

## IN REVIEW

# A Liberal Heretic Contradicts Piketty

◆ REVIEW BY IKE BRANNON

Is Peoria, Ill., special? Of course it is, says I—along with the thousands of other people who, like me, hail from the central Illinois community. It's a great city with wonderful people, as well as a rich culture and heritage that belies the common perception of it being provincial bore or a totem of flyover country.

I'm being facetious in positing such a banality, of course. As a public policy writer with precisely one shtick—being from Peoria—I've laid a foundation for its specialness in myriad ways, mentioning it in over a dozen articles in 2014 alone. Subtle I'm not.

What I've been wondering the last few months is whether Peoria is somehow *economically* special. I've been trying to reconcile my knowledge of the town and the people who live there with the research of Thomas Piketty, Emmanuel Saez, and various other top-drawer academics purporting to show that the plight of the middle class—the folks who people Peoria—has been getting worse over the last three decades.

It's now conventional wisdom that any economic growth we've seen in the last 30 to 40 years has gone mainly to the wealthy. Piketty's recent book, *Capital in the 21st Century* (see review, Fall 2014), attributes over 90 percent of all income gains from improvements in productivity to the top 10 percent of income-earners, leaving the rest of us to fight over scraps. Esteemed Brookings Institute scholar Isabell Sawhill has written that the plight of the working class hasn't improved since the 1960s. When Greg Mankiw suggested that their situation might not be as morose as it's

being made out to be, he was heckled and shouted down—at an *academic conference*. It's now become politically incorrect to dare contradict the notion that life's getting more precarious for people who aren't at the top of the income ladder.

The suggestion that living standards for most households are worse today than in the 1970s is absurd to anyone who remembers that era of unreliable Country Squire station wagons, music on AM radio, a broadcast universe of precisely three television stations that signed off at midnight, and a narrow offering of movies, music, restaurants, literature, and culture that represent a minute fraction of what any American with access to the Internet can find today. There are childhood cancers that few survived 40 years ago that are now easily curable—an improvement for both rich and poor households that's not quantified in most articles about living standards.

But the other experience that makes me question whether things are getting worse for the middle class is that my friends who have chosen to remain in Peoria—largely blue-collar workers without college degrees—seem to have the world on a string.

Steve Rose is the rare economist willing to question the conventional wisdom. In two recent monographs he methodically lays out the postwar income and spending patterns, and by doing so systemati-

cally destroys the axiom that the greater income dispersion since 1980 implies that the lower and middle classes are worse off.

Rose is in a unique position to question the accepted wisdom: He is the author of *Social Stratification in the United States*, a fact book and poster he has been updating since 1978. Few would dare question either his liberal credentials or his empirical chops, which have of late led him to places where other Democrats would rather he didn't go.

**Small-town living** / Last summer I took leave of my wife and children and spent a few weeks with my parents back home. With a lot of free time and no familial obligations, I managed to catch up with a host of old friends and classmates who never left town. What I found was that most of them—many of whom are in their 40s, married, with kids at or approaching college age—have a lifestyle I cannot afford in my big-city neighborhood and with an income several times higher than theirs.

One friend—who's now my hero—has a motorboat, a Harley, a country club membership, and two kids in college that he's paying for—all of which he's doing on a family income of \$110,000. Over several nights of beers at a cozy bar on the Illinois River in nearby Mossville, we bought drinks for a number of former classmates, neighbors, and friends while chatting about their careers and financial situation.

The career path for blue-collar workers in my hometown is almost formulaic: the guys who went on to get some post-high school training end up being welders or pipefitters or in some other occupation that pays somewhere around \$75,000. A few do better than that—more than one of my friends spoke enviously of our friend known about town as the “Picasso of the backhoe,” who commands a premium and is never without a job because of his speed and deftness with his implement. People assumed he cleared \$100,000. There are a

few who are commercial truckers and earn a bit below \$75,000 as well as a few guys who started businesses and are a good step above this, but the distribution is bunched.

