IN REVIEW

The Powerful Case for Immigration

REVIEWED BY DAVID R. HENDERSON

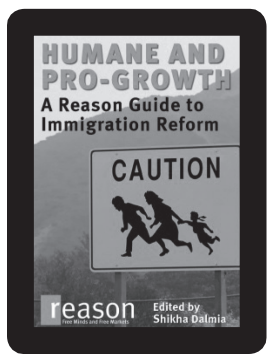
When I dug into *Humane and Pro-Growth*, I realized that I had fallen behind in the immigration debate. Sure, I've read all of my Econlog co-blogger Bryan Caplan's excellent posts on immigration. And I'm quite familiar with the powerful arguments that Kennedy School economist Lant Pritchett and the Center for Global Development's Michael Clemens have made for much more open borders. But what I was not familiar with was how anti-immigration many conservatives at *National Review* and other publications have been and how well journalists like Shikha Dalmia and Kerry Howley have answered them and other critics. My attitude toward this e-book is much like that of John Maynard Keynes after reading Friedrich Hayek's *The Road to Serfdom*: "In my opinion it is a grand book…. Morally and philosophically I find myself in agreement with virtually the whole of it: and not only in agreement with it, but in deeply moved agreement."

The e-book is a collection of various articles that *Reason* writers have published in the magazine and elsewhere since 2006. There is some overlap between the articles. For example, you see a number of times a World Bank estimate that if the wealthier countries allowed a mere 3 percent increase in their labor force through relaxed immigration restrictions, the annual gain to citizens of poor countries would amount to a whopping $300 billion, while the annual gain to the citizens of rich countries would be about $50 billion. But those numbers are so important that they're *worth* repeating.

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

Bit by bit, the various articles build a powerful case, on both economic and humanitarian grounds, for allowing many more people in on the American dream.

My favorite articles in the volume were by Dalmia, a senior analyst with the Reason Foundation, and Howley, formerly with *Reason* magazine and now managing editor of *Houstonia Magazine*. A close third were the pieces by Jesse James DeConto, a contributing editor to *Prism* magazine and a regular writer for the *Huffington Post* and other publications.



Humane and Pro-Growth: A *Reason* Guide to Immigration Reform

Edited by Shikha Dalmia

e-book; *Reason* Magazine, 2013

Mythbusting / The book is particularly good at busting myths about American immigration. Consider, for example, the claim that illegal immigrants are particularly prone to crime. Obviously, they are—to the extent that they're breaking the law by being here. But various critics of immigration accuse them of disproportionately breaking laws against murder, rape, burglary, etc. In "Five Myths that Restrictionists Peddle," Dalmia presents strong evidence against that notion. If illegal immigrants were more dangerous, one would expect crime rates to increase as the percent of residents who are illegal immigrants increases. The evidence, though, is the exact opposite. She writes:

> The violent and property crime rate in Arizona actually declined between 1998 and 2008 as its illegal immigrant population soared, debunking the central rationale for the harsh anti-immigrant law it recently adopted. The same is true for California, New Mexico, and Texas. Indeed, El Paso, a Texas border town that has a predominantly Hispanic population—much of it foreign, illegal, and poor—had the third lowest violent crime rate in 2008, after Honolulu and New York.

That makes sense. The last thing illegal immigrants want is contact with law enforcement—it could lead to their being deported.

Why, then, do many Americans think that illegal immigrants are particularly dangerous? Could it be because we've heard people like Rep. Steve King (R-Iowa) say that illegal immigrants murder 12 Americans a day and kill another 13 Americans daily by driving drunk? In a 2009 article, "The El Paso Miracle," *Reason* contributing editor Radley Balko artfully debunks King's statistics. According to Balko, King says he got those numbers from a Government Accountability Office study that he had requested. Well, not quite. What the GAO study showed is that 27 percent of prisoners in federal prisons are non-citizens. According to Balko, King then applied that 27 percent to all murders and drunk-driving fatalities and, voilà, concluded that 27 percent of those crimes are committed by non-citizens. Talk about proof by assumption! I would not want King teaching statistics. Of course, as Balko notes, most convicted murderers and drunk-driving offenders are in *state* prisons or *local* jails, not in federal prisons. And according to the U.S. Justice Department, only 6.4 percent of inmates in all prisons combined are non-citizens. My own quick check of U.S. data shows that in 2010, 7.3 percent of people living in the United States were non-citizens. In other words, non-citizens are slightly *underrepresented* in U.S. prisons.

What about the idea that illegal immigrants don't pay taxes and disproportionately collect the benefits of the welfare state? Dalmia punctures that myth, writing, "[A]vailable evidence suggests that unauthorized workers contribute more in taxes than they consume in services." She quotes a National Research Council finding that over their lifetimes and factoring in their children's taxes, unskilled immigrant families pay on average $80,000 more in federal taxes than they consume in federal benefits. Moreover, she notes:

> [T]hat was before the 1996-welfare reform act. Since then, illegals have been barred from collecting most means-tested federal benefits except for emergency medical services. However, they didn't get a reprieve from taxes. All of them pay state sales taxes and property taxes (through rent) that help offset the cost of roads, schools, and other non–means tested services they use. And 62 percent of them also pay federal income taxes (via withholdings) while 66 percent contribute to Social Security and Medicare. Their Social Security contributions put $50 billion annually into something called the "earnings suspense file" that they'll likely never see again because they use fake Social Security numbers on their returns that can't be traced back to them.

