

IN REVIEW

Is There Value in Revisiting the Lehman Collapse?

◆ REVIEW BY VERN MCKINLEY

The failure of Lehman Brothers and the ensuing fallout remain hot topics of conversation in the world of finance nine years after the investment bank came crashing down. The principals who decided to allow Lehman to fail have issued their respective memoirs, arguing their options were limited and awkwardly attempting to reconcile the decision on Lehman with their choice to bail out Bear Stearns and AIG.

Apart from the principals, analysts fall into two predominant camps on Lehman. One argues that allowing failure was the right call but the decision was part of such a confused and inconsistent policy approach that the subsequent decision to bail out AIG and other institutions wiped out any benefit derived from the Lehman failure in combating moral hazard. The other camp claims the government should have propped up Lehman like it did so many other large institutions, although in truth most in this camp did not come to that conclusion until after the key decisions were made in mid-September 2008.

Into this thicket, Oonagh McDonald enters to shed light on the failure, the fallout, and in particular the question of value of the Lehman asset portfolio. McDonald is a former member of the United Kingdom parliament and author of several books, including most recently *Fannie Mae and Freddie Mac: Turning the American Dream into a Nightmare*. I got a preview of *Lehman Brothers: A Crisis of Value* at a small gathering just before its release, during which she made herself available to discuss her research and respond to questions.

She really folds two books into one in *Lehman Brothers*. The initial chapters focus on the buildup in size of Lehman in the run-up to its ultimate failure, how Bear Stearns and Lehman shadowed each

other operationally, the Securities and Exchange Commission's efforts at applying a supervisory framework to the investment banks, and finally what McDonald calls the "Fateful Weekend" when Lehman Brothers unraveled. The second half of the book, with a few exceptions, focuses on matters of valuation: the so-called destruction of value that bankruptcy spawned, how Lehman internally valued its own assets, and the process of measuring and monitoring value. As promotional materials for *Lehman Brothers* gravely summarize it: "On September 12th, 2008, Lehman Brothers was valued at 639 billion US dollars. On Monday 15th September, it was worth nothing."

To bail or not to bail/ McDonald accepts the narrative that it was a big mistake to let Lehman fail, claiming, "It was the lack of understanding of the linkages which led to the calamitous decision to allow Lehman Brothers to fail." She further notes:

The costs of "No bail-out" were far greater than [U.S. Treasury Secretary Henry] Paulson, [Federal Reserve Board Chairman Ben] Bernanke and [New York Federal Reserve Bank President Tim] Geithner could ever have envisaged for a single moment. If they had

been aware, as they should have been, of at least some of the possible effects, then it is entirely possible that Lehman Brothers would have been rescued.

This quote, combined with her favorable quotation of a description of the aftermath of failure as "Armageddon," makes clear that she would have sided with those who, mostly after the fact, argued that intervention would have been better than allowing Lehman to fail. McDonald does not trace in detail her "linkages" argument.

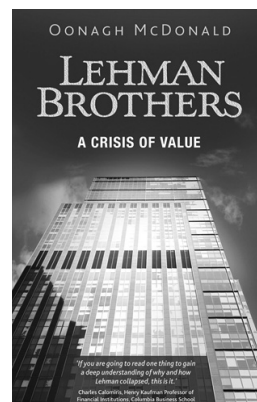
She makes a clearer argument when she enters the well-trodden ground of whether or not the Federal Reserve had legal authority to bail out Lehman. Bernanke, Paulson, and Geithner all contended that the Fed could not lend without a reasonable expectation of payment, and in the case of Lehman

they could not reach that relatively low bar. McDonald favorably quotes Tom Russo, general counsel for Lehman Brothers, in this regard, "Any court would have deferred to the Federal Reserve on an interpretation of its statutory powers, especially given the unprecedented circumstances." She then concludes that the argument on lack of powers "appears to be a post hoc view." I would agree with that conclusion.

She also judges rather harshly Paulson's ziggling and zagging on whether to lend to AIG in comments made a few days after the fall of Lehman:

"The rescue of AIG took place on 16 September, and made a nonsense of Paulson's stand on moral hazard and no more government bailouts." On point again.

McDonald dedicates quite a bit of ink to the March 2008 failure of Bear Stearns, noting that the expectations were that Lehman Brothers would likely be the next domino to fall as indicated by the 20% drop in its stock the day after the bailout of Bear Stearns. She is right that Bear Stearns should have



**Lehman Brothers:
A Crisis of Value**

By Oonagh McDonald
274 pp.; Manchester
University Press, 2016

been a red flag for Lehman and the market should not have been surprised by its failure. But she fails to point out that it was the contrasting and perplexing way that the financial authorities handled Bear and Lehman that threw the market into turmoil, not the fact that Lehman was some type of trigger in and of itself.

She makes a curious distinction at points throughout the book on this issue. She argues that Lehman Brothers was not the “cause” of the crisis but it was the “trigger.” This would have been more convincing with some evidence of a knock-on effect of Lehman Brothers’ failure in the form of financial institutions that failed as a result of its collapse, but McDonald does not provide such evidence.

Trimont and Repo 105/ The valuation chapters that take up much of the rest of the book are a focal point primarily because of the over-valuation of Lehman’s real estate-related assets. These chapters are a difficult read as McDonald goes into excruciating detail to explain various appraisal and valuation guidelines of the federal banking agencies and the Financial Accounting Standards Board Fair Value Measurement Standard. I admit that I had not previously given much thought to this aspect of Lehman’s failure. McDonald traces much of the problem with the valuation work to Trimont, Lehman’s real estate adviser, and their flawed methodology for determining the potential success of a project. The methodology did not take into account the overall deteriorating mortgage market.

McDonald also explains that the mysteriously named “Repo 105” was a technique that Lehman Brothers used to manipulate the extent of leverage reported in its financial statements. Unfortunately, she does so by jumping into the topic without much in the way of background, such as the fact that this method was specific to Lehman. I did find useful her comparison of Lehman’s calculated leverage as presented using Repo 105 and adjusted figures without. I should note that there didn’t seem to be that much difference. Unfortunately, she does not give an example of how the Repo 105 technique

was used to dress up Lehman’s balance sheet, background that would have been a nice way to ease into the topic.

This is a problem throughout the book. There are almost no explanatory tables or charts, which would have been a nice way to break up the unending recitation of the issues. The only exception is an organogram of Lehman’s corporate structure at the very end of the book.

“Destruction of value” describes the value that Lehman’s creditors saw vanish because of the way the firm was unwound in bankruptcy, what McDonald and others have called a “disorderly” bankruptcy. This loss is estimated to have been \$150 billion as compared to what would have been achieved in a more “orderly” bankruptcy. “That’s \$150 billion of value out of pension funds and savings,” she writes. But this conclusion is problematic given the difficulty in picturing the perfect, orderly bankruptcy proceeding. As reform measures go, McDonald places a lot of hope in two Dodd-Frank provisions to improve the chances of retaining value in future bankruptcies of financial institutions, one on orderly liquidation authority and another on recovery and resolution plans.

Final thoughts/ The last chapter of *Lehman Brothers* is a curious diatribe on the efficient market hypothesis, a chapter that seems entirely out of place in the progression of the book. McDonald relies on supporters of heavy-handed government intervention for this chapter. First, Joseph Stiglitz: “The Chicago School bears the blame for providing a seeming intellectual foundation for the idea that markets are self-adjusting and the best role for government is to do nothing.” Second, George Soros: “On a deeper level, the demise of Lehman conclusively falsifies the efficient market hypothesis.”

The book does not break much ground in the way of original research that was not available for other books that addressed Lehman Brothers. McDonald relies most heavily for her source material on Anton Valukas, who was appointed by the Lehman bankruptcy court to report on the causes of filing. She cites his work dozens of times throughout the book.

The approach that McDonald pursues in blending the historical details on the failure of Lehman with a separate focus on valuation of assets was an ambitious effort. Unfortunately, it was not always executed very well. R

Charting the Genesis of Regulatory Excess

◆ REVIEW BY SAM BATKINS

Can we thank the disputed 1876 presidential election between Rutherford B. Hayes and Samuel Tilden for the modern administrative state? Not directly, but in 1877, when the election and the somewhat forgotten case of *Munn v. Illinois* were decided, both proved pivotal to establishing Congress’s current power to regulate commerce “affected with a public interest.” Many argue the Progressive era or *NLRB v. Jones and Laughlin Steel* (1937) gave birth to the modern regulatory environment. However, the legal genesis might trace back decades earlier.

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In *Limiting Federal Regulation*, Paul Ballonoff tracks the rise of congressional power back to *Munn*, in which the U.S. Supreme Court ruled that government can regulate prices without infringing on sellers’ property rights. Examining the rise in federal power through the lens of the patent clause, he blends a

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wealth of historical and some contemporary examples to argue that had the Supreme Court ruled in favor of *Munn* instead of the state, “we might today be free of much of the regulatory burden of modern government.” His arguments are historical and legal in nature, and provide an important understanding of when and how government veered toward frequent intervention.

