, coupled with substantially higher tax burdens, will do little economic harm, pointing to European nations like Denmark that seem to be decent and fairly prosperous places despite their high tax burdens.

In this discussion, Miller gives no thought to inefficiency and opportunity cost, and the likelihood that government expansion would increase them. The more of GDP the government takes and spends according to the preferences of politicians, the less is left for individuals and private organizations (profit and nonprofit) to use as they would like. Miller, in his calls for bigger, more centralized government, writes as if Beltway inhabitants are paragons of virtue and knowledge, when in fact the political process is dominated by short-term thinking focused on electoral popularity and bureaucratic self-preservation. Under such conditions, waste and inefficiency can continue indefinitely. In contrast, private decision-making has more incentive to consider long-term tradeoffs and to stomp out waste and inefficiency. This is not to say that private decision making is infallible or that there is little need for a public sector, but instead that

policymakers who are concerned with public welfare should be reluctant to transfer private decisions to the public sector. By increasing the government’s take, we diminish the sector of the economy that is especially adept at producing and innovating. That is a bad tradeoff.

Miller points to Denmark in order to dismiss concerns that higher taxes and bigger government could prove economically harmful. But I can point to similarly heavily taxed, heavily politicized nations like Argentina that ultimately descended into economic oblivion. Perhaps Denmark and a bigger-government United States would ultimately not suffer decline, but I

am skeptical. I think we would be much better served to find ways to cut the burden of government.

**Conclusion** In short, Miller wants us to believe that it is possible for the United States

to significantly increase taxes; federal control of education, health care, and retirement; further redistribute income — and simultaneously become more prosperous. I am not optimistic that policymakers can be such careful architects. Everywhere I look, I see political meddling contributing to our present and looming future woes: the housing bubble and resulting financial implosion; the avalanche of unfunded federal and state liabilities; high unemployment; low national savings; misallocated investment; an inefficient educational system, and so forth. Yet Miller’s book proposes still more politicization as the cure for problems that have roots in politics.

To be sure, Miller prescribes all sorts of limits to the government expansion he advocates, in order to protect us from what he acknowledges are problems of big government. But there is no reason to think that real-world politics would play out anything like Miller’s ideal. The wealth and power that would be created by such centralization and expansion would provide enormous incentives for mischief for even the most benevolent-minded political leaders. Instead of the benign results he envisions, we would get a considerable increase in rent seeking by special interests. The result would not be the unleashing of “a new prosperity,” but the unleashing of more lobbyists. **R**

# Losing the Privilege

Reviewed by William L. Anderson

## LOSING THE NEWS: The Uncertain Future of the News that Feeds Democracy

By Alex S. Jones

256 pages; Oxford University Press, 2009

As U.S. newspapers continue their financial slide, journalists are launching a pity party, watching once-lucrative and influential careers slip away. Alex S. Jones, a Pulitzer Prize-winning journalist formerly with the *New York Times* and now with Harvard University, serves as a host of that party with his recent book *Losing the News*. While this is a thoughtful work by a thoughtful writer, in the end it slips into the fantasy that our very way of life is in peril unless newspapers are rescued, either by government or by consumers having a change of heart.

I write from a different perspective than most economists, in that I was an undergraduate journalism major and worked at a few newspapers. I also briefly worked for Jones while at a paper owned by his family in Tennessee. (This review states my opinion of the book, not of Jones, who was a good boss.)

Jones is correct that American newspapers are in trouble. Many have closed. Others have downsized, and their futures are in doubt. However, the loss of newspapers in their present form does not equate to a lost society. *Losing the News* does not make its case that the decline of newspapers is a tragedy. Mainstream journalists are not losing their ability to report news, but instead are losing privileges that they once enjoyed, privileges that gave them special status. The salient issue is not that Americans are not “losing the news,” but rather that mainstream journalists have lost influence, which is quite a different matter.

**Watchdogs** Newspapers, Jones claims, are responsible for an “iron core” of important material:

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Inside the core is news from abroad, from coverage of the war in Iraq to articles describing the effort to save national parks in Mozambique. There is news of politics, from the White House to the mayor’s office.... There is policy news about Medicare reform and science news about global warming.

He continues:

What goes into this cannonball is the daily aggregation of what is sometimes called “accountability news,” because it is the form of news whose purpose is to hold government and those with power accountable. This is fact-based news, sometimes called the “news of verification” as opposed to the “news of assertion” that is mostly on display these days in prime time on cable news channels and in blogs.

This core, he contends, is vital to our way of life and is threatened by cable and satellite channels and the Internet. Jones is not a Luddite and does not call for restrictions on new media, but nonetheless he labors under the false premise that mainstream journalists are “watchdogs” of government.

His second mistake is that, as a “progressive,” he fails to consider the role of entrepreneurs — and profits — in creating the outlets for “hard news.” Jones believes in the core of “objectivity” of news and asserts that a journalist has a duty to report facts, whether or not the facts adhere to the journalist’s worldview. For example, on the PBS show *Media Matters*, of which he was executive editor, Jones noted that the mainstream media gave false information about so-called partial birth abortion, claiming the procedure is rarely performed when, as investigations later demonstrated, thousands of them are performed each year. This admission took some courage, and I applaud his integrity. However, he erroneously assumes that this anecdote is a rare exception that “proves” the rule of mainstream media objectivity.

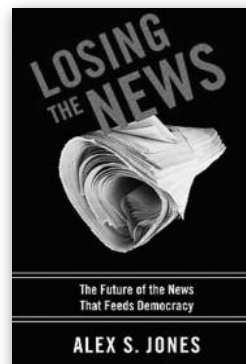
**Editorializing the News** Jones also claims there is little or no connection between newspapers’ editorial policy and the newsroom, with this necessary gulf preventing confusion between fact and opinion. In reality, this “gulf” is practically nonexistent, resulting in biased, politicized “news” coverage. Two case studies bolster my point, the first being the infamous Duke lacrosse team “rape” case, and the second the government’s pursuit of alleged “white-collar criminals.” These occurrences show how journalists often become enablers of government misconduct.

In March 2006, an African-American stripper falsely accused three white Duke University lacrosse players of raping her during a team party. Mainstream news outlets exploded with indignation. Daniel Okrent, former public editor for the *NY Times*, told *New York* magazine’s Kurt Andersen, “You couldn’t invent a story so precisely tuned to the outrage frequency of the modern, metropolitan, *bien pensant* journalist.” Indeed, the *Times* immediately ran columns implying guilt, even though the original reporter assigned to the case doubted the story.

The *Times* gave the story to another reporter and openly pursued the “race, sex, and class” angle that conformed to the paper’s editorial viewpoint. Even after serious questions arose about the veracity of Durham County district attorney Mike Nifong’s case, the *Times* ran numerous stories ignoring the evidence, including

one in which the paper featured what turned out to be a fabricated police report. Only after a December 2006 hearing demonstrated that Nifong had lied to judges and withheld exculpatory evidence did the newspaper change direction and start scrutinizing its own narrative.

The *NY Times* was not alone in this rush to judgment. Most major news organizations, including the *Washington Post*, the *LA Times*, *Newsweek*, *Time*, and the main broadcasters, all treated every statement issued by the prosecutor as being *ex cathedra*. *Newsweek* even ran a cover story using mug shots of two of the three indicted students, with the hackneyed title, “Sex, Lies, and Duke.”



The journalists later complained that they could not get the facts. This complaint is nonsense — it is reporters' job to get the facts, not to mindlessly recite what government officials give them and ignore or reflexively deride statements made by anyone who disputes those officials. As opposed to the traditional media journalists, bloggers and independent writers began questioning Nifong and gathering troubling information almost as soon as the story broke. K.C. Johnson, a history professor at Brooklyn College and the City University of New York Graduate Center, created a popular blog called "Durham-in-Wonderland" that systematically took apart the prosecution's case. Only one mainstream media member, CBS News' *60 Minutes*, took those dissenting voices seriously, broadcasting a segment in October 2006 that called the charges into question.