What's more, these guys almost all had spouses working and earning decent pay. A number of the spouses were nurses, making around \$50,000 a year themselves, and those without any college tended to be receptionists and earned about half of that. It adds up to an average household income for my blue-collar friends of roughly \$100,000 a year in a community where nice homes cost \$150,000 and public schools are fine. That makes for a very nice life.

I assumed that my town or group of friends was anomalous. Not so, says Rose, who reports a median household income for married families of ages 48–59 to be nearly \$90,000, a number so out of line with the implied blue-collar poverty of Piketty and Saez as to be unbelievable.

Part of what's going on, of course, is that there remain significant life-cycle differences in earnings, and there is a very real fear that today's struggling twentysomethings will never be able to get a solid hold onto the career track anywhere.

It's a fear my friends shared when they were starting out. Few of them made much money in their 20s. The 1980s were a trying time for Caterpillar, which is by far the area's largest employer, and the burgeoning baby boomer generation entering the job market conspired to create high unemployment rates in Peoria throughout that decade. Few in my crowd who remained in Peoria got married before the age of 30 simply because they didn't earn enough to support a family. But a decade of gaining skills and building connections in the job market and an improving economy eventually opened up opportunities that my friends were able to exploit.

**Dicing the data** / That my central Illinois friends are doing well and are not so different than other blue-collar workers in their cohort is comforting, but also a mystery. How does Rose get such a different result than Piketty? Rose begins by pointing out that the bottom quintile of “earners” that Piketty spends so much time worrying about in his work represent, in fact, not households at all but rather the children of other earners, living at home. There's a big difference between the median income of Piketty's bottom 20 percent of earners, at a mere \$2,000, and that of the 2014 Congressional Budget Office report on U.S. income, which reckoned their income in the five-figures, or an order of magnitude higher.

The difference isn't perplexing: the CBO—correctly, in most people's eyes—excluded the millions of tax filers who are school-age dependents or else are retirees collecting Social Security. The former are not who we typically think of as “the poor,” and retirees—who depend on pensions, saving, and Social Security—are not nearly as poor as their reported income would lead us to believe. By excluding such households, the CBO's universe consists of 118 million U.S. households versus Piketty's 157 million.

The other important difference in the two data sets has to do with defining income. Piketty chooses to use pre-tax income and ignore all transfer payments, both of which have the effect of narrowing the income distribution. The CBO, on the other hand, is more focused on actual living standards and thus includes those in the mix. The result is, again, a vast difference between the incomes of the bottom quintile and those at the top.

Rose agrees with the CBO, arguing forcefully in his recent studies—*Was JFK Wrong?* and *The Economy Goes to College*—

that living standards need to be the focus of the debate. The former study, which is to some degree an updating of his forceful 2010 book *Rebound*, shows that, when measured properly, living standards for the poor and middle class have risen steadily over the past 40 years and that trend shows no signs of dissipating, even after the financial crisis and accompanying recession. Rose's data show that real median household income went up 33 percent from 1979 to 2007.

Other research has called into account the very notion of a growing gap between the rich and poor. For instance, the difference in consumption patterns between the top quintile and bottom quintile is much narrower than the income data would suggest. Gene Steuerle, an economist at the Urban Institute, has pointed out that even the widening of the income gap depends on how both income and dispersion are measured, observing that the gap between the person at the precise 20th percentile and the precise 80th percentile (which is different than the mean of the bottom and top quintile, as is typically presented) has not changed over the last few decades.

Every piece that dares question the claim that life is growing more onerous for everyone who's not at the top of the income pyramid conditions such heresy with various caveats, averring that we still need to do more about the scourge of income inequality and the plight of the poor and whatever else might suffice as a bone to the attack dogs on the left. To his everlasting credit, Rose—a man who arguably has thought longer and harder than anyone else about this issue—largely dispenses with such banalities.