Opening for Congress / As Ballonoff notes, *Munn* dealt with state, not federal, power—Illinois wanted to set a maximum price on what agricultural storage and transport firms could charge for their services. It was somewhat understood that states had a general patent power to promote science and commerce through copyright, but there was plenty of dispute arising from Congress’s general regulatory power. The decision in *Munn* held that the operation of a grain elevator constituted business “affected with a public interest.” Thus, states had general power to regulate this activity. This case gave rise to modern utility regulation.

The book traces the decision in *Munn* to Congress usurping federal power without explicit constitutional authority. Shortly after the decision, Congress created the Interstate Commerce Commission via the 1887 Interstate Commerce Act. Ballonoff concludes that the lack of general patent power and the limitations of the “general welfare” and “necessary and proper” clauses preclude much of Congress’s power to regulate commerce and, by extension, the almost countless regulatory agencies that sprung up through congressional delegation. *Munn* provided a way around that lack of authority.

Although much of the book is a historical and legal review of expansive federal and state power, Ballonoff takes care to

incorporate some contemporary examples, including the U.S. Environmental Protection Agency’s “Clean Power Plan” and the Affordable Care Act. He views the former as an unconstitutional usurpation because “Congress can neither create rewards nor immunities for the promotion of commerce and the manufacture of electricity.” Likewise, he views state involvement in health care and the 10th Amendment as firm bars against increased federal regulation of health care.

Compromise of 1877 / Libertarians and conservatives who have studied constitutional law might find little to disagree with in this book. Many make the argument that much of the administrative state is unconstitutional or at least should not have been delegated in the first instance.

These arguments aren’t novel, but the historical approach Ballonoff takes does offer a new perspective on this debate. Nascent constitutional scholars are often taught about the “Switch in Time that Saved Nine,” when the Supreme Court, under pressure from President Franklin D. Roo-

sevelt’s court packing plan, succumbed and began allowing New Deal legislation to pass constitutional muster. However, Ballonoff makes the point that the roots of modern congressional power trace back to the regulation of grain elevators in Illinois, long before the New Deal, and to the strange juxtaposition of the Hayes-Tilden presidential battle.

Of the latter, Tilden, a Democrat from New York, bested Hayes, a Republican from Ohio, by 3% the popular vote, thanks in part to Southern Democrats’ suppression of Republican voters. However, Hayes appeared to have the upper hand in the Electoral College. The so-called Compromise of 1877, an unwritten agreement between the two political parties, permit-

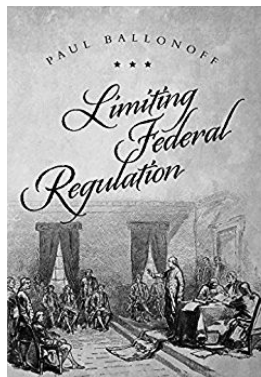
ted Hayes to take the Electoral College victory in return for the withdrawal of federal troops from Florida, Louisiana, and South Carolina, where they protected Republican state governments and voters. The result was a Hayes presidency in exchange for the departure of white Republicans and disenfranchisement of black Republicans in the South.

Interestingly, *Munn* and the election were intertwined. At the time, Supreme Court Justice David Davis, viewed as a non-ideological independent, was appointed to a 15-member Electoral Commission to settle the election. Shortly before, Davis cast a vote in favor of state power in *Munn*. As the commission pursued a compromise, the Illinois legislature selected him to serve in the U.S. Senate. The independent Davis then resigned his Supreme Court commission and Republicans selected one of their own to fill the seat, helping to pave the way for the 1877 Compromise.

Learning from past mistakes / The new Trump administration has vowed to prune the U.S. regulatory state. The history Ballonoff outlines in this book and the failed attempts at regulatory reform should help to inform the current debate.

In general, never trust regulators to implement reform aimed at curbing federal regulation. If regulatory modernization is to succeed, there must be either carrots or sticks to nudge the administrative state toward “regulatory management” over the bureaucratic status quo. Sticks could take the form of heightened judicial review of agency actions, or the diminution of pay for officials, or lower agency budgets. Carrots, as Hoover Institution scholar Adam White has outlined, could grant agencies more deference for carrying out regulatory reform proposals and no deference for trying to avoid it.

Whatever the approach Congress and the administration take, they will have ample historical examples to guide them toward a solution that could prove far more durable than the patchwork mess that continues to produce 80 major regulations annually. **R**



Limiting Federal Regulation

By Paul Ballonoff

132 pp., CreateSpace, 2016

Tyler Cowen, Semi-Persuasive Futurist

◆ REVIEW BY DAVID R. HENDERSON

Tyler Cowen, a prolific author and blogger and an economics professor at George Mason University, has written yet another book, *The Complacent Class*. In it, he argues that America has become complacent and that complacency has good and bad effects. He strongly believes that our complacency contains the seeds of its own

destruction. America, he argues, will face tough challenges and our complacency will make dealing with them difficult.

Cowen argues that our decisions, although “economically and indeed socially rational,” have “made us more risk-averse and more set in our ways, more segregated, and they have sapped us of the pioneer spirit that made America the world’s most productive and innovative economy.” He makes a good point. But many of the crucial decisions behind the problem are ones made by government. At times he recognizes that fact, but at other times he downplays or omits it altogether. Along the way, as is typical of most of Cowen’s work, he has or reports interesting insights: on the serious problems caused by building restrictions, on income mobility, on how U.S. governments have slowly eroded free speech, and on why he thinks that crime will increase. Sometimes, though, he misfires: on income mobility, on the effect of reduced geographic diversity on mobility, on free trade, and on standards of living.

Gridlock/ Consider two of the major problems that Americans now face daily: high housing costs and slow traffic.

Cowen nails the causes and effects of high housing costs. He points out that restrictions on building have driven housing prices sky high in many major cities,

especially in coastal California and the Northeast. Somewhat disappointingly, although his claims are generally well-cited, he doesn’t mention the path-breaking work by Harvard economist Edward Glaeser and Wharton economist Joseph Gyourko, which shows the high prices are indeed due to a scarcity of building permits rather than a scarcity of land. (See “Zoning’s Steep Price,” *Regulation*, Fall 2002.)

However, Cowen goes beyond that fact to make another important point: those high housing costs have discouraged movement by workers to those cities and have kept them in lower-productivity jobs elsewhere. The overall negative effect on productivity and output is huge. He cites a 2015 National Bureau of Economic Research paper by University of Chicago economist Chang-Tai Hsieh and University of California, Berkeley economist Enrico Moretti, who find that lowering regulatory constraints in those cities to the level of regulation in the median-regulated city in the United States “would expand [those high-cost cities’] work force and increase U.S. GDP by 9.5%.”

On traffic, Cowen writes, “Traffic gets worse each year and plane travel is if anything slower than before.” True. But why does traffic get worse each year? One’s

knee-jerk response would be to say that it’s because more people are driving. But more people are going to Starbucks each year, too; yet has the wait at Starbucks increased? Not that I can see. What accounts for slow traffic on roads but not “slow traffic” at Starbucks? Starbucks is private and for-profit, and it has the right incentive to expand and manage traffic, whereas roads are generally provided by government and government has little incentive to manage traffic well. That’s why so few roads are toll roads with congestion pricing. One little-known fact is that state governments were starting to move in the direction of toll roads in the 1940s and early 1950s. But President Eisenhower put a stop to it with his interstate highway system, 90 percent of which was funded by gasoline taxes. It’s

hard to compete with heavily subsidized roads. Disappointingly, in light of the problems caused by lack of tolls, Cowen cites the highway system as a big success.

Less successful are other modes of transportation. He laments the fact that the number of bus routes has decreased, that “America has done little to build up its train network,” and that American cities “haven’t built many new subway systems in the last thirty-five years.” That last lament was shocking because subways, except in high-density cities

such as New York, are notoriously costly and inefficient.

Cowen extensively discusses mobility, both income mobility and physical mobility within the country. His discussion is a mix of tight reasoning and some confusion.

His strongest, best-argued point is that “America’s income mobility is in reality much higher than standard measures indicate.” Why? He explains with an illustrative example: members of a poor household in Mexico might make only a few thou-



The Complacent Class: The Self-Defeating Quest for the American Dream

By Tyler Cowen

231 pp.; St. Martin's Press, 2017

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sand dollars a year. If the family moves to the United States, the household head might make \$22,000 a year at a “mediocre” job. He has moved way up the income scale. Moreover, he probably sends a few thousand dollars a year back to relatives in Mexico, which doesn’t matter for U.S. income mobility but does matter for world income mobility.