As one who wrote a number of articles on this case, I believe that the media's self-proclaimed "ignorance" was willful. The facts did not fit the template of the journalists' worldviews, so the press ignored the facts. Like the details about partial-birth abortion, the news was not "fit to print," at least at Jones' former employer, the nation's "newspaper of record."

If bloggers, independent writers, and good attorneys rescued the Duke defendants, people convicted of "white-collar crimes" have been less fortunate. As one who has written much on white-collar issues (see "Federal Crime and the Destruction of Law," Winter 2009–2010), I see the mainstream media as keeping people charged with white-collar crimes from receiving a fair hearing.

The *NY Times*, *Wall Street Journal*, and other mainstream media enabled Rudy Giuliani's Wall Street witch hunt two decades ago. Unfortunately, we found that journalists will help prosecutors commit felonies and file questionable charges, as long as the prosecutors claim to be "fighting capitalism." Daniel Fischel in his 1995 book *Payback* described how Giuliani and his lieutenants illegally leaked grand jury material to reporters from the *N.Y. Times* and *Wall Street Journal* to implicate Michael Milken, despite the fact that much of the material turned

out to be false or misleading. The Giuliani leaks cannot be justified as "the public's right to know" trumping "the defendant's right to a fair trial." Prosecutors teamed with reporters to commit felonies in order to keep prominent defendants from being able to defend themselves against criminal charges. As attorney Harvey Silverglate notes in his recent book *Three Felonies a Day*, Milken ultimately pleaded to "crimes" that the U.S. Supreme Court a few years later would say were not crimes at all, yet no one in the mainstream media was interested in that fact.

Misconduct of "prestigious" journalists hardly is limited to the cases I presented. Journalists often report prosecutors' statements (and especially statements from

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Because most journalistic "sources"  
are people employed in government,  
journalists have become a voice of government.

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federal prosecutors) without skepticism. The mainstream media is *not* a "watchdog of government." Indeed, because most journalistic "sources" are people employed in government, journalists have become a *voice* of government.

**Progressive Advocate** When journalists do perform what they see as a "watchdog" role, their watchfulness tends to consist of admonishing government for not regulating to the extent "progressives" demand. Furthermore, government agencies like the Environmental Protection Agency are outright sacred cows that mainstream journalists seem to believe should have no limits on their power.

Take "climate change," for example. Jones excoriates the media for even interviewing people he calls "skeptics," as he considers them "shills for industry." Yet when emails from prominent "climate" scientists were made public last fall, we found these scientists had massaged and hidden data and bullied others to push their points of view. Just like prosecutors who illegally leaked material to the press, the scientists knew that the mainstream media had their backs.

Jones' old employer, the *NY Times*,

ignored the story, running editorials that, in effect, told readers to "pay no attention to the man behind the curtain." Other "prestigious" media outlets followed suit and sat on the story. In fact, bloggers and independent writers made the scandal known to the public.

Why do mainstream journalists like Jones seem to be champions of the Leviathan state? One reason, I believe, is that the modern media is a creation of the Progressive Era of a century ago. For all its emphasis on "good government," the very heart of progressivism was and is the empowerment of state authority and the elimination of protections for individuals and the checks and balances on government authority that the U.S. Constitution created.

Jones claims that progressivism arose because of a public revulsion of corruption and misuse of power, and that out of this revulsion, journalistic "objectivity was born." Furthermore, he repeats the canard that the Standard Oil

Company was an evil monopoly that was engaged in "bullying and business malfeasance." The last charge is interesting, since Standard Oil's real "crime" was adopting business innovations that resulted in the price of kerosene falling from 50 cents a gallon to nearly a nickel by the end of the 19th century.

Jones follows the account of Standard Oil presented by Ida Tarbell in her *History of the Standard Oil Company*. Tarbell, of course, was the daughter of a competing oil producer who was unable to cut costs as well as John D. Rockefeller and so went out of business. Jones may believe that cutting costs may be "malfeasance," but others would call it good for consumers. For good measure, Jones also repeats the claim that Wal-Mart "destroys communities."

The progressives envisioned a country with a powerful executive branch, a relatively weak Congress, a court system that places the burden of proof on private parties and gives the benefit of the doubt to government, and government bureaucracy staffed with "experts" who would run the daily affairs of individuals. As part of this vision, the Fourth Estate has publicized the brilliance and exploits of

“good government” and has tried to keep government on that narrow “progressive” path.

For many years, this arrangement worked well, at least for the media. Reporters had cozy relationships with government officials (and many still do) who were happy to feed them stories, and in return the media promoted those officials and their friends, and punished their enemies. The broadcast media, protected by the Federal Communications Commission, had an even cozier arrangement. Broadcasters acted within a government-defined sphere of “public interest,” and progressive journalists had no argument against what essentially was state censorship of broadcast news.

Too many journalists see themselves as combating two great evils: government officials who do not follow progressive ideals and private business firms. In the 1950s, President Eisenhower and General Motors were the bad guys; in the 1960s, IBM; the oil companies in the 1970s; Ronald Reagan and Wall Street (and Michael Milken) during the “Decade of Greed;” Microsoft in the 1990s; George W. Bush, medical insurance firms, pharmaceutical companies, and Wal-Mart in the New Millennium. The storyline was pretty much taken from the same page as Tarbell’s *History*: companies have tried to spread their tentacles and control our lives, all the while providing shoddy products and services at high prices, while complacent government failed to stop those predations.

Because of the lack of alternatives, there was no way to break up the media oligarchy. If media leaders did not want a story to be told, then there was silence. For example, in an interview in *Playboy* in 1978, Geraldo Rivera (then with ABC News) told of the deliberate suppression of a story that would have been unfavorable to the Panamanian government, which at the time was demanding that the United States turn over the Panama Canal. Rivera explained that he and other journalists from prestigious media outlets feared that anything that gave bad publicity to Panama might kill the canal deal.

Consider the account of the affair President Bill Clinton had with Monica Lewin-

sky. In his book, Jones claims that Internet writer Matt Drudge forced *Newsweek* to run its story breaking the affair prematurely, an assertion that is untrue. Drudge wrote his story only after *Newsweek*’s editors spiked it. Two decades before, a large media outlet could have sat on such a story indefinitely, and it may have never become public knowledge; today, such silence is much more difficult to enforce, thanks to the Internet.

**In Need of Saving?** The rise of the information age, together with media and telecommunications deregulation, has created a number of new media entities, complete with news operations. Bloggers put their opinions — and often accurate analysis and unreported facts — on the web, and

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The mainstream media has been creating its own reality, promoting a view of government that is no longer defensible.

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more and more stories are broken by new media instead of traditional media. Traditional media no longer have the same special privileges they once enjoyed — and they do not like that one bit.

When Jones complains that the decline of newspapers will curtail the collection of “fact-based news,” he is wrong. He seems to believe that the average consumer of news is little more than a mindless cretin, eating fast food, shopping at Wal-Mart, and ignoring the news that he or she needs to know in order to keep our democracy functioning properly. Furthermore, Jones seems to believe, the consumer no longer is buying newspapers and has no commitment to supporting journalistic excellence.

What to do? Jones turns to the government as savior. His recommendations include expanding PBS, subsidizing newspapers, and empowering the FCC to once again determine what counts as news “in the public interest.” The irony that the supposed “watchdog of government” would thus be heavily dependent on that same government is lost on Jones, but such ideas are perfectly in line with his “progressive” beliefs. He believes that the “watchdog of government” must in

turn be watched over and cared for by government.

I disagree strongly that we are “losing the news.” Journalists are losing their former benefits; news anchors no longer stride around like gods come down from the sky. Dan Rather endorses Jones’ book, but one should remember that Rather lost his job because he insisted on using forged documents whose authenticity he had not verified in order to push a story that was little more than a political hit job on a president Rather did not like. The blogs, not the *NY Times*, exposed Rather’s malfeasance, and it is clear from Jones’ weak defense of Rather that he does not like this new order in which the mainstream media itself is closely monitored by people other than the usual “progressives” at the *Columbia Journalism Review*.