The difference between the rich and poor is the wrong metric for discerning the plight of the poor. If we look at their living standards from a historical basis, it's clear that their life is much better today than 20 or 30 years ago. We live in a society where many poor households have cell phones and computers that are far better than any that existed a decade ago and that can be had for less than \$100. To be clear, Rose isn't a fan of rising income inequality, but he argues

**Was JFK Wrong? Does Rising Productivity No Longer Lead to Substantial Middle Class Income Gains?**

**By Stephen Rose**

**28 pp.; Information Technology and Innovation Foundation, December 2014**

**The Economy Goes to College: The Hidden Promise of Higher Education in the Postindustrial Service Economy**

**By Stephen Rose**

**Georgetown University Center on Education and the Workforce, forthcoming.**

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that the living standards of the poor, not their relative income, needs to be the focus of our public policy machinations.

In *The Economy Goes to College*, Rose marshals up a wealth of evidence to support the claim that living standards are improving. For this, he uses data from the Commerce Department's Input-Output Accounts to measure the proportion of consumer expenditures that go to various categories. The biggest change the data reveal is that food and clothing—two necessities that took almost half of all consumer spending in 1947—today require just 18 percent. So what do people spend money on today? Recreation (which went from 8 percent of spending to 14 percent) and health care (which quadrupled to 20 percent in 2007). And while the reflexive response of many to this latter statistic is to lament that “rising cost,” it's helpful to remember how much better health care became over this period—we spend more for health care, but we also get more from that spending. In 1947 the typical doctor's advice to the survivor of a heart attack was to get one's affairs in order.

**Too good to fact-check** / Despite Rose's pedigree and his meticulous, thoughtful studies pointing out that the supposed stasis in living standards for the poor and middle class doesn't hold up, a contrary narrative has taken root in the media and few dare to contradict it. Nobel-winning economist Joseph Stiglitz, who followed Rose on a panel at an academic conference devoted to inequality in January, remarked that he had no idea that people found flaws with Piketty's data. When someone widely regarded (by himself and others) as the smartest economist in the profession can't be bothered to read anything contrary to what he declares to be the most important issue of our time, it's clear that an intellectual battle is over, and those who want to continue it can't expect to be treated politely.

Journalist Rod Dreher garnered much attention with his 2013 book *The Little Way of Ruthie Lemming*, a moving portrait about his hometown's embrace of his sister as she fought cancer. The warmth he felt for the

town led him to reject the big-city rat race and move back to the town later in life to raise his family. It's a story that those of us who've abandoned our hometowns can empathize with from time to time.

But my fleeting pangs of longing for home aren't because I'm trapped in some big-city rat race. The notion that it's harder to make friends and be a part of one's community or that we all work harder in a big city is nonsense. Rather, I'm jealous of the lifestyle my blue-collar friends back home have achieved.

My friends who stayed married and aren't afraid of hard work have created good lives for themselves in our blue-collar hometown. The march of progress hasn't cost any of them their jobs, either; rather, it's made living in a pleasant community even better than it was a generation ago. Their televisions, pickup trucks, and telephones are

miles ahead of anything the richest of the rich could have obtained just 20 years ago, let alone in the halcyon days of our youth.

Peoria and Mossville are not unique, Rose has shown. While blue-collar jobs these days may require more training and experience than they did a generation ago, the notion that people who don't finish college are doomed to penury is greatly overstated. If we're going to begin the debate over how to raise living standards with an empirical story in which the data used bear little resemblance to the real conditions and that cannot be questioned, the prospects of reaching some sort of agreement are slim.

And that's probably for the best. Piketty's prescription of greater income redistribution isn't going to do much for my blue-collar friends back home, let alone the rest of us. R

## More than a Principal Deputy Assistant

◆◆ REVIEW BY PIERRE LEMIEUX

**R**obert Litan is an economist and lawyer who has moved between think tanks (the Brookings Institution and Kauffman Foundation), the private sector (Bloomberg), and numerous government jobs. This book, one of the two dozen he has authored or coauthored, pursues two broad goals: showing that “economists and their ideas have made important contributions to the world of business” and to better public policies. They have created benefits worth trillions of dollars—hence the title of the book.