When Cowen sticks with the more narrowly defined measures of income mobility, though, he errs. He points out correctly that traditionally measured U.S. income mobility, which rose for a long time, has leveled off in recent years. But, he says, “that means Americans are more likely to ‘stay put’ in their educational, social, and income classes than before.” No, it doesn’t. If income mobility stays constant—that’s what “leveled off” means—then Americans are *as likely* to stay put as they were before.

Cowen claims that reduced American geographic diversity has reduced geographic mobility. Each region of the country “has its shopping malls, its hospitals, and its schools in what is now a nationally recognizable sameness.” Therefore, he claims, people have less reason to move from one region to another. But it could just as easily go the other way. What if the fact that one region is more similar to another than it used to be makes people more comfortable moving? Indeed, Cowen himself seems to doubt his own conclusion because just five pages later he argues that a Mexican moving from Houston to Chicago will find familiar foods, familiar faces, and a support network, and these similarities encourage Mexicans to move. That’s my view, too, but it contradicts Cowen’s earlier view.

Government constraints / One of the areas in which I found Cowen depressingly persuasive is on free speech. He documents how over the last few decades governments have used force to blunt and marginalize protests. A major legal change that helped cause this, he writes, was the Supreme Court’s “public forum doctrine.” For people to be free to speak in a physical area, he writes, interpreting

the Supreme Court’s decisions, “that area should be a properly designated forum for speech.” Cowen notes that the famous 1963 March on Washington, at which Martin Luther King Jr. gave his “I Have a Dream” speech, “enjoyed a freedom of movement that today would be very difficult to reproduce.”

Cowen also believes that crime, which has fallen for a few decades, is on the rise and will continue to grow. The form, he says, will change, with more crime being committed in cyberspace. He’s almost certainly correct. He also believes that “the next crime wave is going to break the internet, or at least significant parts of it.” He doesn’t address the extent to which cybercrime is *due* to government regulation. We know that the National Security Agency, for example, has the ability to observe our personal lives. Will cybercrime hackers figure out ways to get the data that the NSA has on us?

One factor that could substantially protect us is encryption. Yet Federal Bureau of Investigation director James Comey has been hostile to encryption, and in 2016 two U.S. senators, Democrat Diane Feinstein and Republican Richard Burr, introduced a bill to undercut encryption so that the government could have access to people’s documents and communication. That would facilitate cybercrime but, disappointingly, Cowen doesn’t mention these hostile government attitudes.

Economists, caring as they do about overall economic well-being, tend to applaud free trade even when firms reduce labor costs by outsourcing. But Cowen is amazingly lukewarm on the gains from outsourcing. Cost-cutting developments, he writes, “build America’s productive future less than coming up with neat and new ways of doing things, such as harnessing electricity, developing antibiotics, or inventing automobiles.” But whether that’s true depends on the degree of cost cutting. And what if American firms developed antibiotics by outsourcing to lower-cost outfits in, say, India? He sees outsourcing as “a way of keeping the status quo in place—for some, that is—at lower cost to

owners of capital and privileged workers who have kept their incumbent status.” Actually, that’s not true. By definition, outsourcing improves on the status quo.

Note, also, in the quote directly above, Cowen’s use of the word “privileged.” This is not his only use of that term in the book. Elsewhere he discusses “the privileged class,” whose members are “usually well educated, often influential, and typically stand among the country’s highest earners.” But what makes them privileged? He never says. Cowen seems to use “privileged” as a synonym for “wealthy.”

Cowen worries, quite rightly, about the increasing percentage of the federal government’s budget that is likely to be spent on three programs: Medicare, Medicaid, and Social Security. One reason for his worry, though, is that when a problem arises somewhere in the world—for example, “military crises in the Baltics and the South China Sea at the same time”—the American government “probably would need more resources” to deal with it. Nowhere in the book does he even hint that maybe the U.S. government having more resources helped lead to some of the problems in the world. If the U.S. government hadn’t had the slack to invade Iraq in 2003, for example, that country would almost certainly be in better shape than it’s in, and the Islamic State would not even exist. The Islamic State is an outgrowth of al Qaeda in Iraq, which itself didn’t exist until the Iraqi occupation had been going on for a year and half. “Ultimately peace and stability *must be paid for*,” he writes (italics in original) “with real resources, with tax revenue.” Something closer to the opposite is the truth: *war* must be paid for. So avoiding war and letting countries around the world deal with their own conflicts rather than interfering in them is more likely to create peace for us and is certainly likely to allow deficit reductions and even tax cuts. And maybe even a little less domestic surveillance.

Related to his concern about too little spending on the military is his concern about Americans’ distrust of government. He notes a recent Pew poll that “found that

only about 19 percent of Americans feel they can trust government always or most of the time.” The data, he says, “are not so cheery.” But he never considers whether that distrust is justified. In the late 1950s, he writes, 77% of respondents trusted the government. He seems to think that’s good. Remember that this is the government whose FBI tried to persuade Martin Luther King Jr. to commit suicide.

Why does Cowen think that trust in government is good? Because, he writes, among other things it led to Americans supporting the moon program, the interstate highway system, and “even the Rea-

gan military buildup.” But were those good things? Cowen doesn’t even make the case. The one I’m most familiar with, the Reagan military buildup, wasted hundreds of billions of dollars.

The subtitle of *The Complacent Class* is “The Self-Defeating Quest for the American Dream.” Maybe Cowen can argue that the American dream is harder to achieve—although in this era in which almost everyone over 20 has a pocket computer, that’s an uphill argument. But he can hardly argue—and doesn’t even try to—that pursuing the American dream is self-defeating. Which is fortunate. R

that crime has decreased since the 1990s, and knows virtually nothing about the political parties’ platforms. Voters tend to cast their ballots for the better-looking candidates. More than a quarter of Americans don’t know which foreign state the colonists fought during the Revolutionary War. These are just a few examples.

Brennan divides the electorate into three categories. Most voters are “hobbits,” who know nothing about political issues and social science. The rest—including “many, perhaps most libertarians”—are mostly “hooligans,” people who have strong, irrational, and biased views. Finally, “vulcans” are the small number of voters who know the facts and theories and analyze policies rationally. Only vulcans “can explain contrary points of view in a way that people holding those views would find satisfactory”—what Caplan has called “the ideological Turing test.”

The mistakes that democratic electorates make are systematic; they are not random and don’t cancel each other. For example, “the U.S. public as a whole makes systematic mistakes about economics, including most of the mistakes [Adam] Smith warned us not to make back in 1776.”

The nature of democratic voting does not encourage voters to learn. This is because the individual voter will have an actual influence on the result *only if* there would otherwise have been a tie in the vote.

In any large group of electors, the probability of a tie is infinitesimal. Depending on the assumptions made, this probability, and thus the probability of a single voter changing the result of the vote, is *at most* equal to the probability of winning the lottery jackpot. Have you ever met anyone who can say, “Without my vote, the other presidential candidate would have been elected”?

Thus, most voters spend little time gathering and analyzing information about the issues or candidates. Since the

Power to the Knowers!

◆ REVIEW BY PIERRE LEMIEUX

The recent presidential election campaign reminded us of an often-neglected fact: libertarianism has both a populist and an elitist strand. The populist strand was represented (perhaps with a vengeance) by those libertarians who supported populist Donald Trump. A representative of the elitist wing would be H.L. Mencken, the early 20th-century journalist and critic, who denounced democracy as “the theory that the common people know what they want, and deserve to get it good and hard.” No doubt, Mencken would see Trump as an exemplum.

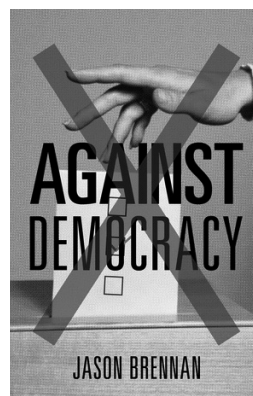
Jason Brennan’s *Against Democracy* comes from the same perspective as Mencken. It is a well-argued and challenging book.

Ruled by ignoramuses / The author, a libertarian philosopher and professor in the McDonough School of Business at Georgetown University, starts by analyzing the irrationality of voters, in the tradition of Geoffrey Brennan, Loren Lomasky, Ilya Somin, and Bryan Caplan. But Brennan’s critique goes further.

It is quite obvious that some people know more than others. And some know

very little; they ignore simple, relevant facts and do not understand the general theories (in economics, political science, philosophy, etc.) necessary to interpret those facts. Anybody who reads this article must agree that we—my readers and I—know things that others do not know, and we also admit that others know things that we don’t. We have to start from there. *Against Democracy* helps.