One objection many people have to immigration, legal or illegal, is that "they take our jobs." But in "Don't Badmouth Unskilled Immigrants," George Mason University economist Tyler Cowen and Daniel M. Rothschild, associate director of the Mercatus Center's Global Prosperity Initiative, note that much foreign labor complements that of U.S. citizens. For example, "54 percent of tailors" in the United States are foreign-born. Moreover, much of the labor that illegal immigrants do is the kind of hard work that our immigrant grandfathers did, but that few Americans will do today.

In his 2006 article, "America Spurns the Foreigners It Needs," DeConto tells a moving story about legal and illegal immigrants working on Christmas tree farms in North Carolina. Often working 10- to 16-hour shifts hauling and piling Christmas trees, they worked for wages ranging from $6 to $8 an hour. DeConto highlights the story of a legal immigrant named Buca. He writes, "To comply with federal law, Buca must return to his native Veracruz, in southern Mexico, and renew his H-2A temporary guest worker visa or risk losing it and drawing up to $10,000 in fines for his employer." Thus his family is temporarily disrupted every time he has to travel for renewal.

One of the most common views that Americans hold, whether or not they oppose immigration, is that illegal immigrants have "cut in line" in front of would-be immigrants who are trying to enter the United States legally. The fact, notes Dalmia, is that "there is no queue for unskilled workers to stand in"—that is, no immigration slots allocated to unskilled workers. One implication of this fact, she notes, is that "Amnesty for them therefore has zero bearing on the wait time of skilled workers."

Dalmia also challenges columnist George Will's view that the Constitution should not be read literally to give citizenship to everyone born in the United States. Will would not automatically extend citizenship to people born here if the birth mother was here illegally. Dalmia notes that the idea that illegal immigrants are showing up to have an "anchor baby" that would enable the family to stay in the United States doesn't fit the facts. Quoting a *Time* magazine report, she writes, "[O]f all the babies born in 2008 to at least one unauthorized parent, over 80 percent were to moms who had been in the United States for over one year. Actual instances of 'birth tourism,' where moms expressly came here to deliver babies on American soil, accounted for about two-tenths of 1 percent of all births in 2006." Besides, she writes, "Kids have to wait until 21 to seek legal status for illegal parents and the parents must typically then wait outside the U.S. for at least 10 years before they can obtain their green cards."

Conservatives? / As I noted above, I had no idea how nasty some conservatives at *National Review* are, both to illegal immigrants and to those who would hire them. In her 2007 piece, "Women Need Immigrants," Howley reports on a blog post by *National Review* writer John Derbyshire titled, "Mow Your Own Lawn." And she quotes *National Review* editor Rich Lowry's statement, "It's time to tell middle-class families across the country, from California to the suburbs of New York: Mow your own damn lawns." Howley, showing more sympathy than Lowry for those who would employ illegal immigrants, replies: "We could mow our own lawns. We could also make our own candlesticks and churn our own butter. The question to ask isn't why we don't live in a more self-sufficient America, but why Americans—and especially women—would ever want to." Howley, noticing the obvious gains from trade, sympathizes with immigrants also. She writes, "There is no development policy, no feasible amount of foreign aid, no poundage of fair trade coffee that will help someone from a developing country to a better life more than opening the door to a better economy, instantly doubling or tripling the value of their labor." Amen.

Various authors also point out the fact that serious restrictions on immigration require a seriously large government. In a 2012 piece, "Big Brother's Border Blindness," *Reason* contributing editor Greg Beato points out that between 2000 and 2010, the Border Patrol's budget had grown from $1 billion to $3.4 billion and the number of agents had grown from 9,212 to 21,444. In a 2012 article, "Captive Citizens," Dalmia calls attention to the "business death penalty," first pushed in Arizona by then-governor Janet Napolitano. The penalty is a kind of "three strikes law" in which the third time that businesses are caught employing illegal immigrants, they are forbidden to operate in the state. That's not small government.

So what should be done about immigration? One promising proposal made by Pritchett in an extensive interview with Howley is to let people in as guest workers but not give them all the benefits of citizenship, including welfare. He challenges the late Milton Friedman's view that open borders are incompatible with the welfare state. Pointing out countries with broad welfare systems but liberal immigration laws, Pritchett says:

> Singapore manages to maintain an enormously high level of benefits for its citizens with massive mobility. Kuwait has one of the highest immigrant populations in the world, and you can't ask for a more cradle-to-grave welfare state than what Kuwait gives its citizens. So it's obviously possible to maintain whatever level of welfare state you want and have whatever level of labor mobility you want, as long as you're willing to separate the issues.

What about the concern that guest workers would be second-class citizens? That's better, he says, than what they are now in their home countries: fifth-class citizens.

I've hit a few highlights, but there's so much more in this fine book. Read, learn, and agitate for open (or, at least, more-open) borders.

No Longer the Land of Opportunity?

REVIEWED BY GEORGE LEEF

For much of its history, the United States enjoyed a comparative advantage over nearly every other nation with respect to its legal institutions. Our laws were widely known and understood, applied to all, were fairly administered, and were not subject to capricious change. That environment made America attractive to people around the globe because the rule of law was weaker or even nonexistent in their native lands. A large part of what made the United States the land of opportunity that attracted people and capital was the fact that here law protected liberty and property—against both criminals and overreaching government officials.