**Economics at work** / Economic ideas, Litan claims, “have *directly* made money for firms” (emphasis in original). For instance, the idea of price discrimination (charging a lower price to the most price-sensitive consumers) comes from economists. The book gives many other convincing examples.

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Consider the proliferation of auction practices in today's business activities. In the 1960s, Julian Simon conceived the idea of auctioning overbooked seats on planes—specifically, using a reverse auction, which would pay the minimum price necessary for passengers to happily switch to another flight. Today, this idea is only imperfectly applied, as airlines typically offer vouchers to passengers who volunteer to be “bumped.” Another example is Google's auctioning of online ad space, which company executives initiated without apparently realizing that they were using a sort of auction previously designed by Nobel prizewinning economist William

Vickrey. Google later hired Hal Varian to improve its auctions and data processing. Although Litan does not put it in these terms, economists naturally think in terms of auctions because they understand that free-market prices are, in fact, the result of continuous silent auctions.

Another example of the usefulness of economists is the recent explosion of “data mining” or “Big Data,” which has been made possible technologically by the growth of computing power and the proliferation of data available on the Internet. Statistical techniques are essential for processing these data (on prices, choices, consumers, other businesses), but economists are useful to interpret the statistical results—and to know what to look for in the first place.

Perhaps the best example of Big Data is the increasing use of statistical analyses in hiring players and devising strategies in sports. Michael Lewis’s book *Moneyball*, about the statistical work used by Billy Beane and the Oakland A’s front office, was turned into a (good) movie with Brad Pitt. Big Data is especially prominent in advertising and marketing: “Do customers respond better to solicitations in blue or white envelopes?” Similarly, Litan tells us that “there is no single Google website”; instead, visitors are presented a number of different Google homepages so that their reactions can be measured in order to optimize the site.

Another field where economists have helped business is matchmaking between suppliers and demanders where prices do not provide a sufficient signal. Examples of this include sectors where pricing is forbidden, like in organ transplants, or the good is subject to information asymmetries (the seller knows more than the buyer), like in online dating. Cupid.com hired two economists to solve a vexing problem: women were receiving too many

requests and men, therefore, were getting too few replies to their approaches. The economists’ solution was to increase the cost of men-to-women communications by limiting their number. Another dating site, Whatsyourprice.com, openly put a money price on communications and dates.

Economists have contributed much to the financial industry. They have shown that, for any given level of risk, a diversified portfolio brings higher returns. This discovery led to the 1970s creation of index funds, mutual funds made of diversified stocks or other financial instruments.

Index funds have consistently generated higher returns than actively managed funds. The Efficient Market Hypothesis, which claims that no stock-picker can consistently outperform the market because all available information is incorporated in the prices of financial instruments, formalized this idea. Eugene Fama won the 2013 Nobel Prize in economics for his work in this area.

Although options (tradable contracts to buy or sell commodities or, now, other financial instruments) have existed for centuries, three financial economists—Fisher Black, Myron Scholes, and

Robert Merton—contributed to the growth of this market by developing a famous options pricing formula to determine what an option should be worth.

**Public policy implications/** Economists have also contributed much to public policy. Litan emphasizes the importance of entrepreneurship and blames economists for “failing to recognize how increasing bureaucracy and regulation are stifling American entrepreneurship.” But economists have also been instrumental in the deregulation experiments that began in the 1970s.

At the time, transportation was heavily regulated. Litan reminds us that “airlines could not transport air cargo by truck

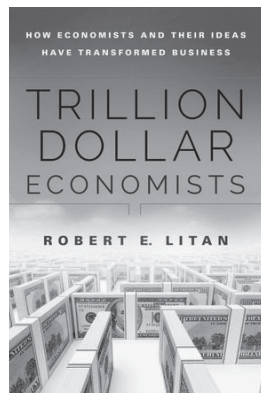
beyond 20 miles of an airport.” Like airlines, truckers were subject to rate fixing and route controls. He notes, “Economists from across the political spectrum were well ahead of the politicians and regulators in advocating deregulation.” Without deregulation, much of the online commerce revolution and just-in-time delivery systems we know today could not have happened. And airline fares would probably be double what they are now.