Brennan cites much evidence of ignorance, cognitive biases, and groupthink among the general electorate. The typical American does not know which party controls Congress, has no idea of the broad distribution of the federal budget (for example, people typically think that foreign aid makes up 28% of the federal budget, while it is closer to 1%), doesn’t know



Against Democracy

By Jason Brennan

304 pp.; Princeton University Press, 2016

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individual voter knows that his own vote does not count, it is rational for him to remain ignorant and to think irrationally. He can indulge in his biases or follow his political tribe. For the same reason, as evidence shows, the voter who has an opinion will not vote his interest but his opinion. For example, he tends to be nationalist because he mistakenly believes that this will further the common good.

The consequence is that an ignorant electorate elects ignoramuses to coercively rule over us. Even the voters who vote for what they think is the “common good” will often harm those they want to help.

Despite its deification, democracy is not the right to govern oneself, but the power to rule others. And it is against justice to be ruled by an incompetent government.

Here comes epistocracy / To solve this problem, *Against Democracy* argues for “epistocracy,” that is, “the rule of the knowledgeable” or, more exactly, the distribution of political power, including the right to vote, in their favor. (In ancient Greek, *episteme* means knowledge.) Just as physicians must demonstrate their knowledge and competence before they may practice medicine, citizens who want to vote should have to prove a minimum level of knowledge or analytical competence.

A “license to vote”—or to cast multiple votes—would be granted to citizens who successfully pass an exam showing they are sufficiently knowledgeable—for example, the civics test portion of the U.S. citizenship exam. Another means to this end would be to create an “epistocratic council” that would have the power to veto any democratic decision. Whatever the means, the principle is that there is no right to vote, except for the informed voters.

Brennan emphasizes that his choice of epistocracy over democracy is instrumental: better political decisions would be made this way. Individuals would get what they’d really want if they understood the facts and consequences of different policies.

The author of *Against Democracy* criticizes the philosophers who believe that democracy is necessary to symbolize and

implement the equal dignity of individuals. He writes:

Democracy does not empower *individuals*. It disempowers *individuals* and instead empowers the majority of the moment. In a democracy, individual citizens are nearly powerless. (emphasis in original)

He believes that individuals, including minority individuals, would be better treated in an epistocratic regime. For example, “U.S. voters tend to be ignorant of the effects of the drug war on minorities ... and how being ‘tough on crime’ tends to cause disproportionate harm to minorities.” Brennan also argues that democratic politics appeals to people’s baser instincts, “makes us worse,” and “tends to make us hate each other.”

His proposed regime is not as radical as it appears at first glance. It can be interpreted as democracy corrected by a knowledge requirement. The current democratic regime already includes epistocratic elements such as the courts. “Most epistocrats also want the rule of the many,” he writes, but of “the many-but-not-quite-everybody.”

He wants prudent, experimental, and gradual moves toward (more) epistocracy. He explains that if voters are incompetent to choose policies, they may be competent to establish general standards of political competence. “Whether we should prefer epistocracy to democracy is in part an empirical question, which I am not fully able to answer,” he writes in the last chapter of *Against Democracy*.

Epistocratic problems / There are many problems with epistocracy. I see three main ones.

The first is hubris. Even if we grant the easy point that “We the People,” taken in a collective sense, don’t know what we’re talking about, it does not follow that some elites know what is good for the rest of us. It may be true regarding some genuine public goods, but it is certainly not true with regard to most government interventions. Regarding personal tastes (is dark chocolate better than white chocolate?) and most personal goals, the Latin dictum

espoused by economists applies: *De gustibus non est disputandum* (“There is no disputing about tastes”). This objection becomes moot if epistocracy produces a minimum state, but this is what remains to be proven.

Brennan claims that “the case for epistocracy does not rest on the authority tenet; it is based on something closer to an *anti*-authority tenet” (emphasis in original). He also argues that “as people ... become more informed, they favor overall less government intervention and control of the economy.” But we are not sure that this is how an epistocratic system would actually develop.

The second problem is that epistocracy would further promote a society where the individual is trained to request permits and licenses. “The unequal distribution of power on the basis of competence seems elitist,” Brennan writes, “but it is not inherently more elitist than the unequal distribution of plumbing or hairdressing licenses.” There probably are better reasons to regulate the right to vote than the right to, say, repair a leaky toilet, but any license analogy plays into the hands of the regulatory state. Proponents of parenting licenses invoke the example of drivers’ licenses; indeed, raising children certainly has more social consequences than driving a clunker. We have to escape the licensing logic, not give it another lease on life.

It is one thing to make the easy argument that some people know things that others don’t. It is another to believe that, in this Brave New World, everybody has to be trained before he gains the right to do something. From this point of view, John Stuart Mill’s idea of giving additional votes to citizens with certain academic degrees is a more attractive idea than setting a formal system of state exams for political competence. But even this form of epistocracy is risky.

A third problem is that we have tried epistocracy and found it does not work as in Brennan’s model. From the Progressive era to our own days, academics, high-level bureaucrats, and pundits—in brief, the intelligentsia—have constituted an informal epistocracy, in cahoots with the state. Imagine what would have happened to the Second Amendment if the reigning intel-

ligentsia had had still more power. Imagine what would happen to the First Amendment if the high priests of college political correctness were to form the government's epistocratic council. Imagine the proponents of the parenting license among the top epistocrats of the future. If a mild level of epistocracy has not worked, it is not clear that more of the same is the solution.

Classical liberal solution / An alternative solution, which is the classical liberal solution, is to limit the scope of state action. If the state did little, the damage done by political ignorance would be limited, especially in a representative democracy, and more to the point in a republic based on the division of power. Brennan does not disagree with this, but he believes that more epistocracy would lead us to less government, which is a contentious claim.

Power to the knowers? No. But power to the ignorant neither. Some mild epistocratic elements could be added to the current political system. State propaganda should not actively encourage the ignorant to vote. (An ignorant nonvoter is more respectable than an ignorant voter.) If politically palatable, a poll tax would reduce the electoral participation of those who vote only to follow the crowd and entertain themselves. (Brennan hints at a similar measure.) The voting age could be raised.

Libertarian economist and political philosopher James Buchanan's way of conceiving the foundations of classical liberalism may be useful here: "Each man counts for one, and that is that," he wrote in *The Limits of Liberty* (University of Chicago Press, 1975). Is Brennan too quick to discard the symbolic value of democracy? What is the best form of government (if we need any) to protect individual liberty? On these deep issues, political philosophers disagree after 2,500 years of analysis and debate. This observation does not invalidate the necessary pursuit of truth, but it does cast further doubts on epistocracy.

Perhaps libertarians should be content to dwell somewhere between wild populism and undisguised epistocracy. This may be the true lesson of *Against Democracy*. R

Who Will Nudge the Nudgers?

◆ REVIEW BY PHIL R. MURRAY

David Halpern heads the United Kingdom's Behavioural Insights Team, also known as the "Nudge Unit." It was originally a part of the UK government but now is a partly private entity. "This book," he writes of *Inside the Nudge Unit*, "is about the application of psychology to the challenges we face in the world today." He is dedicated

to applying behavioral psychology as a "tool" of government. "Love it, or hate it," he declares, "nudging is here to stay."

Richard Thaler, professor of economics and behavioral science at the University of Chicago, and Cass Sunstein, professor of law at Harvard, introduced the idea of nudging to the public in their 2008 book *Nudge*. (See "A Less Oppressive Paternalism," Summer 2008.) Halpern explains, "A 'nudge' is essentially a means of encouraging or guiding behaviour, but without mandating or instructing, and ideally without the need for heavy financial incentives or sanctions." As such, nudging seems harmless.

Opposition arises, however, from those who see nudges as too tame, as well as those who see nudging "as some kind of pernicious form of meddling." To illustrate the former view, take the example of an anti-litter campaign that paints footsteps on a sidewalk to show the way to a garbage can. The nudge supposedly encourages people to dispose of litter properly; critics of the effort would prefer a law that prohibits littering and a fine for those who disobey.

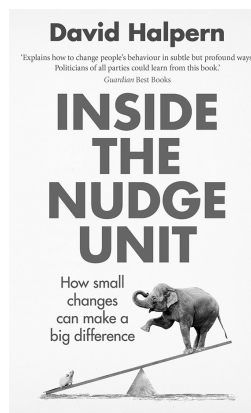
To illustrate the latter criticism, take the "midata clause," which "gave the Secretary of State for Business [in the UK government] the power to require firms to allow their customers access to their own con-

sumption data in 'machine-readable form.'" This nudge supposedly helps consumers make more informed decisions in the marketplace, for instance by showing them which nearby supermarket sells selected items at the lowest prices or with the least carbon footprint. The secretary could not unilaterally impose this regulation. "But," as though it were a feature and not a bug, Halpern writes, "this sword of Damocles had an almost immediate impact, encouraging at

least some companies to comply before they were pushed." Perhaps he chose his words poorly, but he appears to be saying that nudging worked in this case because the nudges, if you will, feared being "pushed." That undermines his argument that nudging is a noncoercive tool of government and gives ammunition to his opponents who fear the "sinister" application of nudging.