As this elegant book makes clear, however, what advantage we once had with regard to our legal framework has turned into a severe disadvantage—our *illness*.

Editor and contributor F. H. Buckley, a George Mason University law professor, has assembled an all-star cast of law and economics scholars whose work exposes the damage we have inflicted on ourselves because our commitment to the rule of law has so atrophied over the last half century. That damage is largely economic. We now divert more and more resources from productive uses—all those lawyers who are needed in our hyper-litigious system could otherwise be doing work that adds to our national wealth. And our entrepreneurs face the constant risk that even their most innocuous-seeming decisions will result in ruinous legal consequences.

The damage has a moral aspect as well. Americans who have unwittingly fallen into the spider's web of regulation face crushing fines and even prison terms. We are less of a nation when peaceful individuals regularly suffer injustices at the hands of our legal system.

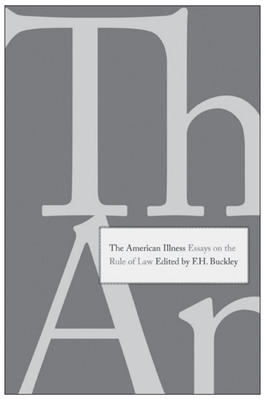
GEORGE LEEF is director of research for the John W. Pope Center for Higher Education Policy.

Foreign competitors / With regard to the rule of law, the idea of American exceptionalism has been turned completely around. We are now *exceptionally bad* compared with many developed countries. Yale University law professor George Priest writes that our legal system has turned into "a significant instrument of redistribution that harms economic welfare in the U.S. and places us at a substantial competitive disadvantage to other nations." A good example is the thick minefield of regulations sowed by the Sarbanes-Oxley law, which was a gigantic overreaction to the Enron scandal. Instead of preventing misconduct by corporate officials as it was supposed to do, it has driven lots of business away from the New York Stock Exchange to London. Brokers there have framed photographs of Paul Sarbanes and Mike Oxley, labeling them "our favorite Americans."

The book provides many illustrations of the superiority of foreign law. In Canada, for instance, the tort regime is far less hostile to enterprise than ours is: cases are decided by judges rather than juries (easily misled and swayed by emotional appeals), the cost of discovery rests on the plaintiff rather than the defendant (which discourages "fishing expeditions"), and the losing party pays the other side's costs.

Arguably, the most shocking element in the decline of the rule of law in the United States is the way the formerly sharp line between criminal and civil liability has been blurred. Under traditional legal concepts, criminal behavior required a showing of *mens rea*—a guilty mind. That is, prosecutors had to prove intentional wrongdoing beyond reasonable doubt. That is no longer the case. We now have an expanding category of "public welfare crimes" under which a person can be convicted of a crime over mere mistakes or accidents, even when the conduct was by a subordinate. Environmental enforcers, such as the Environmental Protection Agency official who proclaimed that he liked to "crucify" some businessman in order to terrify others, are eager to make their reputations by proving their "toughness." (That particular official was subsequently removed for having blurted out the truth.) The law ought to restrain prosecutorial excesses, but no longer does.

Another aspect of the erosion of the rule of law in America is the departure from upholding contracts as the parties wrote them and allowing a judge to "interpret" or simply ignore the terms on paper so as to bring about what he thinks would be a more fair result. Columbia University law professor Robert Scott explains that this move away from *textualism* and toward *contextualism* empowers judges to tamper with even carefully negotiated business agreements. That encourages disappointed parties to run to the courts when a deal turns against them, thus undermining the reliability of contracts.



The American Illness: Essays on the Rule of Law

Edited by F. H. Buckley

534 pp.; Yale University Press, 2013

Looking at that development from a British perspective, Michael Bridge, a law professor at the London School of Economics, points out that English courts are aware that firms are apt to forgo ventures if they cannot count on the enforceability of contracts. Bridge also observes that English courts (and those of other advanced nations) often tend to think globally: considering how their decisions will affect their country's attractiveness for business. American courts rarely think that way.

The American legal culture is also inferior to that of other nations in the way it tells lawyers that they can and in fact should put the interests of their clients above everything else. As University of California, Berkeley law professor Robert Kagan writes, "American lawyers' professional culture is unique in permitting and implicitly encouraging them to advance unprecedented legal claims, coach witnesses, and attempt to wear down their opponents through burdensome pretrial discovery." To their benefit, other nations put some restraints on lawyers to dampen the "win at any cost" mentality with concern over justice and the broader social impact of cases.

Special interests vs. the public / Defenders of the American litigation/regulation complex contend that its costs are outweighed by a large benefit, namely that it makes business more inclined to improve the safety of their products. Not so, says Vanderbilt law professor W. Kip Viscusi. He argues that huge product liability awards (themselves a consequence of the erosion of common law defenses such as contributory negligence) do not lead to safer products, but rather impede the introduction of safer products. Innovative companies are prime targets for lawyers when a new design turns out to be less than perfect. Moreover, the prospect of enormous payoffs for successful lawsuits is a strong incentive for lawyers to go prowling for any case, no matter how minor or even speculative the injury.

Viscusi also explains how litigation often substitutes for regulation. Inefficient as regulation tends to be, the results of litigation are much worse. Regulatory agencies have access to expert witnesses and testing procedures, and are required to accept public comments on proposed rules. Courts have none of that, but when they rule in lawsuits, they effectively dictate regulations. Viscusi points in particular to the litigation that led to the Master Settlement Agreement (MSA) over the tobacco industry. The MSA was negotiated without the safeguards of administrative rulemaking, public input, or any cost-benefit analysis. It also showered money on the law firms that managed to get themselves in on the process. Viscusi thinks that the MSA is a terrible precedent that is likely to encourage more regulation through litigation.