There are plenty of good independent writers and bloggers who are interested in promoting the “iron core” of news and analysis. For example, Christopher Halkides, a chemistry professor at the University of North Carolina-Wilmington, has done a masterful job on his own blog, taking apart the forensic evidence in the Amanda Knox case in Italy, something that the mainstream media has largely ignored. The Internet has proven to be a marvelous way to inform people, and whole groups of people find they can communicate without having to go through a media gatekeeper.

At the end of the book, Jones recites the story of the Bush administration official who told a reporter that “we create our own reality,” a statement that left journalists steaming. Yet, since the Progressive Era, the mainstream media has been creating its own reality, promoting a view of government that no longer is defensible. Just as the Bush administration’s attempts to create its own reality imploded under the costs of war and the collapse of the housing bubble, the mainstream media is losing its ability to shape our view of the world.

That does not mean we have “lost the news.” To the contrary, we are finding that we no longer need or even want a Progressive Era dinosaur to tell us what we are supposed to believe about the events of our time. **R**



# 'Clean' Energy and Disguised Costs

Reviewed by David R. Henderson

## THE ECONOMIC BENEFITS OF INVESTING IN CLEAN ENERGY: How the Economic Stimulus Program and New Legislation Can Boost U.S. Economic Growth and Employment

By Robert Pollin, James Heintz, and Heidi Garrett-Peltier

65 pages; Political Economy Research Institute and Center for American Progress, June 2009

Suppose that you want to build a house, and you solicit two builders for estimates. Builder A's eight employees can build the house in three months for \$300,000. Builder B's four employees can build the same house in the same time for just \$150,000. Which builder would you choose?

This is not a trick question. You would choose Builder B, right? But Robert Pollin, James Heintz, and Heidi Garrett-Peltier would select Builder A if they employ the same reasoning they exhibit in their recent monograph *The Economic Benefits of Investing in Clean Energy*. Pollin is a respected professor of economics at the University of Massachusetts-Amherst, where Garrett-Peltier is a doctoral student, and the three are staffers at the university's Political Economy Research Institute. Given their expertise in economics, it is surprising that their monograph confuses benefits with costs, counting it as a benefit that a shift to "clean energy" would create lots of high-paying jobs.

In this, Pollin, Heintz, and Garrett-Peltier are not alone; many non-econo-

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mists (especially ones with "Rep.," "Senator," or "President" in front of their names) make the same mistake. They regard a make-work project as a good project because, in their minds, it "creates jobs" for people who otherwise would not have jobs. Such thinking ignores a basic economic concept: opportunity costs. Every worker employed could have been employed elsewhere, doing something of value. One of the huge advantages of a free market in labor is that, whether the employer is a private firm or a government entity, it must recognize this opportunity cost in the price it pays for labor. That causes employers, especially for-profit employers, to be careful about how much labor to hire. That is a good thing.

### If It's Good, Then Costs Are Benefits

The monograph's gist is that because burning carbon-based fuels is causing global warming and, therefore, hurting the environment, we need to reduce our use of such fuels and use what the authors call "clean energy." Even economists who accept these views — that global warming is happening, that it is harmful, and that we should shift from lower-cost to higher-cost fuels to reduce this harm — will admit that shifting from lower-cost carbon-based fuels to higher-cost alternative fuels will cost more. That is what moving from lower-cost to higher-cost means.

But Pollin et al. say that there is a silver lining: the shift will use more labor, and that is good. Why is it good? Because, they say, many more workers will have jobs. What they have actually done is regard costs — the added jobs — as benefits.

Almost no one spending his own money makes this mistake. The prospective homebuyer above could employ twice as many workers, but he chooses not to do so because it would double the cost of

the house. As Dwight R. Lee pointed out in his modern classic, "Creating Jobs vs. Creating Wealth" (*The Freeman*, January 2000), what matters is the wealth that workers produce for themselves and their employers. Our goal as employers or customers is to maximize the value of what we get for a given outlay.

**Response** Surely, I thought, at some point in this 65-page monograph, the authors will recognize their error. They do, sort of. About halfway through, they have a section titled, "Low productivity is not the result of clean-energy investments." They refer to some unnamed critics and state their criticism as follows:

By definition, if we increase labor intensity through clean-energy investments — if we generate about 17 jobs per \$1 million through clean-energy investments versus about five jobs through fossil fuel spending — then we reduce labor productivity in the energy sector through shifting spending toward clean energy.

Lower productivity, of course, is another way of saying lower output or higher cost for a given output.

How do the authors answer? This criticism, they write, "ignores two crucial and widely understood considerations." The first allegedly ignored consideration is that "clean-energy investments provide new opportunities to previously unemployed workers," thus raising "the productivity level of millions of workers from zero to a positive number." In other words, their whole analysis is based on the idea that all the net jobs created by switching to "clean energy" would be filled from the ranks of the unemployed. That does not seem likely. What does seem likely is that a substantial number of the new jobs would be filled by people moving from other jobs, with very little effect on the overall number of unemployed.

Moreover, even if Pollin et al. were right that the new "clean energy" jobs would be filled solely by the unemployed, this is a short-run situation. When the current recession is over, the high cost from more people being employed in these jobs would rear its ugly head. But the authors do not sell their proposals as short-term. They want a permanent shift in the U.S. economy. Even Paul Krugman, who believes we are currently in a liquidity trap, would



admit that we will be out of that trap in the long run.

The authors seem aware that they need to deal with this issue. They write: “[T]he economy has not approached full employment since the late 1990s.” They seem to be suggesting that full employment is something we will never reach. But many economists would disagree. Many of us have thought that the unemployment rate at full employment was five or six percent; yet the U.S. economy had an unemployment rate below six percent from the late 1990s to the middle of 2008. So even if their plan carries a low opportunity cost now because many of the jobs will be filled by the currently unemployed (again, something that is doubtful), in the long run the output foregone as a result of labor being allocated to “clean energy” jobs is a problem.

The authors’ second response to the criticism is to change the subject. They write that because of what they believe is a global climate crisis, “we need to begin incorporating environmental effects into the measurement of output and productivity.” Their argument is basically that an uncounted benefit of clean energy is the reduction of the harm generated by burning carbon-intensive fuels.

This argument is correct, assuming that their premise is correct: if burning carbon-intensive fuels hurts the environment, then it is true that moving to “clean” energy could create a net improvement in well-being. But that argument is beside the point. The benefit from the improved environment is not the jobs created. In fact, the jobs created are a cost of improving the environment. Suppose that we could get the same “clean energy” results by using half the number of workers that the authors estimate. That would be a good thing, as the benefit would be achieved at a lower cost. But with their methodology, the authors would say that it would be a bad thing. Thus are costs disguised as benefits.

**Trade Is Bad?** Confusing costs with benefits is not the only economic error that Pollin et al. make. They also argue that reducing international trade is good:

Reducing the U.S. trade deficit through cutting oil imports means, by definition, a higher proportion of

spending by U.S. households, businesses, and governments will happen within the domestic U.S. economy. This promotes faster U.S. GDP growth.

But if reducing oil imports is good for the reasons they state, then trade economists from James Mill and David Ricardo to the present have been wrong. Suppose that we were to promote even *faster* growth by cutting off *all* trade. Let’s forbid imports of bananas so that people will build hothouses and grow them in the United States.

Of course, reducing trade is not good; it’s bad. Pollin et al. have already argued that the shift to clean energy would reduce negative climate externalities. Point taken (though not necessarily agreed with). But then the benefit of the shift is

that negative externalities are reduced, not that we trade less.