Government nudges / Most of the book is about seemingly uncontroversial nudging. Halpern begins with a history of such policies. One early example was Frederick the Great, who wanted his

Prussian subjects to produce and consume potatoes. Initial coercive efforts failed. However, by growing potatoes for his own consumption and feigning to protect his crop from theft, he successfully generated covetousness in his subjects and nudged them into producing and con-



Inside the Nudge Unit: How Small Changes Can Make a Big Difference

By David Halpern
383 pp.; W.H. Allen,
2015 & 2016

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suming spuds for themselves. Another example, Halpern tells us, is the painted lines on a road, which were an early nudge to promote traffic safety; rumble strips are a more recent nudge.

Turn now to policy nudges that relate specifically to the work of the Nudge Unit. The author is proud of nudging more people to save. The Nudge Unit did this by “changing the default.” Employers used to invite their workers to participate in payroll deduction savings plans, but the default was no participation. Participation required a modest initiative to sign up. The UK government passed legislation that switched the default to participation. Employers henceforth “automatically” put their workers in savings plans. The workers retained the right to “opt out,” but that choice would now require the modest initiative. The effect, Halpern reports, is that “more than 90 percent of eligible workers chose not to opt out.” If these workers continue to save over the long run, they will be in better financial shape when they retire.

“Still, just because changing the default works,” he wonders, “is it what people really want?” Indeed, people might say they would like to save more but, when yoked to do so, regret it. But this regret doesn’t appear to be happening. Halpern quotes Harvard economist David Laibson on American attitudes to similar initiatives:

It is hugely popular. US survey data suggests that 9 out of 10 workers who have experienced the pension opt-out support the changes in 401k defaults. And even among the small minority who do opt out, more than 7 out of 10 of *them* still think the opt-out is preferable to an opt-in arrangement.

Halpern is also proud of nudging delinquent taxpayers. To pull this off, the Nudge Unit borrowed a principle of psychology from Robert Cialdini, emeritus professor of psychology and marketing at Arizona State University. Halpern outlines Cialdini’s principle: “Social norms, and the inferred behavior of others, are powerful influences on our behaviour.” This nudge notified delinquent UK taxpayers that

“nine out of ten taxpayers paid on time.” Implementing this nudge was complex, based on a hallmark of the Nudge Unit’s work: the randomized controlled trial. Researchers mailed a standard letter to over 8,000 delinquent taxpayers reminding them to pay up. They mailed another letter, “adding the single (truthful) line that ‘nine out of ten taxpayers pay on time,’” to another group of about 8,000 delinquent taxpayers. Some 33.6% of the control group paid up; 35.1% of the latter group paid up. “This might not sound a lot,” Halpern realizes, “but if you are in the business of gathering hundreds of millions of pounds or dollars, and the marginal cost of the intervention is essentially zero, then this is very valuable indeed.” This story continues. Researchers mailed three other types of letters with alternative wording based on social norm theory, and found that they could coax even more late payers to pay up.

Nudges or markets? / Although Halpern is proud of the Nudge Unit’s accomplishments, he is not arrogant. He makes this clear by eschewing “the God Complex: the tendency we all have to believe that what we think and do is right.” A better way of thinking, which he encourages everyone to adopt, is this: “I don’t know—but I know how we can find out.”

The way to find out is through the aforementioned randomized controlled trial (RCT). Consider the use of an RCT to learn the most effective way of encouraging more people to donate their organs. The Nudge Unit was given the opportunity to present British car owners—upon completion of their annual online registration—a proposal to donate. Researchers “brainstormed” to compose a “control” webpage that some car owners would see, plus seven others “each based on one or more behavioural effects” that were intended to increase participation.

The beauty of the RCT is that they didn’t have to guess which webpage would induce most people to join the register; testing would show that. The control page stated, “Please join the Organ Donor Register.” Of more than 100,000 British car

owners who saw that, 2.3% opted to sign up. The biggest response came from those who saw the control message plus this: “If you needed an organ transplant would you have one? If so please help others.” Of the more than 100,000 who viewed that page, 3.2% signed up. “This is equivalent,” Halpern calculates, “to around 100,000 extra people joining the register a year compared with the control.” The trial also showed that those who viewed a webpage with “a picture of happy, healthy people” induced a *smaller* proportion to join than the control webpage. This is humble pie for “leading behavioural scientists and policy experts” who predicted the picture would prompt more people to donate.

What is missing from Halpern’s discussion of nudging more people to donate organs is the prospect of a market for organs. We can be confident that a well-informed policy analyst understands the promise a market holds for reducing a shortage of human organs. In the case of e-cigarettes, we might expect him to give the market process more of the credit it deserves. “The battle over e-cigarettes,” as Halpern sees it, “illustrates a classic type of policy: deciding what the position should be on whether to allow or restrict an activity or product, ultimately expressed through regulation and law.” E-cigs caught the attention of behavioral scientists because their research shows that “it is much easier to break a habit, or shift a behavior, by introducing a substitute behavior rather than simply extinguish it.” In other words, e-cigs offered a new way to quit smoking by substituting them for traditional cigarettes.

The Nudge Unit supported a market; the role of government would be “to make sure that e-cigs didn’t have other toxins, and that they had enough nicotine in them to be effective.” Health officials, reluctant to allow individuals another way to obtain a nicotine fix, and producers of nicotine patches and gum, resentful of new competition, resisted. Faced with resistance, the Nudge Unit examined “quit rates of smokers.” Quit rates among smokers using “nicotine replacement therapy” (patches and gum) had been declining

from the late 2000s through 2014. However, the quit rate for users of e-cigs ramped up from about 5% in 2011 to about 30% in 2014. The quit-rate data helped convince UK officials to allow e-cigs on the market without onerous regulation.

Permitting the market to operate is so far a successful policy. “Depending on your assumptions,” Halpern reports, “estimates suggest that from 20,000 to 200,000 extra smokers are quitting a year as a result of the availability of e-cigs in the UK alone.” On that basis, he broaches the possibility of prohibiting traditional cigarettes. Perhaps he attributes too much credit to the success of e-cigs to “an argument based on behavioural science principles” and not enough to the market because the Nudge Unit would not have had quit-rate data to examine without a market. And if we are to believe that nudgers respect the freedom to choose, why flirt with a ban?

Why trust nudgers? / Behavioral science is Halpern’s hammer, and real-world problems are the nails. The author sees applications everywhere. At the individual level, behavioral principles imply that workers looking for jobs should disregard “what they had done last week” in order to focus on “what they would do next week.” On a macroeconomic level, they overcome the pessimism that grips an economy during recession and influence businesses to adopt “government growth-related schemes.” Halpern and colleagues even managed to persuade UK officials to produce data on “subjective well-being” and gear policy toward increasing it. If the public embraces his enthusiasm for “a well-being viewpoint,” we can expect politicians to start taking credit for increases in the index of life satisfaction during their tenure. At this point, one begs to know, is nudging a panacea?

Fortunately, Halpern recognizes that “there are real dangers in getting too carried away with thinking that nudges are the answer to everything.” He engages criticism from three sources: “the right,” “the left,” and “liberals and democrats.”

Right-wing critics view nudging as a

threat to freedom. He takes their challenge seriously. He vows that the Nudge Unit will tell the truth, deliberate in the public eye, and submit to “checks and balances.” For instance, “an academic advisory panel” provides feedback and ethical advice.

Left-wing critics view nudging as insufficiently aggressive to achieve their paternalistic goals. If my impression is correct, he has little interest in this critique. Nudgers, by nature, prefer subtle forms of persuasion over blunt mandates and prohibitions. Nudges influence behavior at the margin, he explains, and he describes how they may

work in both the short and long run.

On behalf of “liberals and democrats,” the author asks, “Why should we trust the nudger to know better?” and “Who nudges the nudgers?” Not only liberals and democrats want answers to those questions.

“Ultimately,” Halpern concludes, “you—the public, the so-called ‘ordinary citizen’—must decide what the objectives, and limits, of nudging and empirical testing are.” This is a tall order. We are already busy dealing with government interventions in the market; we now have the job of checking government interventions into our minds. R

Smarter to Be Lucky

◆ REVIEW BY GEORGE LEEF

In our increasingly competitive world, the greatest rewards don’t necessarily go to those who are objectively the best, but often to those who happen to be lucky. The documentary *Virtuosity*, which I recently chanced to see, drove that point home.

The documentary is about the 2013 Cliburn International Piano Competition, named for the late Van Cliburn. The Cliburn is one of the foremost musical competitions in the world. Thirty superb pianists entered and played for a jury consisting of internationally renowned musicians. After the first round, only 12 were chosen to continue on. The second round winnowed the field to six finalists.

Those six all played superbly, as you can see and hear in *Virtuosity*, but prizes went to only three: third to Sean Chen of the United States, second to Beatrice Rana of Italy, and first to Vadym Kholodenko of Ukraine. For those three, and especially Kholodenko, the awards boosted their careers into orbit.