In his essay, New York University law professor Richard Epstein points to the ideology of Progressivism as the root of the decline of the rule of law, weakening it through "a thousand cuts." The Progressives of a century ago looked with disdain on a nation where the grubby self-interest of free enterprise was dominant. We needed to bring order out of all that chaos with a wide-ranging administrative state under the Progressives' control. They could, of course, only see the imagined benefits of the transformation and none of the costs. Epstein observes, "The rush to greater government control over the economy downplayed the risks of faction and confiscation, and belittled the role of traditional institutional safeguards—separation of powers, checks and balances, constitutional protection of economic interests—that had been put in place to blunt their force." The Obama years have been marked by increasingly rapid decay of those safeguards.

Among the many undesirable effects of the Progressive tide is what Epstein calls "permititis," which is to say, the need for a business or individual to obtain permission from some government agency before being allowed to do something. Under the old rule of law, people could act, but with the understanding that if that action harmed others, there could be legal consequences. Now, we must fill out applications, wait, fill out more forms, wait some more, and in the end abide by the official ruling—which might be that permission is denied. Like a spreading rash, permititis is taking a toll on our economic vitality.

Conclusion / Is there any hope for a cure, or at least remission, of our disease? In his concluding chapter, Buckley explains that in a political system such as ours, with divided governing authority, it is very hard to line up all of the levers for change. Therefore, federal legislation to undo some of the damage, such as repeal of Sarbanes-Oxley, is unlikely. He does, however, point to some hopeful signs that we now realize that we have this problem and are starting to address it. The U.S. Supreme Court has taken a few small steps to make our legal system more rational, such as insisting on tougher standards for what will count as "expert" testimony

IN REVIEW

and tightening rules for class actions. Also, some states have managed to curtail the misuse of their courts as places where the tort bar goes to reap gigantic judgments.

All in all, however, this is a pessimistic book. The rule of law has been eroding on many fronts and it won't be easy to catalyze a countermovement. "Restore the Rule of Law!" just isn't much of a political rallying cry. The damage that is done by the decline of the rule of law falls mostly into Bastiat's "unseen" category and is therefore overlooked, but at least it won't be by readers of this excellent volume. R

Profits and Public Officials

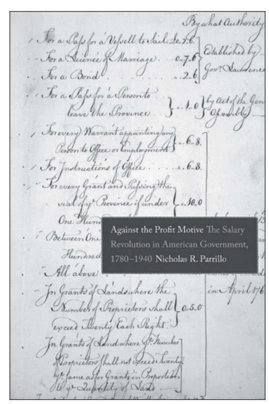
REVIEWED BY GEORGE LEEF

This fascinating and deeply researched book explores what must be one of the least examined aspects of American history: the way compensation for public officials has changed over time. That might seem like a dry subject, but author Nicholas Parrillo, a professor at Yale Law School, demonstrates that the shift away from our early system of paying public officials in a largely piecemeal fashion (wherein compensation depended largely on industriousness), and toward paying flat salaries, reflected dramatic changes in the relationship between the citizen and government. Today's mega-state would, Parrillo argues, be impossible without the changes in compensation he documents.

In early America, some public officials were paid a salary, such as the president and members of Congress. But most were compensated through what Parrillo terms "facilitative payments." That is, citizens would pay officials via fees on such government activities as the issuance of permits and the processing of applications. Those payments were usually not set by law, but even when they were, added gratuities for the official to induce more expeditious service were common.

Was that a bad system? It left the door open to price-gouging by avaricious officials, but on the whole, people seemed content with it. Parrillo writes, "The recipient's freedom to adjust the price and the official's freedom to adjust the service opened the way for mutual benefit. In the eyes of many, bargaining between officials and recipients was not only convenient, but necessary to the continued functioning of government as the needs of service recipients evolved."

When the facilitative payments system was later replaced (first by bounties and later by salaries), the consequences were not altogether favorable. Parrillo observes, "For the recipients themselves, the severing of the reciprocal bond was a profound loss. It psychologically estranged them from the officials they had once viewed as solicitous and friendly." Today's Americans, used to the indifference or even surliness of many of the salaried government officials with whom we must deal, will understand that "estrangement."



Against the Profit Motive: The Salary Revolution in American Government, 1780–1940

By Nicolas R. Parrillo

568 pp.; Yale University Press, 2013

A second form of compensation for early American public officials was bounties. Bounties were paid for performing tasks that the affected individual certainly did not want and would not willingly pay for, such as arrest, discovering tax delinquencies, or being compelled to do hard labor in prison. Bounties gave the official a profit motive for doing disagreeable, unpopular work—often too zealously.

Growth of the bounty system / Beginning in the mid-19th century, federal and state politicians, eager to gain more revenue so government could expand its functions, moved toward bounties in a wide range of government operations. The move coincided with an increasingly nationalistic view of the law and citizenship emanating from top politicians and intellectuals. Parrillo captures that philosophy in this 1887 quotation from Republican congressman (and later Speaker of the House) Thomas B. Reed, distinguishing between crimes against a community and crimes against the United States:

> The whole community is awake to detect murder and punish theft. But what community ever bestirred itself against frauds on the internal revenue, against moonshine distilleries, against smuggling, against a hundred things which are crimes against the United States?