**Coda** One of the big benefits of economics is that it restrains the enthusiasm of zealots who want government to have a big say in how our resources are allocated. Economics reminds us that there are no free lunches. It not only humbles the wild-eyed supply-sider who thinks that we can cut tax rates by 50 percent without reducing government spending by a dime, but also reminds us that even things we strongly want have costs. It is a sign of the zealotry of even some economist-advocates of “clean energy” that they throw off this discipline of economics. But opportunity costs are stubborn things. **R**

## Environmental Policy Memos to the President

*Reviewed by Robert H. Nelson*

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### **BREAKING THE LOGJAM: Environmental Protection That Will Work**

*by David Schoenbrod, Richard B. Stewart,  
and Katrina M. Wyman*

216 pages; Yale University Press, 2010

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**T**he legal framework for managing the environment of the United States was transformed in the 1970s, supported by Republican and Democratic presidents alike. A decade-long spree of environmental lawmaking began with the National Environmental Policy Act, signed into law on New Year’s Day 1970, which created the Council on Environmental Quality in the White House and required the writing of environmental impact statements for major federal actions. Other important environmental laws that followed included the Clean Air Act of 1970, the Clean Water Act of 1972,

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the Endangered Species Act of 1973, the Resources Planning Act of 1974 (reorganizing Forest Service decision-making), the Federal Land Policy and Management Act of 1976 (the “organic act” for the Bureau of Land Management), the Resources Conservation and Recovery Act of 1976 (controlling hazardous waste disposal), the Surface Mining Act of 1977 (controlling surface coal mining), the Outer Continental Shelf Lands Act of 1978 (controlling oil and gas leasing) and, finally in 1980, the Superfund law (cleaning up preexisting waste sites).

These laws cover a diverse set of environmental problems, but they reflect a few key principles. First, the federal government should take charge of the American environment. As David Schoenbrod, Richard Stewart, and Katrina Wyman write in their new book *Breaking the Logjam*, the individual states were federally “conscripted” to do the day-to-day management of the environmental system, obeying detailed federal instructions for controlling land, air, and water pollution. Many individual property owners were also federally required to dedicate parts of their lands to protect environmental assets

such as endangered species and wetlands.

Congress told the relevant federal agencies to achieve certain goals and then authorized them to exercise strong federal powers — in essence, to do whatever it takes — to achieve those goals. The result has often been described as a “command-and-control” system of regulation, although Schoenbrod, Stewart, and Wyman label it as a “hierarchical” system. As they explain, the Environmental Protection Agency administrator and other federal agency administrators sit “atop a hierarchical chain of command that reaches down their various headquarter offices to regional offices, states and localities, and finally businesses and other targets of regulation. Detailed orders go down the chain of command, and detailed reports are required to come back up. This is a hierarchical system of control par excellence.” Its hallmarks are that it is “centralized and complex,” features they regard as making it expensive and even unworkable for some of the most important environmental problems.

**Success, Then Stagnation** While they may have been considerably more expensive and federally intrusive than necessary, the 1970s environmental laws did have three large successes. Air pollution from large new industrial sources was substantially curbed, air pollution emitted by new automobiles was reduced even more sharply, and water pollution from large industrial and municipal sources was also significantly reduced. By the 1990s, there had been substantial improvements in air and water quality across the United States.

The 1970s approach worked best when hierarchical federal organizations could direct the actions of hierarchical public and private organizations further down the chain of command. Under the Clean Air Act, the EPA instructed General Motors, Ford, and other large automakers in the U.S. market to reduce their auto pollution emissions by 90 percent by 1976. While initially resisting, the automakers soon developed suitable technology (the catalytic converter) and the goal was met by 1981. Today, after further

government tightening of the rules, a typical car emits 1 percent or less of the pollution levels of 1970.

Matters were more complicated, however, when federal authorities had to deal directly with the behavior of “non-point” sources — individual drivers, farmers, property owners, housing contractors, timber harvesters, and many other small sources of pollution. These sources are much too numerous to be routinely visited by federal and state inspectors. Moreover, they resent any federal attempts to control their actions, and their large numbers make them politically potent. Even though agriculture is a main source of water pollution in the United States, farmers to this day remain largely unregulated by the Clean Water Act.

Following the initial successes of controls on large industrial sources of pollution, more-recent progress has largely stalled. The command-and-control strategy of the 1970s worked in a fashion for industrial “end-of-the-pipe” emissions. Further reductions, however, require broader changes in business operations such as changes in product lines, whole new production processes, new types of manufacturing inputs, and a host of other internal changes that could slow or even eliminate the amount of pollution that reaches the end of the pipe. Those reductions would require dramatic change by both consumers and producers. Even if the EPA had the requisite knowledge of business methods (which it does not) to bring about such change, any attempt to mandate sweeping alterations in internal business practices would be seen as a virtual federal takeover, incompatible with American traditions of private property ownership.

As *Breaking the Logjam* observes, the pace of environmental gains in the United States thus bogged down in the 1990s. There was one major exception, however. The Clean Air Act Amendments of 1990 authorized for the first time the use of a “cap-and-trade” system of pollution control. Although it had been proposed by U.S. economists since the 1970s, both the EPA and leading environmental groups

had long resisted such an approach. But the adoption of a cap-and-trade system in the 1990s led to large reductions in sulfur dioxide emissions from power plants at a lower cost than had been expected. By granting industrial sources the rights to certain levels of pollution emissions and to buy and sell those rights, along with the flexibility to devise their own methods of emissions reduction, strong private incentives to curb pollution throughout every area of business operations were created. As Schoenbrod, Stewart, and Wyman recommend, the extension of this approach to other common air pollutants could “achieve greater reductions than are now possible” at lower costs and “would be a vastly simpler system for EPA, the states, and regulated sources to administer.” They further recommend that any future U.S. controls over greenhouse gas emissions should be based on a cap-and-trade approach, finding this preferable to the other leading market method, a carbon tax.

**The Environment as Property** *Breaking the Logjam* makes recommendations for a number of other aspects of the U.S. environmental system. A system of “tradeable catch permits,” successfully pioneered in New Zealand, Iceland, Australia, and a few fisheries in the United States, is recommended for much wider American application. It would follow the example of the public lands in the West where the Taylor Grazing Act of 1934 established a system of rancher permits for livestock grazing. Concerning ranching, Schoenbrod, Stewart, and Wyman propose that ranchers be allowed to sell their grazing permits to environmental groups who might then modify the historic grazing practices or even retire public land areas from livestock use altogether.

In general, the authors seek to expand the scope for new or revised property rights as a means of addressing environmental problems. Environmentalists in the 1970s and 1980s typically saw pollution and other environmental problems as a moral failure of industry, ranching, and other private parties in American society, but Schoenbrod, Stewart, and Wyman see them as part of a conventional economic problem. Lacking a properly structured system of rights, the environment becomes



a free good, and rampant overutilization (“pollution”) of the environmental commons becomes a virtual certainty. With an appropriate system of rights, however, the flexibility, efficiency, and other benefits of markets can be harnessed to work for the greater environmental purposes of American society. It is not a complete free-market approach — governments must still fix the overall environmental objectives — but it is superior to the old command-and-control strategies.

**The Book** This book is not the first to make these arguments. Indeed, Schoenbrod and Stewart have been longtime advocates of these ideas in their own individual writings, and Wyman is a more recent contributor. Since at least the late 1990s, think tanks such as Resources for the Future and the American Academy of Public Administration, along with other students of the U.S. environmental system, have been lamenting the gridlock, polarization, lack of flexibility, and the need for a turn away from the hierarchical methods of the past. The question — not fully answered in *Breaking the Logjam* — is why it is taking so long.

The authors’ purpose for the book was not a pioneering analysis. *Breaking the Logjam* was initially conceived as a collective effort to advise the new presidential administration that would follow the 2008 elections. About 50 environmental analysts — a virtual who’s who of environmental scholarship — were invited to write papers that were presented at the New York University School of Law in 2007 and then in revised versions in 2008. The final papers were published in a special 2009 issue of the *New York University Environmental Law Journal*. A report based on this work was delivered in early 2009 to the new Congress and the Obama administration. *Breaking the Logjam* is intended as a popularly accessible review of the results of these efforts. More broadly, it serves usefully as a brief summary of the failings of traditional U.S. environmental policy, and the need for basic redirections as advocated by the mainstream of environmental scholarship for at least the past decade.