Starting with Jimmy Carter’s administration, oil prices were also deregulated thanks to the advice of economists. This was “yet another example,” writes Litan, “where a Democratic president and a Democratic-controlled Congress did what free market Republicans had long been associated with—letting the market, rather than the government, set prices.” This deregulation paved the way for the ongoing shale oil revolution.

What is surprising about all these regulations is that they were imposed in what was supposed to be the country of free enterprise.

The same paradox was apparent in telecommunications. The deregulation movement in telecom, with economists at the forefront, also started in the 1970s. First, AT&T was broken up into regional entities by the Antitrust Division of the U.S. Justice Department. Litan properly criticizes AT&T’s longtime monopoly and the ongoing power that the regional “Bells” have over the “local loop,” but he does not emphasize enough the paradox that these monopolies were creatures of government itself. Also in the telecom section, he discusses the partial deregulation of the electromagnetic spectrum that got underway in the 1990s with the auctioning of frequencies by the Federal Communications Commission. The idea for those auctions had been advanced by Ronald Coase three decades earlier in work that would help earn him the Nobel Economics Prize.

The attentive reader of *Trillion Dollar Economists* will notice that the economists credited for innovations were often not holders of economics Ph.D.s, but instead were statisticians, mathematicians, engi-



**Trillion Dollar Economists: How Economists and Their Ideas Have Transformed Business**

By Robert E. Litan

400 pp.; Wiley & Sons, 2014



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neers, and others who “[think] like economists.” Yet economics remains essential. The advance of Big Data has made empirical work easier, but theory has become even more necessary because aimlessly fishing for data easily leads to misleading correlations.

**Regulation** / Litan is careful not to blame the Great Recession on economics or finance. He recognizes that “politicians promoted home ownership” and thus they deserve much of the blame for the real estate bubble and subsequent collapse. But he is still too soft on the federal government. He thinks that financial regulators did not regulate enough prior to the recession; they “got too cute, or too complicated.” He believes that government can and should manage the macroeconomy. He is persuaded that “Bernanke’s extraordinarily innovative easy-money policy helped save the U.S. economy from a far worse recession than actually happened.”

Perhaps blinded by the limited experience of deregulation of the last decades of the 20th century, Litan seems to overlook the generally growing trend of regulation. Since the end of World War II, the *Code of Federal Regulations* (which annually consolidates all existing federal regulation) has grown from less than 20,000 pages to more than 130,000; state and local regulations have also mushroomed. Even with the late-20th century deregulation era, overall government regulation has continued to grow. (See my “A Slow-Motion Collapse,” Winter 2014–2015.)

Consider finance. It is true, as Litan argues, that some deregulation occurred—brokerage commissions were decontrolled, for example. But the whole industry is quite certainly more regulated today than at any time in American history. Even before the Great Recession, the regulatory burden was heavy; for example, the New York Fed had hundreds of regulating bureaucrats working on the very premises of large banks. Regulation has become so omnipresent that we do not see it anymore.

Nor, seemingly, does Litan. He is sympathetic to cryptocurrencies but he does not seem to realize that they are being

crushed by regulations (many emanating from the war on drugs). He explains well the efficiency of prediction markets (they predicted the 2004 presidential election better than opinion polls) but is soft on the government’s attempts to regulate them out of existence, including with the Dodd-Frank financial legislation. He seems to buy wholesale the necessity of antitrust laws.

Litan is an intelligent and well-informed economist. He knows his classics, from “the great Austrian economist Friedrich Hayek,” to Milton Friedman, not to forget Joseph Schumpeter and Israel Kirzner. He is familiar with public choice theory. He generally believes in the efficiency of markets: “the alternative to allocation by price is allocation by queue.” He is well aware of the disagreements among economists, including on redistribution, even if he himself favors it for equity reasons and as “a form of social glue.” And he understands that in a free economy, what matters is the satisfaction of consumer demand, not the success of producers.