With that expanding view of the role of government, enforcement by "local notables," as in the olden days (reflecting community thinking and mostly cooperating with the citizenry), simply would not do. Governments turned increasingly to bounty-driven officials such as "tax ferrets" who would get a cut of additional tax collections if they identified people who had underpaid their taxes, mostly on intangible assets.

An especially interesting example of the shift toward aggressive enforcement by profit-seeking officials that Parrillo discusses is in tariffs and customs duties. In early America, he writes, customs officials "administered the law in a mild and indulgent manner, and merchants, thinking the government's

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

demands reasonable, complied willingly if loosely." But with the ascendency of high-tariff Republicans to power, that changed. The Republicans wanted to use high tariffs to squeeze more revenue out of trade for a host of new federal expenses.

Toward that end, they gave customs officials a profit motive to find cases of underpayment or evasion. The more aggressively the officials looked, the more they could earn "moieties" for themselves (shares of the penalties on merchants for tariff violations). Naturally, the result was a sea change in the relationship between merchants and officials. The federal government did obtain an increase in revenues as its "moiety men" hunted for every possible infraction. But that came at the cost of destroying the trust and confidence that had formerly existed and bringing about a "cat and mouse" game of evasion over the importing of goods.

That change required far more government power to look into the affairs of individuals, what Yale political scientist James Scott (whom Parrillo cites) calls "seeing like a state." The origins of today's state with its insatiable demands for information about the citizenry can be found in the shift from local law enforcement that was "solicitous and friendly" to distant law enforcement that was much more strict and demanding.

The increasing reliance on bounties to control behavior and extract money led to many problems in society, and Parrillo gives his readers some intriguing examples. In Birmingham, Ala., for instance, policemen were paid in part based on the number of arrests they made. Because of the profit motive, the police arrested many black workers, who spent some of their earnings on illegal pastimes such as gambling. Business owners, however, hated the bounty system because their workers would leave the area in favor of locales where they were less likely to be harassed. Business pressure eventually led to the elimination of the economically counterproductive arrest bounty.

Salaried officials / After several decades of increasing the use of bounties to encourage vigorous law enforcement, government leaders came to understand that the approach was, as Birmingham showed, counterproductive. By the last decades of the 19th century, the trend was strongly away from bounties and toward compensation of government officials by salary.

The principal reason for this change was the psychological insight that the government would elicit more willing obedience to the law if those who enforced it were seen as neutral and objective public servants whose pay was set by law. Parrillo explains,

> (T)he very lawmakers who first imposed modern legislative mandates en masse found such a model inadequate, for it ignored the fact that deterrence is rarely sufficient and that laypersons accept law in part because they come to view the officialdom as a legitimate and reasonable body deserving at least a modicum of trust, not as an opponent to be outsmarted.

Paying government officials bounties was understood to interfere with the more important goal of calming opposition to the continuing expansion of state power.

That insight—how rulers seek to make their control over people easier by instilling a sense of legitimacy—is not new. Franz Oppenheimer made that point in his 1943 book *The State*. Parrillo gives strong support for it with his examples drawn from American history.

Consider the way the profit motive had traditionally been used in naval warfare. During wars, sailors earned prize money (for captured ships) and head money (for killing and capturing enemy sailors). But right after the Spanish-American War, Congress voted to abolish those forms of compensation. Parillo states that following the war, many Americans feared that our new overseas empire would lead to a bigger, more costly navy that would be eager for possible profits through new conflicts. "To allay these anxieties and legitimate the new imperial navy—both for the public and for themselves—the hawks focused on the purity of the navy's motives," he writes.

That phrase "purity of motives" sums up the point: by making it appear that government officials were neutral "public servants" who were paid a flat salary for doing work that politicians had decided had to be done, most people would accept—even if unenthusiastically—the state's increasing predations against their liberty and property.

Profit motive / Parrillo tells this story with little or no judgment on the desirability of the changes he describes. Thus, *Against the Profit Motive* never goes into the cunning deception involved in convincing people that government officials do not have a profit motive. But of course they do, even when paid a flat salary. Their self-interest is just channeled differently.

Take public prosecutors, for example. At one time they were paid based on convictions, creating a motive for maximizing the number of cases they won. Replacing that method of compensation with a salary did not, however, get rid of the profit motive. These days, public prosecutors try to aggrandize themselves by winning high-profile cases, often through overly aggressive and legally questionable tactics, so as to increase the likelihood that they will get elected to higher office. Their profit motive now takes a different form than it once did, but it hasn't vanished.

Nor has payment by salary prevented legions of government workers from using their political clout (often through unions) to extract easy working conditions, generous amounts of time off, and exceptionally high pensions from the taxpayers. Their profit-seeking takes place behind the smokescreen of being disinterested public servants—and arguably is more effective for it.

Baudelaire wrote that the Devil's greatest trick was convincing people that he doesn't exist. Parrillo's book prompts a paraphrase: the State's greatest trick is convincing people that salaried government employees have no private motivations. Supporting the public choice critique of the sociology of the state doesn't seem to be any part of Parrillo's goal, but his book nevertheless makes a valuable contribution in that regard. *R*

Working Papers ➾ BY PETER VAN DOREN

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

Corporate Accounting

"SOX after Ten Years: A Multidisciplinary Review," by John C. Coates and Suraj Srinivasan. October 2013. SSRN #2343108.