There are some caveats that should be mentioned. For a book authored by three law professors, there is surprisingly little about the large role played by judges in

shaping American environmental policy. Schoenbrod, Stewart, and Wyman often make it sound as though Congress established that policy when it wrote the Clean Air Act, the Clean Water Act, and other environmental laws, and then federal agencies administered those laws. It would be more accurate to say that Congress set out a few broad directions and then left it to federal judges to fill in many — maybe most — of the details.

Perhaps reflecting the long period of its genesis, *Breaking the Logjam* is also somewhat dated in places. Very little is said about the impressive results of the cap-and-trade program for nitrogen oxides introduced in 2003 involving 20 Eastern and Midwestern states. The European Union initiated a cap-and-trade system for greenhouse gases in 2005, with major revisions in 2008, yet that is not discussed. There is no mention of the technological breakthroughs in recent years (based on horizontal drilling followed by hydrofracking) in producing natural gas from shale deposits widely distributed across the United States. Given the believed immensity of shale gas reserves, there is a good prospect of ending American coal-fired power production over the next decade and replacing it with natural gas, resulting in major reductions not only in greenhouse gases but also conventional air pollutants. If this becomes a reality, a leading environmental issue of the next decade will be how to manage the transition to natural gas, given the large past investments of financial and human capital in coal mining and power production.

The authors could have said more about another critical issue. The United States’ dependence on foreign oil creates major national security and economic concerns. The nation spends upwards of \$350 billion per year, around half of the total trade deficit, on oil imports, much of it from politically unstable parts of the world. Greenhouse gas policies, including the development of new domestic energy sources, and greater conservation of energy, could help significantly on this front. Even if increasing levels of greenhouse gases turn out to pose less of a threat than many climate change researchers have suggested, there are important foreign policy and international economic policy reasons for changing U.S. energy sources.

*Breaking the Logjam* also gives less attention to the past failings of environmental science than is warranted. Although the Clean Air Act passed in 1970, the basic chemical process by which smog forms in the atmosphere, especially the role of nitrous oxides, was not adequately understood until around 1990, defeating much of the previous heroic efforts to reduce smog levels. Schoenbrod, Stewart, and Wyman appropriately criticize the failure of State Implementation Plans to achieve their purposes in reducing smog, but they say little about a key reason for that failure: the science was not developed until the 1990s to show the long-range character of much air pollution. Chinese-emitted air pollutants are now affecting Los Angeles, while Northeastern states’ air quality is at the mercy of Midwest states’ pollution laws.

As another example, the EPA has mandated the spending of many tens of billions of dollars based on estimates of long-run risks from human exposure to chemical and other hazardous substances, based on animal methods of testing for such risks that may have been close to meaningless. (See “Regulating Unknown Risks,” Spring 2010.) In the case of very small particles in the air, by contrast, there was little appreciation until the 1990s of the large dangers they pose. In the field of clean water, the scientific understanding of the ground movement of phosphorus — the main nutrient form of water pollution, along with nitrogen — was significantly revised in the 1990s, here again defeating earlier efforts and requiring new directions in water policy.

**New Pragmatism** The reality is that for at least 25 years after the enactment of the Clean Air Act in 1970, leading environmental groups treated air, water, and other pollution as more of a moral issue than an economic and scientific problem. Schoenbrod, Stewart, and Wyman hope to change that, and thus they do little finger pointing at the authors of past regulatory failures — except at Congress, which does in fact deserve much blame. But it is impossible to understand the character of American environmental policy without recognizing the moral crusade it has represented for so many of the leading participants. For some, any pollution of

the environment is an intolerable evil that reflects the sinfulness of the polluters, who should be punished. For others, any new limits on pollution emissions present a challenge to the American faith in economic progress. The widespread righteousness has been a poor substitute for carefully crafted scientific and economic solutions.

Fortunately, the moralizing of the environmental debate may now be fading. The environmental era began with the Wilderness Act of 1964. How much land to devote to the national wilderness system is almost a religious question — how many cathedrals of nature, places of genuine spiritual inspiration for millions of Americans, are needed? Today, by contrast, the

leading environmental issue is climate change, posing technically and economically complex questions having implications for virtually every aspect of the American economy. Advocacy groups hoping to have credibility in the climate debate will have to engage many economists and others with specialized professional expertise.

A newly evolving breed of environmental pragmatists would do well to consider the recommendations that Schoenbrod, Stewart, and Wyman make in *Breaking the Logjam*. Readers interested in a more complete discussion might profit equally from reading the many individual writings of these distinguished scholars, as well as others that they assembled at New York University Law School. **R**

the United Nations climate talks, and he is ruthless in pointing out that the moralizing and opportunism that have dominated them lead to a dead end. His handling of the Clean Development Mechanism, biofuels policy, and nuclear power do a superb job of exposing both nonsense and rent seeking.

He sees that the challenge of GHG control centers on the middle-income states, which are likely to host an increasing share of the world's heavy industry, and he sees these states as presenting the main line of resistance to GHG control. Above all, in a world of discourse in which the very mention of power has been taboo, Collier realizes that at least the threat of coercion would be essential to success.

To this end, he offers a quasi-Bismarckian plan. The G-2 — the United States and China — are its cornerstone. Collier claims that his plan reflects their national self-interest: For the United States, climate change may eventually harm Florida, a politically important state. For China, melting Himalayan glaciers will provide a spur to action. The European Union has led on climate, and Japan would like to; so Collier thinks that they will readily fall in line — as will India, although why he thinks so is more than a little hazy.

These states, the G-5, will supply the muscle needed to save the planet from climate change. Access to the markets of the G-5 is of great value to the rapidly growing middle-income states, and the threat of G-5 trade sanctions should bring them to heel. The really poor countries are dependent on aid; threatening to withhold it should yield their compliance.

**Pitfalls** Why, the reader may well ask, when for over 20 years the G-5 have been unable to act on GHG control, will they suddenly coalesce into a global oligarchy? The threat of higher sea levels is neither likely to dominate the next U.S. election nor is it new. The pace of melting of the Himalayan glaciers remains the subject of much debate. Then too, why should the G-2 seek GHG controls instead of building dikes and reservoirs? The EU's actions on climate have lagged behind its rhetoric.

# Climate *Realpolitik*

Reviewed by Lee Lane

## THE PLUNDERED PLANET: Why We Must — and How We Can — Manage Nature for Global Prosperity

by Paul Collier

288 pages; Oxford University Press, 2010

In his new book, *The Plundered Planet*, Oxford University economist Paul Collier proposes using tough measures to restrain climate change. Collier suggests that a small group of the world's most powerful states should impose a global regime aimed at restraining greenhouse gas (GHG) discharges. To achieve this end, the great powers may well need to use a mix of trade sanctions and threats of cutting off foreign aid to countries that do not abide by the regime.

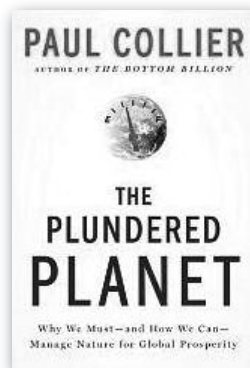
The book covers many subjects at the interface between development economics and the environment. In doing so, it offers a host of bold and striking ideas. But this prescription for climate change may prove to be the most provocative of its ideas. On its face, this proposal seems to give new meaning to the term “climate *Realpolitik*,”

albeit *Realpolitik* in an idealistic cause. But is it, in fact, realistic? I suggest that it is not.