**Values and analysis** / I find in *Trillion Dollar Economists* the same disquieting contrast I contemplate every week in reading *The Economist*. (Interestingly, the review of Litan’s book in *The Economist* blames him for being too obsessed with economic efficiency.) On the one hand, one sees a generally good understanding of markets and their efficiency. On the other hand, one is struck by a constant deference toward those who run the government and interfere in markets. How can they miss that inconsistency? Or is it just me?

The problem is, no doubt, partly attributable to differences in values. Contrary to my view, Litan, like *The Economist*, is willing to call on government coercion to skew in favor of different people the distribution that would otherwise result from the working of free markets. In their perspective, there exists some public goal or purpose to which individual ends must be subordinated, but they realize that this subordination is done at a lower cost if the market is put at the service of public policy instead of being crushed. This approach is very different from the classical liberal—

or, at any rate, the libertarian—approach where only individual preferences, goals, and happiness matter.

But, contrary to what Hayek argued, libertarians and socialists probably also have analytical differences besides differences in values. One such analytical disagreement lies in the social democrats’ belief in the omnipresence of market failures. The fact that Litan was at one time “principal deputy assistant attorney general” in the Antitrust Division reveals something not only about how embedded he was in the monstrous federal bureaucracy, but also about his belief that economic freedom is impossible without constant government threats and meddling. In this perspective, the mildest conditional prejudice in favor of some economic freedom looks like free-market ideology. How else could we understand his claims that the George W. Bush administration was “a Republican administration committed to free markets”?

Another sort of analytical disagreement is probably traceable to the influence of John Maynard Keynes. It is true that Litan shows some skepticism toward macroeconomic management. But he seems to agree that a free-market economy is inherently unstable, as if any other economic system were better. In a more general way, I suspect that Litan would agree with Keynes that, in a society that “thinks and feels rightly”—a society where, probably, the government regularly consults him—politicians and bureaucrats can be trusted to take risks with other people’s liberty.

**Trusting government** / The author of *Trillion Dollar Economists* does not distrust government. He talks fondly of “government service” and “public service.” He does not appreciate that political solutions are generally more risky than the market failures they are (officially) meant to correct. Information asymmetries are potentially more damaging in the political market, where bureaucrats use the information they control to manipulate politicians while the latter use their own privileged information to defraud citizens. Litan argues that a carbon tax or a cap-and-trade system “is really a

matter of prudence,” but he forgets that protecting citizens against Leviathan is a much more serious matter of prudence.

Another sort of reason why our trust in government should be very limited lies in the fuzziness of the very notion of public interest. Society is the locus of private interests resulting from individual preferences that cannot be aggregated into non-dictatorial “social preferences.” Government action nearly always overrules some individuals’ preferences in favor of other individuals’. On the contrary, Litan believes that “the best interest of society as a whole” requires constant attention and meddling with cost-benefit analysis. Perhaps, like many economists, he has just not thought through issues of social choice and welfare

economics, but he should have.

The reader of *Trillion Dollar Economists* will appreciate that Litan has worked with many of the most important economists of our time, but the name-dropping gets a bit tiresome. Everybody seems to be his “good friend.” Is there any liberal economist with whom Litan has not rubbed elbows? Perhaps he is just a sociable guy who has problems finding faults with his fellow citizens. But he may also be much too close to the establishment.

As any author knows in his bones, nothing is perfect. If a good book is a book in which one learns something, *Trillion Dollar Economists* is a good one for me, both for what it contains and for what it underplays. R

a coherent summary of his arguments on the precise cause of the crisis. The depth of the research in the book is nothing short of extraordinary as he addresses all the potential causes, provides an amazing number of on-point documents to support his thesis, and responds to the arguments of his critics who cling to the idea that government housing policy played no or only a small role in the crisis.