But were they really better than the others? If a juror or two had felt just slightly differently along the way, any of the 27 also-rans might have taken one of the awards. Kholodenko, Rana, and Chen, on the other hand, might have gone back home to their

previous lives, hearing friends say, “Better luck next time.”

Who happens to come away with life’s big prizes, pianistic and otherwise, is the subject of Robert Frank’s recent book, *Success and Luck*. Frank, a professor of economics and management at Cornell University, has spent decades thinking about the role of luck in our society. More than 20 years ago he co-authored the book *The Winner-Take-All Society*, arguing that the developed world’s markets are increasingly “winner-take-all,” in which one person or company rakes in almost all the rewards of success with little left for the rest of the field. In his latest book, *Success and Luck*, he returns to this theme and explains why he finds it problematic.

Small differences, big rewards / “In recent years,” Frank writes, “social scientists have discovered that chance events play a much larger role in important life outcomes than most people once imagined.” Despite the American belief in meritocracy, he argues that success and failure “often hinge deci-

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sively on events completely beyond any individual's control." The actor Bryan Cranston, for example, is now enjoying a booming career, his high demand a result of his starring role as methamphetamine kingpin Walter White in the TV series *Breaking Bad*. Frank points out that Cranston was only offered that role after John Cusack and Matthew Broderick turned it down. Yes, Cranston is a fine actor, but without that lucky break he would have been remembered for the respectable but not landmark role of father Hal in the comedy series *Malcolm in the Middle*.

The business world, Frank contends, is full of such good-luck stories. In the market for tax preparation software, for instance, numerous programs that were perfectly capable once competed. But owing to some favorable reviews, Intuit's Turbo Tax eventually came to dominate the field. "Its developers profited enormously, even as those whose programs were almost as good were being forced out of business," Frank laments.

Of course, it has always been true that a few lucky ones manage to reap great rewards even though they were little if any better than their rivals. But Frank maintains that the march of technology is magnifying the gap between winners and losers in such varied fields as law, medicine, sports, journalism, retailing, and even academia. In a revealingly egalitarian passage, he writes:

It's one thing to say that someone who works 1 percent harder than others or is 1 percent more talented deserves 1 percent more income. But the importance of chance looms much larger when such small performance differences translate into thousand-fold differences in earnings.

Much ado? / But is the "winner-takes-all" trend really becoming more pronounced? For all of his anecdotes, Frank's claim that it rests on nothing more than his ipse dixit. The same technological change that allows some to get exceptionally wealthy is also making markets open to far more people than ever before: publishing, for

example. It also allows competitors to erode the positions of the lucky winners more rapidly than ever. This part of Frank's case, I would say, is doubtful.

The key questions remaining are why this trend (assuming it exists) is harmful and what the author proposes to do about it.

One reason why the trend is harmful, according to Frank, is that the quest for great success "may encourage people to compete where they have no realistic prospects." True enough, but hasn't that always been so? For the last century, vast numbers of young Americans have, for example, devoted a great deal of time and energy to perfecting their jump-shots, fastballs, and tackling even though the chance of making it into one of the major leagues (with a multi-million-dollar contract) is vanishingly small. Many others have tried to "make it big" in music or acting, even though the odds of success are similarly microscopic. And still more, lured by the possibility of gigantic profits, have tried to invent things and market them, but like the rivals to Turbo Tax, failed. Frank focuses only on the business failures, but even when people don't achieve their dreams, they usually gain from their efforts in ways that make future success more likely. As Thomas Edison said of his many unsuccessful experiments, "I didn't fail, but learned what didn't work."

But there is a far bigger problem according to Frank: the few plutocratic winners damage the nation with their prodigious spending on mansions, hyper-expensive cars, over-the-top weddings, and so on. All of that conspicuous consumption really doesn't make them happier, he claims:

Wealthy Americans have been building bigger mansions simply because they've received most of the country's recent income gains. Yet there's no evidence that,

beyond a certain point, bigger houses make people any happier. Once houses reach a certain size, further increases in square-footage merely shift the frame of reference that defines adequate.

While the rich are engaged in a sort of arms race to out-do each other, public investment suffers, he claims. Channeling John Kenneth Galbraith's complaints in *The Affluent Society* (1958), Frank sees an America in which the wealthy are living it up at the expense of a starving public sector. He employs this analogy to make his point: we are like a driver who has a \$300,000 Ferrari that bumps along on pothole-ridden roads when we could instead have a \$150,000 Porsche that we drive on perfectly smooth roads.

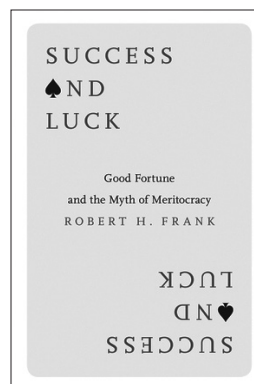
We suffer from a huge infrastructure deficit of some \$3.6 trillion but, Frank argues, the rich fail to understand that they were just lucky and therefore oppose paying the higher taxes that would lead to better roads for all, better education for everyone's children, and so on. In short, we'd all be better off—even the rich—if they paid more in taxes and stopped their wasteful spending.

Several glaring problems beset his argument.

First, all of that needless (to Frank) spending by the rich provides the income for

many people who are not rich. Consider the outlandish Manhattan weddings that now cost on average \$76,000. Frank sees wasteful one-upmanship, but to the companies employed and their workers, that's the money that pays the bills. The de-escalation of the arms race on weddings, houses, cars, boats, etc., that Frank wants would inflict serious pain on many Americans whose livelihoods depend on rich people spending money on their lifestyles.

Second, it isn't true that the super-rich have dug in their heels to oppose any and all tax increases on them. A great many



**Success and Luck:
Good Fortune and the
Myth of Meritocracy**

By Robert H. Frank
187 pp.; Princeton
University Press, 2016

of America's billionaires are supporters of leftist politicians who have pledged to make the rich pay much higher taxes. Something other than insatiable greed of the 1 Percenters is necessary to explain why the tax code lets them keep so much of the money they've been lucky enough to acquire.

Third, Frank's proposed tax transfer of much of the wealth of the lucky few to the government would not produce the social benefits he envisions. That is because he assumes that if the federal treasury had billions more, the politicians and bureaucrats would spend it wisely to give us smooth roads, strong bridges, efficient passenger rail, and above all, good schools for everyone. That is to say, Frank exhibits the standard "liberal" wishful thinking that we can solve our problems by just spending enough on them. Could this eminent economist be unfamiliar with the public choice critique of government spending? Is he unaware that many of the school districts that spend the most per student have consistently poor results? Apparently so.

Frank's proposed solution to the alleged problem that the lucky are "taking" too much of society's income and squandering it is *not* to ramp up the highest income tax brackets, as you might suppose. Rather, he wants to replace the progressive income tax with a progressive consumption tax. That change would, he contends, reduce wasteful consumption spending (especially by the super-rich) while encouraging saving and investment.

Actually, there is much to be said for shifting away from the income tax and into a consumption tax. But the case for that doesn't have anything to do with luck or the "expenditure cascades" of the rich. Frank is prescribing a helpful medicine based on an erroneous diagnosis of the patient's condition.

Success and Luck is not without its useful insights. Foremost among them is Frank's point that the "college earnings premium" that many educators site as proof that we need to put more young people through college is a mirage. That "premium" exists, he notes, only because a small number of

college graduates have enjoyed spectacular earnings. For most college grads, earnings are modest and haven't grown much. Coming from a college professor, that's quite a rebuke to the crowd calling for the United States to regain the world's top spot with regard to the percentage of the populace

with college degrees.

Nevertheless, the book's big point is one that gives aid and comfort to redistributionists who will use almost any argument to justify expansion of the state. "You just got lucky" works just as well for them as another recent claim: "You didn't build that." **R**

The Restless Judge

◆ REVIEW BY DAVID R. HENDERSON

Probably the best-known current federal judge who is not a Supreme Court justice is Richard Posner, who has been a judge on the 7th Circuit since 1981. Posner is known for his judicial decisions, his crystal-clear writing style in those decisions, and his prodigious output: over 40 books and hundreds of articles in law reviews, economics journals, and popular publications.

Given his importance in both academia and the federal courts, we have been due for a book that tells us more about the man. In most of the important ways, William Domnarski's *Richard Posner* is that book.

Domnarski, a lawyer himself, shows obvious respect for his subject, calling Posner "the Wayne Gretzky of appellate judges." He spent three years researching his subject and interviewed over 200 people, including Posner. He studied Posner's early history. He also read all of Posner's thousands of decisions and much of his correspondence. As a result, we get a good idea about how Posner's mind works and his various attitudes.