**Virtues** The greatest virtue of Collier's wide-ranging book involves his weighing in on a long-running and acrimonious debate. The quality of the public discourse in this debate falls far short of its intensity. Many climate scientists insist on proclaiming what are actually their own policy preferences as if they were scientific findings. In response, many conservatives have taken to disputing the findings of climate science. The result, as one wag has put it, is a heated debate between those making claims based on bad policy analysis and those opposing them based on bad science.

Compared to this muddle, many parts of Collier's treatment of climate policy unfold with great clarity. GHG emissions, he notes, have the same impact on climate whatever their point of origin, and halting the rise of GHG levels in the atmosphere requires limiting discharges to quite low levels. Together, these facts imply that, to end manmade climate change, very stringent GHG controls would have to cover all major regions of the globe.

Collier is fully aware of the failure of



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ric, and that statement applies even more to Japan. India has made it quite clear that poverty reduction comes before GHG reductions.

Perhaps Collier is troubled by these thoughts, because he offers a second conjecture about why his proposed policies might be implemented. The power of informed citizens, he surmises, will compel governments to adopt enlightened policies. Collier rests his hope on three grounds: a new ethic of environmental values may come to animate people everywhere; government may become more transparent; and citizens could begin to take the trouble to inform themselves about the economics of the natural world.

Like a *philosophe* presaging the imminent arrival of the age of reason, Collier's hopes seem to have overpowered his critical faculties. Over time, green values may indeed gain strength, but for them to attain real power, a society must first be wealthy for several generations. Some governments may have become more transparent, but the global political economy has also become more complex and more opaque. Have people become better informed? Perhaps we have, but about 40 percent of the world's population has still not even heard of global warming, let alone formed a clear concept of what to do about it.

Other trends, moreover, have been working against Collier's grand design. As Stephen Krasner has noted, today's more constrained United States is less likely to persist in costly, ideologically-driven global regime building than was the case in earlier decades. Resources are scarcer, and there are many calls on them.

Worse still, the United States seems to be drifting toward protectionism. Collier's scheme depends on the G-5 threatening trade sanctions, but also on withholding or lifting them when other states give in on GHG control. The implicit risk is that we get the first effect, but not the second.

Finally, in both of the G-2 states, internal political trends are clearly hobbling action on climate. China's energy-intensive heavy industry has forged tight two-way bonds with its Communist Party, and the shift of power away from Beijing and to regional and local governments has largely insulated this sector from regulation. With Beijing's very limited con-

trol at the local level, foreigners would have little grounds for trusting any GHG control promises that China makes. In the United States, too, regional interests are very powerful, and the votes of the many coal-dependent states have checked demands for stringent GHG control. If Collier had looked at the actions of the G-2 states instead of projecting his own wishes onto their governments, he would have read the prospects for his scheme far more skeptically.

**Conclusion** *The Plundered Planet* is a splendid book. It is chock-a-block with insightful analysis. It explores the stakes for the world's poorest countries of reforming resource extraction policies or

of failing to do so. If the book fails in the task of offering a convincing solution to climate change, it is in good company. Indeed, it is not that Collier has overlooked some obvious means of curbing GHG emissions — it is that, under current conditions, no such means exist.

That conclusion is an unwelcome one. It implies that the world will need to cope with continued high GHG emissions for much longer than many idealists, including Collier, would wish. In turn, this prospect implies that adaptation to climate change must be a higher priority than it has been, and the option of engineering the climate to curb warming even as GHG levels rise deserves serious study. **R**

## Some Intellectuals and Society

Reviewed by David R. Henderson

### INTELLECTUALS AND SOCIETY

By Thomas Sowell

416 pages; Basic Books, 2010

“Let’s get my judgment of Thomas Sowell’s new book out of the way first. There is not a single interesting idea in its more than three-hundred pages.” So wrote Alan Wolfe in his recent *New Republic* review of Sowell’s latest book, *Intellectuals and Society*. Yet Wolfe did not mention, let alone discuss, any of the ideas presented in the book (interesting or otherwise), and so I could not tell from his review whether the intellectual staleness is Sowell’s or Wolfe’s.

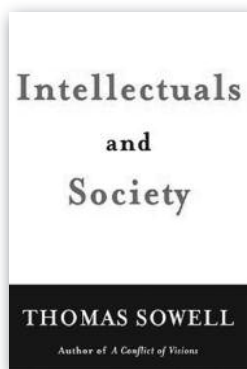
I picked up the book myself and found that, in fact, it is chock full of interesting ideas — like much of Sowell’s work. Of

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course, interesting ideas can be wrong or unimportant or both. But the book contains many interesting ideas that are correct and important, as we shall see. My bottom line is that *Intellectuals and Society* has large strengths — and some large weaknesses.

**Intellectuals** One large weakness, both in the title and throughout the book, is that it is not really about intellectuals, per se, but about a subset of intellectuals. Sowell uses the terms “intellectuals” and “intelligentsia” (in his view, intellectuals are part of the intelligentsia) inconsistently. He characterizes intellectuals as people who work in the world of ideas, but who are not accountable for the effects when their ideas are followed.

He admits that this definition would apply to two intellectuals that he and I both admire and have learned from: Friedrich Hayek and Milton Friedman. Yet, in assessing the influence of the intelligentsia (which he does not define), he claims that its influence has been reduced



as more and more attention has been given to people like Friedman and to conservative and neoconservative intellectuals. Isn't this a reduction in influence of some members of the intelligentsia due to other members of the intelligentsia? If so, it does not qualify as a reduction of influence per se.

One senses that Sowell wants to criticize a number of people whom he often refuses to name, and so he lumps them into the "intellectuals" category. The problem is that his generalization does not hold. I think of myself as an intellectual; many of you readers are intellectuals; and don't look now, but Thomas Sowell is an intellectual. In short, his whole argument about intellectuals as a class becomes incoherent.

A related problem is that Sowell is careless at times. He too often refers to various people's thinking without actually naming the people to whom he attributes the thoughts. How can one evaluate his accuracy in characterizing a group of people when he will not tell us who is in the group?

**Fixing Fumbled Facts** But when he does name names, Sowell makes important criticisms.

Take his discussion of MIT economist Lester Thurow's much-celebrated 1980 book, *The Zero-Sum Society*. Thurow wrote that, on unemployment, the United States is "the industrial economy with the worst record." What is remarkable about that statement, notes Sowell, is that Thurow made his case by referring only to the unemployment record in the United States and saying nothing about that of other countries. Sowell points out the obvious, but as my marked-up version of Thurow's book shows, it is not so obvious that I had caught the problem — namely, that you cannot compare without doing a comparison. Sowell also points out that Thurow was wrong even about the United States. Thurow wrote:

Lack of jobs has been endemic in peacetime during the past fifty years of American history. Review the evidence: a depression from 1929 to 1940, a war from 1941 to 1945....

Huh? Sowell points out that unemployment during the war was extremely low.

Or take Sowell's numerate pick-apart of

the 1996 "arson of black churches." The *Chicago Tribune*, he notes, referred to "an epidemic of criminal and cowardly arson." (By the way, isn't "criminal" redundant in that sentence? Is there any arson that is not criminal?) Columnist Barbara Reynolds of *USA Today* claimed that the fires were "an attempt to murder the spirit of black America." President Clinton added to the plot, claiming that the church fires reminded him of similar burnings of black churches in Arkansas when he was young.

The problem with those statements? Let Sowell tell it:

This story began to unravel when factual research showed that (1) no black churches were burned in Arkansas while Bill Clinton was growing up, (2) there had been no increase in fires at black churches, but an actual decrease over the previous 15 years, (3) the incidence of fires at white churches was similar to the incidence of fires at black churches, and (4) where there was arson, one-third of the suspects were black.

In his chapter "Intellectuals and the Law," Sowell humorously analyzes quotes by columnist Michael Kinsley, reporter Linda Greenhouse, and law professor (and now White House official) Cass Sunstein. All three criticized federal court decisions, not by reference to the Constitution, but by reference to majority rule.