The Sarbanes-Oxley Act of 2002 (SOX) was enacted after the bankruptcies of Enron and WorldCom. Enron was ranked seventh on the Fortune 500 in April 2001; by December, it had filed for bankruptcy. WorldCom was ranked 80th at the peak of its market capitalization in 1999; it filed for bankruptcy in July 2002. Both bankruptcies were associated with accounting fraud and SOX was passed as a congressional response before the 2002 elections.

Academic criticism of SOX has been intense. In an article in this journal (Winter 2005–2006), Yale law professor Roberta Romano described the law as "Quack Corporate Governance." She went on to say,

> An extensive empirical literature suggests that those mandates were seriously misconceived because they are not likely to improve audit quality or otherwise enhance firm performance and thereby benefit investors as Congress intended. In the frantic political environment in which SOX was enacted, legislators adopted proposals of policy entrepreneurs with neither careful consideration nor assimilation of the literature at odds with the policy prescriptions. … The more general implication is the cautionary note that legislating in the immediate aftermath of a public scandal or crisis is a formula for poor public policymaking (at least in the context of financial market regulation).

Given that literature, I read this paper by John Coates (professor of law and economics at Harvard) and Suraj Srinivasan (associate professor at Harvard Business School) with great interest. Their conclusion is that SOX's direct costs can be calculated easily but its benefits and indirect costs cannot, so evaluations of the law are based largely on authors' prior assumptions about benefits. Despite the intense early criticism by academics, most informed observers now conclude that, as implemented, SOX's costs and benefits are roughly equal or net positive.

One of the main concerns of scholars was that SOX would federalize corporate law and reduce the important role of state corporate charter competition. Coates and Srinivasan find that of 1,293 Delaware corporate law decisions from 2002 to 2012, only 15 referred to SOX and not one imposed liability on directors for failing to live up to SOX.

Another concern was that SOX would change financial regulation from disclosure to prescriptive command-and-control. But the authors conclude that it is a "comply or explain" regime and, surprisingly, many firms still disclose weaknesses only upon restatement of earnings rather than because of SOX. In their view, SOX still does not induce enough disclosure.

Did SOX drive listings to foreign exchanges or cause firms to delist, as some critics predicted? No, because many foreign countries adopted similar standards. Smaller, less liquid, more fraud-prone firms did indeed exit U.S. public markets, but they would not have been subject to SOX anyway. Initial public offerings (IPOs) started declining before SOX, and the exemption of small firms from onerous SOX regulations under the 2010 Dodd-Frank Financial Reform Act has not resulted in a subsequent increase in IPOs. Fewer foreign firms have cross-listed on U.S. and foreign exchanges, but those that do cross-list are larger and more profitable, so net capitalization of foreign firms in the United States is higher post-SOX.

Has SOX created benefits? Earnings management and restatements have gone down. One innovative study examined the stock market reaction to firms that lobbied for and against SOX. Firms that lobbied against were larger, more profitable, retained more cash, and had lower future growth opportunities. They experienced abnormal positive returns during passage that did not dissipate over time. The authors interpret this as evidence of managerial mismanagement of free cash flow.

Bank Capital Regulation

"Market-Based Bank Capital Regulation," by Jeremy Bulow and Paul Klemperer. September 2013. SSRN #2317043.

The bank failures caused by the Great Recession have prompted numerous proposals to increase bank capital requirements. For some examples, see the paper by Anat Admati et al. that I discussed in my Winter 2010–2011 "Working Papers" column and the paper by Viral Acharya et al. that I discussed in Summer 2012. In this paper, Jeremy Bulow and Paul Klemperer offer the most recent paper in this genre.

Several stylized facts motivate their analysis: Regulatory capital is a poor measure of banks' financial health. Some banks that are certified as having adequate capital fail shortly thereafter. Investment tail risk is shifted to taxpayers. The current capital regime is procyclical. Banks have too much capital during booms and too little during recessions. The need to raise equity during recessions acts as a tax on new investment during hard times. And finally, even a 20 percent capital requirement (much higher than proposed by prominent reformers) would not have prevented bank failures during the Great Recession; the losses at the 400 government-insured banks that failed between 2008 and 2011 averaged 24.8 percent of assets.

Bulow and Klemperer propose a new banking regime in which banks offer 100 percent reserve banking and at-risk maturity trans-

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

formation banking without taxpayer risk. Deposits once insured by the Federal Deposit Insurance Corporation would now be invested in treasuries (i.e., narrow banking). All unsecured debt would be in the form of "equity recourse notes" so that if the bank stock price ever went below some threshold (say 25 percent of the price when the debt was issued), the note holder would receive stock in the bank instead of a cash dividend. The bonds would not be permanently converted to equity; rather the owners would receive stock instead of cash, one dividend payment at a time. Reconversion of the equity recourse notes to normal debt would occur if the market price of the bank stock later rose above the contractual threshold. Unlike other "catastrophe bond" proposals, the conversion to equity would be based on market prices rather than the breach of easily manipulated regulatory capital standards.

Health Expenditures and Bankruptcy

"Health and Financial Fragility: Evidence from Car Crashes and Consumer Bankruptcy," by Edward R. Morrison, Arpit Gupta, Lenora M. Olson, Lawrence J. Cook, and Heather Keenan. November 2013. SSRN #2353328.