Domnarski details the judge's thinking in dozens of his decisions, telling us Posner's bottom line and, in many cases, how he reached his conclusions. For example, we get to see the strong role that economic analysis and broader social science play in his court decisions.

We see Posner call out various judges for intellectual laziness. He tangles with the late Supreme Court Justice and his for-

mer University of Chicago colleague, Antonin Scalia. He acerbically dresses down some police officers who have violated a defendant's Miranda rights. He confidently reaches conclusions about public policy based on his largely self-taught economic understanding.

Unfortunately, we often *don't* get to see how Posner reaches his conclusions. As an economist, I usually was able to fill in the blanks, but many readers will not. Filling in the missing arguments would probably have added 20% to the book's length and so it's understandable that Domnarski didn't do so. In the age of the Internet, though, there's an easy fix: put in links to a special website that details Posner's reasoning.

Beyond advocacy/ In the opening chapter, Domnarski describes Posner as a star student from an early age: in public school, then as an undergraduate literature major at Yale, and finally as a law student at Harvard. Posner then took some fairly important jobs in federal government agencies in the 1960s. Before reaching age 28, while at the Office of the Solicitor General under President Lyndon Johnson, he had argued six cases before the Supreme Court.

Posner, it turns out, "practiced his oral arguments to his cat." However, Domnarski writes, those arguments "had as much

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influence on the Justices as they had on the cat.” Said Posner, “Whatever drove Supreme Court decisions, it wasn’t the lawyers’ advocacy.” That was one reason he left his job with the solicitor general.

But then he got lucky—if luck is the right word to apply to someone who works very hard, thinks for himself, and searches out interesting intellectuals. In 1968 he joined the Stanford Law School faculty and met Aaron Director and George Stigler. Director, the older brother of Milton Friedman’s wife, Rose, had moved to Stanford in 1965. While at the University of Chicago Law School, he had started the *Journal of Law & Economics* and was one of the founders of the field of law & economics.

While you won’t find Director’s name as an author of many important works, he is often in the acknowledg-

ments as the person who came up with the idea that led to this or that path-breaking article. One early such article was John S. McGee’s “Predatory Pricing: The Case of Standard Oil of New Jersey.” In it, McGee found—as Director had suspected based on a priori economic reasoning—that Standard Oil had *not* engaged in predatory pricing.

Stigler, an economics professor at the University of Chicago, spent part of every winter at Stanford. (For some reason, Domnarski never mentions that both Director and Stigler worked at Stanford’s Hoover Institution.) Stigler was arguably the leading economist in industrial organization at the time. Posner used his time with Director and Stigler well, soaking up their insights. His conversations with them profoundly affected his career.

He moved to the University of Chicago Law School in 1969. There, he became thoroughly familiar with the law & economics literature and started making his own contributions. And those contributions didn’t take long. In 1971 he started the *Journal of Legal Studies*. By 1973 he had

published his first magnum opus, *Economic Analysis of Law*. The book made a big splash at the time, earning many reviews, and established Posner as one of the leading scholars in law & economics.

In 1981, President Ronald Reagan appointed him to the 7th Circuit, based in Chicago. From then on, what made the biggest splashes were Posner’s opinions in many of his thousands of decisions. And his prominence and ability as a judge led to opportunities to write about policy issues, judicial and otherwise.

In 1988, for example, Chief Justice William Rehnquist appointed him and 14 other “judges, legislators, academics, and lawyers” to the Federal Courts Study Committee. The impetus for the committee was the congestion and delay in cases that federal courts were experiencing. Posner and

Larry Kramer, future dean of Stanford’s Law School, wrote their subcommittee’s report. It included a number of recommendations such as, in Domnarski’s words, “establishing a \$10,000 minimum for federal tort claims” and repealing the Jones Act, which requires that all goods shipped between U.S. ports be carried on U.S.-built ships staffed with U.S. citizens and permanent residents.

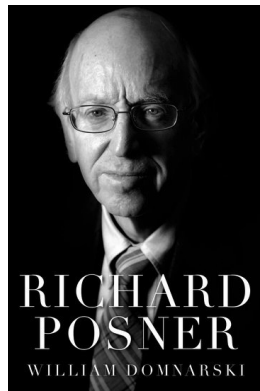
Domnarski doesn’t explain why they made those recommendations. As an economist, I think I can fill in some of the reasoning. The purpose for the \$10,000 minimum would presumably be to “not make a federal case,” to use an old expression, out of relatively small claims, thus freeing up valuable court time. The Jones Act is one of the laws that informed economists especially hate because it makes shipping very expensive. Foreign ships can’t deliver freight to two different U.S. ports in one voyage. Instead they must break bulk in one port and then use U.S. ships to take the cargo to the other port. The economic inefficiency is obvious.

When Domnarski does spell out Pos-

ner’s reasoning on various court cases, he generally does a good job. Take, for example, *Vande Zande v. State of Wisconsin Department of Administration*, a case under the Americans with Disabilities Act involving a paraplegic employee. The act requires an employer to “reasonably accommodate” employees with disabilities. Posner pointed out that reasonable care is not the same thing as maximum care. Drawing on negligence law, in which the issue of reasonableness arises, Posner wrote that “similar reasoning could be used to flesh out the meaning of the word ‘reasonable’ in the term ‘reasonable accommodations.’” If there were no limitations, Posner argued, employers could be faced with “potentially unlimited financial obligations to 43 million disabled persons.” This unlimited obligation would impose “an indirect tax potentially greater than the national debt.” Posner concluded that there was no basis in the law’s language or history for concluding that Congress’s intention was “to bring about such a radical result.”

Sharp critic, fawning worshipper / One pleasurable (to me) part of the book consists of portions of Posner’s letters to University of Chicago philosophy professor Martha Nussbaum. Apparently, after she had criticized “Chicago-style economics,” Posner wrote in response, “Your acquaintance with economics seems so distinctly second-hand.” After she had argued for rent control, he wrote, “Not to seem too impertinent, it seems to me that your views of rent control stem from ignorance of a large economic literature about it.” Indeed. In response to her claim that Americans feel inferior because they lack culture and are familiar only with economics, movies, and Wagner, Posner wrote, “Leave out economics and Wagner, and it’s still wrong. I don’t think you know what country and century you’re living in.”

One fact that surprised me—because I have not followed Posner closely—is that he is an “uncritical, fawning worshipper” (Posner’s own words) of Justice Oliver Wendell Holmes. Posner edited and wrote a long introduction to *The Essential Holmes*, a book



Richard Posner

By William Domnarski

289 pp.; Oxford University Press, 2016

of excerpts from Holmes's decisions and letters. What did Posner think of Holmes's majority opinion in the infamous *Buck v. Bell* case, which upheld the constitutionality of compulsory sterilization? On his assumption that Carrie Buck was "feeble-minded," Holmes wrote his famous line, "Three generations of imbeciles are enough." Although Posner loved the rhetoric, he did criticize "the reasoning and the result."

He is a harsh critic of federal judges, arguing that many of them are lazy and that they should write their own decisions rather than have their clerks write them. Two famous judges whom he takes on are current Chief Justice John Roberts and the late Justice Antonin Scalia. In a 2012 article in *Slate*, after Scalia had dissented from parts of the majority opinion that invalidated some provisions of an Arizona law on immigration, Posner raked Scalia over the coals. Scalia had written, "[Arizona's] citizens feel themselves under siege by large numbers of illegal immigrants who invade their property, strain their social services, and even place their lives in jeopardy." Wrote Posner, "But the suggestion that illegal immigrants in Arizona are invading Americans' property, straining their social services, and even

placing their lives in jeopardy is sufficiently inflammatory to call for a citation to some reputable source of such hyperbole. Justice Scalia cites nothing to support it." Aside from his question-begging use of "hyperbole"—if it were hyperbole, one would be hard put to find a "reputable source" to support it—Posner made a good point.

In my view, Posner was at his finest in his 2014 *United States v. Slaughter* opinion reversing the conviction of Michael Slaughter for receipt and possession of child pornography. The police had clearly denied Slaughter his Miranda warning, and Posner saw through it. Dismissing the police argument that they wanted to interview Slaughter at the police station rather than at his home because his windows were covered with trash bags, blocking the sunlight, he wrote sardonically that "the officers gave no reason why an interview, unlike painting a landscape, requires natural rather than artificial light." As to their argument that the house "had a strong smell of cats," Posner, who to his credit is pro-cat throughout the book, wrote that "police smell much worse things in the line of duty." The final two sentences of his decision are terse and beautiful: "These facts are incontrovertible and show that the

average person in Slaughter's position would have thought himself in custody. Any other conclusion would leave Miranda in tatters."

Central planners / There is no mention in the book of any basic insights from public choice in Posner's decisions or writings. Indeed, there is no evidence that he understands and applies such insights. At times he comes across as someone who has much more faith in government officials than seems justified. Whether it's his advocacy of a domestic intelligence agency in *Remaking Domestic Intelligence* or his support of Keynesian economic policies in *A Failure of Capitalism*, Posner shows little inclination to think through some of the perverse incentives that government officials might have when carrying out the programs he advocates.