Sowell quotes Kinsley's criticism that then-Court of Appeals Judge Antonin Scalia overturned "a major piece of legislation passed by large majorities in both houses of Congress and signed with a flourish by a popular president." Writes Sowell: "as if these were things that make a law Constitutional." Greenhouse, who covered the Supreme Court for the *New York Times*, complained that the Supreme Court "invalidated a law that two houses of Congress and the President of the United States approved." Sowell points out that other laws overruled by the Supreme Court were duly passed. And Sunstein accused the Supreme Court of forbidding "Congress from legislating on the basis of its own views." Well yes, says Sowell — whenever the Supreme Court overrules a federal law, that is what it does.

**Information and Incentives** One of Sowell's strengths is that he has laid out,

better than Hayek, why central planning of an economy cannot work. Sowell's 1980 book, *Knowledge and Decisions*, expounds and applies Hayek's insight beautifully. Those not familiar with this earlier book will find his thoughts on central planning in his latest book valuable. While Hayek focused solely on the information problem — central planners do not have access to the circumstances of time and place that individuals have — Sowell goes beyond that, integrating that insight with the incentive problem. Sowell writes:

Why the transfer of decisions from those with personal experience and a stake in the outcome to those with neither can be expected to lead to better decisions is a question seldom asked, much less answered. Given the greater cost of correcting surrogate decisions, compared to correcting individual decisions, and the greater cost of persisting in mistaken decisions by those making decisions for themselves, compared to the lower costs of those making mistaken decisions for others, the economic success of market economies is hardly surprising and neither are the counterproductive and often disastrous results of various forms of social engineering.

Although that quote could have used some editing, it is still a nice statement of the information and incentive problems with central planning. While I agree with Sowell that the dominant mindset among many intellectuals is that a central government can do it better, his argument would have been stronger had he identified four or five, rather than zero, prominent intellectuals who hold this view. Since he did not do this, I will: Into that category I would put lawyer Robert Reich and, increasingly, economists Paul Krugman (on health care), Joseph Stiglitz (on financial markets), and Jeffrey Sachs (on foreign aid.)

**Selective History** The biggest weakness in *Intellectuals and Society* is Sowell's discussion, in two chapters, of war and the intellectuals. It is not all weak. He does an effective job of skewering intellectuals' wishful thinking about the threat posed by Hitler. For instance, I had not known before reading this book just how strong France's military was before World War II and how well positioned it was to stop Hitler's drive to his west. France, says Sowell,

ell, because of its understandable distaste for war, lacked the will to fight Hitler early, when he could have been defeated.

So why do I find this section of the book weak? Because Sowell is quite selective in his recounting of history. Consider his discussion of Vietnam. He leads off with this long sentence:

Whatever the merits and demerits of the decision of the United States to become a major participant in the war to prevent South Vietnam from being conquered by North Vietnam's Communist government, the stark fact is that more than 50,000 Americans died winning military victories in Vietnam that ended in political defeat because the climate of opinion created by the intelligentsia in the United States made it politically impossible not only to continue the involvement in the fighting there, but impossible even to continue to supply the resources necessary to defend itself after American troops were withdrawn.

After that, Sowell goes on to lay out the specifics of how the antiwar movement in the United States helped pave the way for defeat in Vietnam. I am not enough of an expert on Vietnam to know whether Sowell is oversimplifying, but I know enough about rhetoric to know that with his first five words in the above quote, Sowell avoids the major issue: did it make sense for the United States government to intervene in Vietnam? What if the demerits exceeded the merits, as many Americans, including me, came to believe? Should the intelligentsia have remained silent? How did defense of America imply that the U.S. government should get involved in an Asian civil war thousands of miles away? Does it matter to Sowell — or does he even know — that an American president, Dwight Eisenhower, intervened in 1954 to help set up a government in South Vietnam in violation of the Geneva Accords, under which there was to be a 1956 vote on whether to unify the two parts of Vietnam? Although the term was not used then, this was an early version of U.S. “nation building,” in which the ersatz nation was South Vietnam. This was, in short, central planning of a country, something Sowell criticizes when a government centrally plans an economy. But Sowell sidesteps all those questions with his casual, “Whatever the merits and demerits....”

All in all, Sowell offers a number of intriguing ideas in the book, but he leaves too many of them only partly developed and defended. One final example: Sowell claims that those of us who favor free markets are more empirically inclined and have less ego invested in our views than those who advocate central planning and

heavy government intervention generally. That is my impression too, and it is one of the most interesting and important ideas in his book. Unfortunately, he gives no evidence for that comparison. The book would have been a great forum in which to do so, but on this idea and too many others, he leaves his readers unsatisfied. **R**

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#### IN REVIEW | WORKING PAPERS

For every article that appears in *Regulation*, I read 50 papers that do not. Most of them deserve to be passed over, but some do not. Beginning with this issue, *Regulation* will regularly include this section, summarizing and discussing some of the papers that I believe merit attention.—PVD

## Shadow Banking and the Financial Crisis

By Peter Van Doren

CATO INSTITUTE

Not surprisingly, many of the interesting papers that I have been reading in recent months discuss the financial crisis. I have learned much from the work of Gary Gorton, professor of finance at the Yale School of Management. He argues that a vast “shadow” banking system has developed over the last 40 years outside the traditional regulated banking system of governmentally chartered institutions that accept deposits and make loans. As of 2007, two-thirds of U.S. lending was in the shadow banking system and only one-third in the traditional banking system.

In the shadow banking system (also called the “overnight repurchase” or “repo” market), corporations, governments, and investors “deposited” hundreds of millions of dollars overnight in the equivalent of extremely large money market accounts, invested in securitized loans for cars, houses, and consumer credit. When this shadow banking market operated normally, the trade of cash for securitized assets was automatically renewed every day.

But in the fall of 2008, an old-fashioned bank run occurred in the repo market. A bank run is a systematic withdrawal of demand deposits from the banking system as a result of news that the bank is in poor financial health. In this case, instead of renewing the trade of cash for

securitized loans, the “depositors” in the repo market changed the terms or simply withdrew their money.

Prior to the 2008 crash, depositors in the shadow banking system traded cash for securitized loans of equivalent face value and required the investment bank to set aside very little or no collateral (cash or capital that is not loaned out). That is, \$1 million in cash was traded for \$1 million in securitized loans, because depositors thought of the senior tranches of securitized loans as “super safe.” By November 2008, the terms had changed drastically because depositors feared securitized loan losses. That same \$1 million in cash was traded for \$1 million in securitized loans, but with an additional requirement that \$500,000 be set aside in cash or capital. These so-called “haircuts” severely reduced the lending ability of the shadow banking system, as did the behavior of other investors who withdrew their money entirely and invested it instead in U.S. treasuries. The result was a severe contraction in lending, which exacerbated the contraction in the real economy that was already occurring because of the collapse of new housing construction and housing-backed consumption.

Gorton's work presents a challenge for libertarians: Unregulated banking is subject to bank runs, but government-mandated deposit insurance and regulated

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banking eliminated them. But large corporate checking accounts were uninsured and received no interest within the post-New Deal regulated banking system. Markets thus responded with the shadow banking system. This provided income for large corporate and investor demand deposits that funded loans for consumers at lower cost than the regulated banking system. For more than 30 years, this market response appeared to be “good” arbitrage around the expensive regulated banking system. But then a large run occurred in the shadow banking system and the Federal Reserve responded by becoming a lender of last resort to all the markets abandoned by “depositors” in the shadow banking system.

**Insurance or Narrow Banking?** Two polar opposite policy responses have been proposed to avoid future “shadow bank runs.” The first proposed response, called “narrow banking,” has been advocated by Larry Kotlikoff, Oz Shy, and Amar Bhidé, among others. Narrow banking is an attempt to carefully demarcate the difference between the payments system (checking accounts, passbook savings, and other demand deposits) and all other investment. Money in the payments system would be fully backed by cash or treasuries. All other investment would be at-risk. The second proposed response is the extension of the current safety net to all demand deposits, along with restrictions on financial activities. That would bring the shadow banking system back within the regulated system, extending deposit insurance to overnight repo and money market mutual funds.