Before becoming a U.S. senator, Elizabeth Warren was a professor at Harvard Law School. Her intellectual reputation came from research showing that health care cost shocks play a disproportionate role in personal bankruptcy. That research showed that substantial medical bills (over $5,000) were found in half of the bankruptcies studied. The research gave support to those who supported the Affordable Care Act as a remedy for the lack of health insurance by some Americans.

Those stylized facts, of course, are not proof that adverse health conditions cause bankruptcy. It is possible that personal financial management behavior and underlying risk preferences simultaneously cause the development of both costly health conditions and financial default. So the observed relationship between health care costs and bankruptcy could be the result of selection rather than causal effects.

The authors use a data base of police reports on all car crashes in Utah from 1992 through 2005, and link them to hospital admissions and bankruptcy cases. They find that the bankruptcy rates of the people involved in car crashes who suffered severe injuries that required emergency room admission were 30 to 50 percent higher in every year *prior* to the crash than those who only had minor injury. Unobservable driver characteristics increase both the risk of a severe accident and bankruptcy. A household's exposure to a severe car crash is endogenous to a household's underlying and unobserved characteristics.

In every year prior to the crash, bankruptcy rates were 30 to 50 percent higher for people who suffered severe injuries than people with minor injuries.

To avoid the non-random selection of people into severe accidents, the authors propose a difference-in-difference research design that exploits differences in the timing of the crashes. The assumption is that the driver's pre-crash financial condition is uncorrelated with the timing of the crash as long as the timing is short (one or three years). The treatment group is those who had crashes in the years 1999–2002 and the control group is those who had crashes in 2002–2005. The authors found no difference between the pre- and post-crash bankruptcy rates between the treatment and control groups. Thus, large medical costs have no causal effect on personal bankruptcy rates in the context of Utah car crash victims.

Health Care Expenditures

"Physician Beliefs and Patient Preferences: A New Look at Regional Variation in Health Care Spending," by David Cutler, Jonathan Skinner, Ariel Dora Stern, and David Wennberg. August 2013. NBER #19320.

Price-adjusted Medicare expenditures per beneficiary vary across metropolitan areas from $7,000 to $14,000 per year. Why? One possibility is patient demand. Another is physician preferences. John Wennberg, the intellectual father of the evidence-based medicine movement at Dartmouth's Geisel School of Medicine, has always thought that physician preferences rather than scientific evidence played a large role. In this paper, David Cutler (professor of economics at Harvard), Wennberg's son David (Dartmouth medical school), Dartmouth economist Jonathan Skinner, and Kennedy School of Government doctoral candidate Ariel Dora Stern attempt to document the relative role of patient demand and physician preferences through two surveys merged with geographically coded Medicare expenditure data for the last two years of life. The authors survey doctors (using actual patient vignettes that test for implementation of clinical guidelines) and patients (random sample of Medicare beneficiaries) to ascertain their preferences about hypothetical end-of-life decisions and find that doctor preference variation accounts for more of the expenditure variation than patient preference variation.

Cardiologists were asked questions about the treatment of two Class-IV (the most severe) heart failure patients who are symptomatic even when at rest. The vignettes were designed to demonstrate clearly to the reader that neither patient was a candidate for further surgery such as angioplasty, stents, or bypass. "Comforters" were defined as those doctors who would discuss palliative care always or almost always in these cases. "Cowboys" were defined as those doctors who would recommend intensive surgery most of the time. Some 29 percent of cardiologists were comforters and 27 percent were cowboys. Across 64 large metropolitan areas, the higher the percentage of physicians classified as cowboys, the higher the two-year end-of life Medicare expenditures. Increasing the percentage of cowboys by 10 percentage points increases end-of-life expenditures by 7.5 percent. In contrast, there was no relationship between increased aggregate patient demand for intensive treatment and expenditures. The authors conclude from their empirical model that if there were no cowboys and all physicians recommended palliative care, end-of-life expenditures would decrease by 36 percent and total Medicare expenditures would be reduced by 17 percent.

Unemployment Insurance

"Unemployment Insurance Experience-Rating and Labor Market Dynamics," by David D. Ratner. January 2014. SSRN #2376364.

Readers of *Regulation* likely are familiar with the work of University of Chicago economist Casey Mulligan about the role that the incentive effects of transfer payments played in increasing the unemployment rate during the Great Recession and its aftermath. This paper makes similar arguments about the role of experience-rating in unemployment insurance.

Unemployment insurance benefits are paid for by taxes on employers set by the states. The taxes are not fully experience-rated; that is, employers with a high rate of layoffs do not pay taxes sufficient to cover the benefits for their discharged employees, while employers with a low rate of layoffs pay taxes that are larger than the benefits received by their discharged employees. The degree of experience-rating varies across states and thus the marginal tax on employers for layoffs varies across states.

In this paper, Federal Reserve Board economist David Ratner utilizes the variance in experience rating across states to calculate the effect of increased experience-rating. The average state marginal tax cost of a layoff to employers (the present discounted value of benefits paid back in future higher taxes) is 54 percent of the benefits paid to a firm's employees. Job reallocation (the sum of job creation and job destruction) falls linearly as the marginal cost to employers of a layoff increases. Job destruction goes down because employers understand that layoffs increase future unemployment taxes. Job creation also decreases because employers anticipate the possibility of layoffs and subsequent higher taxes when they hire someone. Ratner concludes that increasing experience-rating by 5 percent would decrease layoffs by 2 percent but decrease job creation by 1.5 percent, resulting in a net decrease in unemployment of 0.21 percentage points. However, if the system were fully experienced-rated and employers paid 100 percent of the costs of the benefits to a laid-off employee, job destruction would decrease by 17 percent while job creation would decrease by 13.7 percent, resulting in a net increase in employment.