Posner has shown that he can attribute bad incentives to the police, but he doesn't worry enough, in my view, about the incentives and motives of employees of intelligence or fiscal agencies, among others. In his mind, there is more than a little belief in the benevolence—and competence—of central planners. Still, Domnarski's book reminds me that I'm glad that Richard Posner is in this world. R

Working Papers BY PETER VAN DOREN

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

Air Pollution

"The Mortality and Medical Costs of Air Pollution: Evidence from Changes in Wind Direction," by Tatyana Deryugina, Garth Heutel, Nolan H. Miller, David Molitor, and Julian Reif. November 2016. NBER #22796.

Reducing exposure to fine particulate matter (PM 2.5) accounts for 90% of the estimated benefits of conventional federal air pollution regulations. This has raised questions about the reliability of those benefit estimates; are they too optimistic?

The estimates of the mortality benefits of PM 2.5 reduction used by the U.S. Environmental Protection Agency come from two studies, commonly referred to as the American Cancer Society Study and the Harvard Six Cities Study. Both have been the subject of much methodological criticism.

Economists have responded to the methodological weaknesses of those studies by investigating the results of natural experiments in which people are exposed to pollutants in a manner that is plausibly random. One such research design involves random changes in prevailing wind direction that briefly expose different populations of people to pollutants. I described one such study in my Winter 2015–2016 Working Papers column. Here is another.

The authors argue that changes in wind direction affect subsequent short-term morbidity and mortality only through exposure to air pollution. They examine three-day mortality and morbidity effects among Medicare patients at the county level from 1999 to 2011. A 1 microgram per cubic meter ($\mu\text{g}/\text{m}^3$) increase in PM 2.5 for one day causes 0.61 additional deaths per million elderly during the next three days, 2.7 life-years lost per million beneficiaries, and 2.3 additional emergency room visits per million elderly, costing \$15,000 per million elderly. At \$100,000 per statistical life year, they estimate that the mortality cost of a 1 $\mu\text{g}/\text{m}^3$ increase in PM 2.5 is \$270,000 per million elderly, an order of magnitude higher

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than the cost of the additional emergency room visits.

From 1999 to 2011, average PM 2.5 concentrations declined by 3.65 $\mu\text{g}/\text{m}^3$. According to the estimates of the paper, this reduction would result in 150,000 extra life-years annually, which if valued at \$100,000 per life year would equal \$15 billion in annual benefits. The EPA estimates that the annual compliance costs of the 1990 Clean Air Act standards were \$44 billion in 2010. This suggests the PM 2.5 regulations do not pass a cost-benefit test.

Health Care Expenditures

“Do Certificate-of-Need Laws Limit Spending?” by Matthew D. Mitchell. November 2016. SSRN #2871325.

From 1965 until the early 1980s, Medicare encouraged health care capital expenditures because of its “cost-plus” reimbursement framework, which guaranteed federal payments above the marginal cost of a service. As a result, many providers were accused of wastefully overinvesting in capital, at the public’s expense.

Rather than change the incentives in this reimbursement framework, the federal government responded by mandating that states enact Certificate of Need (CON) laws. The laws would require health care providers to seek approval from state boards before making major capital investments. The thinking was that such oversight would reduce unnecessary capital expenditures. CON critics, on the other hand, charged that the laws discourage both market innovation and competition, resulting in higher prices and lower service quality.

Medicare changed its reimbursement practices in the mid-1980s and repealed the CON requirements in 1987. But 35 states and Washington, D.C. still have CON requirements. This paper surveys the refereed literature on the effects of CON programs to determine if they did, indeed, reduce wasteful expenditures and health care costs. The papers overwhelmingly conclude that CON programs increase per-unit costs and expenditures because they restrict entry and reduce health care competition.

Payday Lending

“Much Ado about Nothing? Evidence Suggests No Adverse Effects of Payday Lending on Military Members,” by Susan Payne Carter and William Skimmyhorn. March 2015.

“Access to Short-term Credit and Consumption Smoothing within the Paycycle,” by Mary Zaki. March 2016. SSRN #2741001.

Congress effectively banned payday lending to active members of the military in 2007. Prior to 2007 some states had payday lending bans while others did not. The initial assignment of soldiers to training bases at the start of their military service is random; some were assigned to bases in states that allowed payday lending, others were assigned to bases in

states that did not. These facts allow the authors of these papers to conduct an assessment of how the end of payday lending for those affected by the federal ban affected outcomes relative to those soldiers who never had access to payday lending because they served in a state with a preexisting ban.

The first paper found no differences in separation from service or denial of security clearances because of bad credit among those with and without access to payday lending.

The second paper examined commissary purchases. After the ban, sales on paydays at bases were 21.74% higher than sales on non paydays. Before the ban, sales on paydays at bases near payday loan outlets were only 20.14% higher. There was a 1.6% smaller gap between payday and nonpayday sales when troops had access to payday loans. Payday loans allow members of the military to smooth their consumption across the paycycle.

Airline Mergers

“Are Legacy Airline Mergers Pro- or Anti-Competitive? Evidence from Recent U.S. Airline Mergers,” by Dennis Carlton, Mark Israel, Ian MacSwain, and Eugene Orlov. October 2016. SSRN #2851954.

Airline mergers have reduced the number of legacy airlines from six to three. Delta and Northwest have merged under the Delta name, United and Continental under the United name, and American and US Airways under American. Airlines are also now profitable for the first time in decades. Many armchair antitrust observers have thus concluded that the mergers were anticompetitive, harming consumers while pumping up airline profits.

The authors of this paper attempt to determine if this is the case. If the mergers had anticompetitive effects, routes on which the merged airlines competed directly (overlap routes) should see fare increases and output reductions (flight frequency and/or passenger loadings) relative to non-overlap routes.

The authors confirm that fares and output on controls and treatment routes were statistically similar pre-merger. On average across all three mergers, fares on overlapping routes *decreased* 6.2% post-merger relative to control routes. Passenger loadings increased 12.4% and available seats *increased* 23.8%. Prices went down and output went up. The mergers were not anticompetitive.

Energy Standards

“Energy Efficiency Standards Are More Regressive than Energy Taxes: Theory and Evidence,” by Arik Levinson. December 2016. NBER #22956.

Economists recommend that policymakers combat negative externalities like pollution by changing prices rather than implementing “command-and-control” regulation. A tax on harmful air emissions, for instance, would encourage

polluters to find the most efficient ways to reduce their emissions, whereas specific emissions control requirements—scrubbers, for instance—would fail to distinguish more efficient means of pollution control.

Unfortunately, legislatures almost always enact regulation rather than taxation; politicians would prefer to be seen mandating “clean” technologies rather than adopting new taxes. But many politicians claim that this policy choice is for a more high-minded reason: taxes are regressive, while mandates are more even-handed. Is this justification sound?

This paper examines the distributional effects of one specific command-and-control regulation: Corporate Average Fuel Economy (CAFE) standards. These standards mandate that automakers’ model-year vehicles, as a group, meet a minimum fuel-efficiency standard. The author, Arik Levinson, endeavors to determine if CAFE standards are less regressive than a similarly effective fuel tax.

Levinson first points out that a discussion of the distributional implications of taxes is incomplete without discussion of how the resulting revenues are used. The most affluent households have 10 times the income of the least affluent, but use only four times more gasoline, so a gasoline tax would be regressive in the sense that the affluent would pay a lower percentage of their income. But if the proceeds from that tax were rebated equally to all households, then the overall tax-plus-rebate program would be progressive because

low-income households would get back more money than they paid.

The author then demonstrates that efficiency standards are equivalent to a tax on inefficient appliances. In the case of cars, a direct tax on energy use is a tax on gallons of gasoline used while the tax-equivalent of CAFE standards is a tax on gallons used per mile. Thus Levinson says that for any given use of the revenue (or imaginary revenue equivalent in the case of CAFE standards), the question is whether the direct tax increases faster with income than the “efficiency standard–equivalent tax.” Affluent households use four times as much gasoline as poor households, but affluent households use only three times the gasoline per mile as poor households. Thus the gas tax goes up faster with respect to income for affluent households than the tax-equivalent cost of efficiency standards with respect to income.

Since 2011, efficiency standards for cars have varied with the size of the “footprint” of the vehicle. Larger vehicles have more lenient standards on gasoline use. More affluent people buy larger vehicles. Levinson demonstrates that the net effect of the new footprint CAFE standards is to make efficiency standards even more regressive relative to a gas tax.

He concludes that on a revenue-neutral basis, a gasoline tax would indeed be regressive. But the old CAFE standards were more regressive than a gas tax would be, and the new footprint CAFE standards are even more regressive. R

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