Both of these “solutions” have logical flaws. The problem with narrow banking is the time inconsistency of government policy. Fannie Mae and Freddie Mac were not legally backed by the government, nor were money market funds, nor overnight repo. But when the system came under severe financial stress, the government changed the policy. Likewise, if future stress were to hit at-risk deposits, placing the broader economy in jeopardy, the White House and Congress would surely ride to the rescue again — and investors know that. So what would stop investors from taking on higher-than-appropriate risk if they know Washington stands ready

with bailout money?

The second problem with narrow banking is that it would require the legal suppression of what most people now call banking, i.e., financial intermediation in which short-term deposits are transformed into longer-term investment. Banks arise naturally in a free society, and the narrow banking regime would require the use of the power of the state to suppress the transformation of demand deposits into investment

Morgan Ricks, a U.S. Treasury official, has written an important paper that takes Gorton seriously, recognizes the time inconsistency involved in the narrow banking solution (the state cannot precommit not to help at-risk investment), and advocates the second solution: deposit insurance must be provided to all demand deposits and lending entities, subject to capital requirements and activity restrictions. He agrees with Gorton that banks (and shadow banks) strive to create informationally insensitive debt — financial obligations that are unlikely to be upset by news (good or bad). This is in contrast to equity and corporate bonds, which are informationally sensitive — stock and bond prices frequently change as news comes in. Informationally sensitive financial instruments trade in the secondary market, and market actors expend resources to inform their decisions about buying and selling stocks and bonds. In contrast, loans to businesses and individuals from traditional banks and securitized loans in the shadow banking system do not trade in secondary markets, and no one outside the original lender attempts to gather information about loan repayment probability.

When circumstances conspire to make loans in the traditional banking system or securitized loans in the shadow banking system informationally sensitive, depositors and repo investors respond by making a run on the bank. The threat of a run could impose market discipline, incentivizing banks and shadow banks to do a good job in creating informationally insensitive debt, and giving opportunities to entrants to profit from picking up the pieces if a bank fails. But runs would have to be allowed by government in order to enforce that discipline and provide those opportunities. Since the Depression, governments have not been willing to run

that experiment. So we do not know whether the Federal Reserve’s creation of all its lending facilities, which replaced repo and supported securitized asset lending during the crisis, occurred more quickly and effectively than private facilities would have. And going forward, government cannot credibly commit to allow the experiment to occur.

Ricks modifies (in my opinion, correctly) the Gorton view that the shadow banking system developed simply to meet the exogenous needs of large demand depositors who wanted to arbitrage around the expensive traditional banking system. The Gorton view may have been true initially, but the increasing flow of funds from the traditional to the shadow banking system was the result of an endogenous feedback loop. The greater the use of short-term repo, the more damaging a panic of those creditors would be and the more likely that government would provide a bailout if a panic were to occur. Thus the likelihood of a bailout is an increasing function of the overall quantity of liabilities that are potentially subject to panic. Put simply, shadow banking creates more shadow banking and increases the likelihood of a run and subsequent federal intervention, so one might as well return to the old system and have explicit government assistance *ex ante* (i.e., deposit insurance) accompanied by rules that constrain lending behavior. The difficulty, of course, with a regulated deposit insurance world for all demand deposits is the mismatch between the potential federal liability of trillions of dollars (the total amount of money in the current banking and shadow banking systems) and the actual federal resources available, as well as the need to suppress arbitrage around the regulated system.

**Bankruptcy** An important modification to the Gorton-Ricks thesis comes from Mark Roe, professor of law at Harvard. He argues that the use of overnight repos and derivatives, the heart of the shadow banking system, was endogenous, as Ricks argues, but not simply because of the inability of the political system to precommit not to bail out short-term creditors. Instead, important changes in the bankruptcy code that Congress enacted to prevent systemic risk actually encouraged it. The changes gave priority to repos and derivatives in

the bankruptcy process, which encouraged the use of such instruments and led to a lack of concern by repo owners about the quality of assets swapped for overnight cash. That is, the informational insensitivity of the repurchase agreements described by Gorton and Ricks was the result of the privileged position held by such investments at the head of the bankruptcy line, which insured full reimbursement. Thus Roe argues that the ever-increasing reliance on short-term repurchase agreements was the result of bankruptcy policy changes. And the bankruptcy priority made runs the rational response of participants in the overnight repurchase market.

Roe argues that all creditors should be treated identically in bankruptcy. This would increase market monitoring by the suppliers of deposits on investment and decrease the use of short-term funds to back longer-term investment.

**House Prices** At the root of the financial crisis was a steep reduction in the value of homes in many housing markets and the resulting defaults on mortgages whose face value greatly exceeds the reduced market value of the homes on which they are written. Some have argued that the steep rise and fall in prices is sufficient to conclude that housing supply constraints arising from zoning restrictions are the main cause of the housing bubble, and that the current focus of the media and political system on easy mortgage availability ignores the real regulatory problem.

Thomas Davidoff, an economist at the University of British Columbia business school, has written a paper that attempts to determine the importance of demand increases and supply constraints in the recent housing bubble. He does so by comparing house price behavior in what he calls “coastal” metropolitan areas (those areas with low supply growth and large price appreciation in the 1980s, from Boston to New York and California) during the 2004–2007 bubble and the 2007–2009 crash with a “comparison” group of metropolitan areas (those areas with large supply growth and low price appreciation in the 1980s). The appreciation from 2004 to 2007 and depreciation from 2007 to 2009 were not significantly different in coastal versus comparison groups. Thus, metropolitan areas with a history of low price

and large supply appreciation in the past had a boom-and-bust pattern in the 2000s that did not differ from metropolitan areas that had a history of the opposite. This lack of difference in pricing behavior casts doubt on the role that supply constraints (natural or regulatory) played in the housing bubble.

It is possible that the supply in the comparison areas changed from elastic to inelastic between the 1980s and 2000s, throwing off Davidoff’s test. He checked for this by calculating the ratio of housing units permitted in each metro area between 1998 and 2007 with the units permitted between 1980 and 1990, and then determined whether the ratios were different in the coastal and comparison cities. There was no significant supply change in the comparison cities, evidence consistent with a demand-driven rather than a supply-constrained housing bubble.

A recent paper by the New York Federal Reserve corroborates the role that non-traditional mortgage instruments played in augmenting housing demand. Across metropolitan areas, the correlation between nonprime loans per 1,000 housing units and 2000–2006 housing price appreciation was 0.64. And across metropolitan areas the correlation between nonprime loans per 1,000 housing units and 2006–2008 housing price depreciation was 0.75. “Why might this correlation hold?” ask the authors. “It is likely that causation runs in both directions — an increase in nonprime lending led to more significant home price appreciation, and more rapid home price appreciation led to a rise in nonprime lending.”

**Foreclosure Assistance** Many have argued for foreclosure assistance modeled on the New Deal-era Home Owners Loan Corporation (HOLC), which refinanced short-term mortgages into long-term, low-interest, amortizing mortgages. What effects did HOLC have? In theory, such assistance should have increased demand for and probably the supply of owner-occupied housing and reduced demand for and maybe the supply of rental housing. But did that in fact happen?

In an important new paper, Price Fishback and colleagues regress 1940 housing data against 1933–1936 per-capita HOLC funding. Their initial regression finds

increased home ownership as a result of the program. But the addition of control variables for differences that varied across states and time, as well as the fact that HOLC funding was not random (more funding went to troubled housing markets), reduces the effect of HOLC to zero. The effects were positive in counties with less than 50,000 people, but that result arose from the lack of integration between rural and national lending markets in the 1930s. These results suggest great caution in using HOLC as an example of the positive effects that foreclosure assistance can have on housing markets. **R**

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