The Great Recession has resulted in a debt of $20 billion that the state unemployment trust funds must pay back to the federal government. Ratner demonstrates that if those funds are repaid through an increase in experience rating, unemployment will decrease because of better incentives. In contrast, if the debt is repaid through a flat-rate tax increase with no change in experience-rating, unemployment would increase because of the perverse incentives on employers.

Housing Markets

"The 1992 GSE Act and Loan Application Outcomes," by Shawn Moulton. *Journal of Housing Economics*, forthcoming.

A prominent component of the conventional wisdom about the housing bubble, particularly for conservatives, is that government affordable-housing policies fueled the bubble and its collapse. Specifically, those folks criticize the Community Reinvestment Act that Congress enacted in 1977 and lending goals imposed on the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac in 1992. The policies supposedly led to an increase in high-risk mortgages and their subsequent default. Peter Wallison voiced those claims in a recent *New York Times* op-ed (January 6, 2014).

In previous "Working Papers" columns (Spring 2011 and Fall 2012) I described papers that challenge this widely held belief. Those papers used research discontinuity designs, taking advantage of the eligibility standards created in those laws. The arbitrary standards (a loan is credited with advancing the affordability goal if the borrower's income or neighborhood is just below 60 percent or 80 percent of his Metropolitan Statistical Area's (MSA) median income, but does not qualify if his income is just above the same thresholds) serve the same function as random assignment in an experiment. The only things that vary between people just above and just below the qualifying legal thresholds are randomly distributed and thus any discontinuities in outcomes, like defaults or percentage of applicants accepted, can be attributed to affordability standards. The papers found no evidence of any threshold effects. There were no discontinuously worse loan results among loans that just qualified as CRA- or GSE-compliant relative to loans that did not.

In this paper, Shawn Moulton, now an economist at Abt Associates, casts additional doubt on the importance of housing affordability goals in the housing bubble. First, he notes that actual GSE purchases have always eclipsed the goals set for them, which suggests that the goals did not make the GSEs deviate from their preferred lending strategies. Second, he examined individual mortgage data from 1996–1997 (shortly after the GSE goals went into effect) and 2006–2007 (during the height of the housing mania). He examines three outcomes for differences around the eligibility cutoffs: percentage of loans granted, percentage of loans purchased by a GSE, and interest rates relative to comparable Treasury securities. The only effect he finds is that loans to customers whose income was just below 60 percent of median MSA income were 1.1 percentage points more likely to be purchased by the GSE in 2006–2007. The 95 percent confidence interval is 0.16 percentage points to 2.01 percentage points.

The author employs some arithmetic to convey a sense of the potential magnitude of this effect. In the data set there are 1,077,048 GSE-eligible originations whose borrowers earn between 40 and 60 percent of the median MSA income. Suppose the upper end of the confidence interval (2.01 percentage points of all eligible loans) were induced by the affordability goals. That would mean that 21,648 additional loans were bought by the GSEs. According to Moulton, in the second quarter 2009 (at the height of loan defaults), 25.35 percent of subprime loans were delinquent. If that percentage of the additional 21,648 loans lost *all* their value (average loan amount of $92,400), the losses would have been $500 million. Because total write-downs of losses were over $500 billion during 2008, affordability goals—even with those generous assumptions—explain only 0.1 percent of the losses.

Bank Accounting

"Market Reactions to Policy Deliberations on Fair Value Accounting and Impairment Rules During the Financial Crisis of 2008–2009," by Robert M. Bowen and Urooj Khan. September 2013. SSRN #2327732.

During the financial crisis, many commentators argued that accounting rules mandating that loans be written down from face value to "market" value exacerbated the contagion among financial institutions. That is, financial institutions that had to sell off assets to meet capital or margin requirements spread their troubles to other institutions if the latter were forced to mark down similar assets because of the fire-sale prices received by the former. If, instead, accounting rules would allow such assets to be valued at initial or book value, contagion would stop because forced asset selloffs to meet regulatory capital requirements would not have to occur.

This paper assesses the role of accounting rules on the market value of bank stocks during 10 event windows in the fall of 2008 and spring of 2009, during which the relaxation of mark-to-market bank accounting was discussed by regulatory authorities. The paper examines how bank stock values reacted to those discussions. If investors thought relaxation would be good for banks, then they would bid up bank stock values during event windows in which relaxation seemed likely and bid down values when the status quo seemed likely. Conversely, if investors thought rule relaxation made the withholding of information they valued more likely, then investors would bid down bank stocks during event windows in which rule relaxation was discussed and bid up values when the status quo dominated the agenda. The results confirm that investors reacted positively to the possible relaxation of then-existing accounting rules that mandated mark-to-market accounting and reacted negatively to the opposite possibility. R

Regulation CATO INSTITUTE

EDITOR
Peter Van Doren

MANAGING EDITOR
Thomas A. Firey

DESIGN AND LAYOUT
David Herbick Design

CIRCULATION MANAGER
Alan Peterson

PUBLISHER
John A. Allison IV
President, Cato Institute

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