**Government and NTMs** / Wallison’s first chapter sets forth the overarching arguments that he develops later in the book:

- The financial crisis was the result of the government’s own housing policies or, more precisely, “the crisis would not have occurred without those policies.”
- The “seeds of the crisis were planted in 1992” when Congress enacted affordable housing goals for Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs) that purchased loans in the secondary market.
- Fannie and Freddie reduced their underwriting standards not only with regard to low-income borrowers, but also to high-income borrowers.
- Because of the deterioration in underwriting standards, by 2008 half of all U.S. mortgages were “subprime” or “Alt-A,” which means they were of below-prime quality (more on this below). Some 76 percent of the lower-quality loans were held on the books of government agencies or the GSEs.
- The GSEs did not disclose the full extent to which they held such lower-quality loans.
- When the bubble deflated, the financial crisis put at risk many of the largest financial institutions in the country.

Right out of the box after laying out his thesis, Wallison digs down into the data to support his core arguments, and his use of data, tables, and graphs bolsters his arguments throughout the book. The source of the data is research demarcating traditional and non-traditional mortgages (NTMs) undertaken by Edward Pinto, an AEI col-

## Peter Wallison Dissents Again, with Feeling

REVIEW BY VERN MCKINLEY

Ever since it became clear in 2008 that we were in the midst of a financial crisis, we have been hearing dueling narratives over who or what was primarily to blame for the crisis: either greedy capitalists or government housing policy.

One of the most important voices in this dispute has now weighed in with the book *Hidden in Plain Sight*. Since the late 1990s, Peter Wallison of the American Enterprise Institute has been one of the most prolific commenters on the build-up of the housing bubble, the ensuing financial crisis, and its underlying cause. Back in the late 1990s, long before most people understood precisely what Fannie Mae and Freddie Mac did, he was raising red flags (including several articles in these pages) and warning that the market and political dominance of the pair would one day end badly.

Wallison was a member of the Financial Crisis Inquiry Commission (FCIC), the 10-member body that was tasked with

examining the causes of the crisis, among other duties. The final report of the FCIC split along partisan lines, with the six Democratic Party members supporting the final report and the four Republicans dissenting. Wallison distinguished himself as a lone dissenter with his arguments that government housing policy was at the core of the causes of the financial crisis.

In 2013 AEI released his book *Bad History, Worse Policy* as an initial response to the FCIC majority’s findings. However, the book was simply a re-release of multiple policy pieces he had penned from 2004 to 2012, with some limited explanatory text integrated in. *Hidden in Plain Sight*, on the other hand, is all original writing, albeit citing much of the same source materials he has cited over the years, organized into

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league. Traditional mortgages adhere to standards as adjudged under three key elements: a loan-to-value ratio of 90 percent or less, which indicates a material down payment; a debt-to-income ratio of 38 percent or less, which indicates the amount of a borrower's income committed to debts; and a borrower's credit record, which is the history of the borrower's meeting of prior debts and should indicate no late payments (or, in rare cases, one). An estimated 85 percent of sampled loans met those standards between 1988 and 1991.

Growth in the segment of the market dedicated to NTMs—what Wallison derides throughout the book as “flexible” or “innovative” lending standards—was a good indicator of the deterioration in credit standards. At bottom, Pinto estimates the number of troublesome NTMs outstanding as of mid-2008, just at the onset of the major stress and panic of the financial crisis in the fall of 2008. Under Pinto's analysis, the NTMs numbered 32 million of the total (balance of over \$5 trillion) or 58 percent of the total 55 million U.S. mortgages as of mid-2008. Government agencies as a group were exposed to 76 percent of the NTMs, with Fannie and Freddie exposed to over half. Those data are especially significant because Fannie and Freddie did not begin to report their full exposure to NTMs until after they were taken into conservatorship by their regulator, the Federal Housing Finance Agency, in 2008. As a result, “analysts, regulators, academic commentators, rating agencies, and even the Federal Reserve were seriously misled about the scope of the NTM problem, believing that it was much smaller, and the number of traditional prime mortgages outstanding was much larger, than in fact they were.”

**Finding what they wanted to find** / Wallison settles a few scores with those who have criticized his analysis over the years (primarily those he derisively refers to throughout the book as being “of the left” or “on the left”) or that came to different conclusions than he did regarding the genesis of the crisis (primarily his fellow commission

members and select staff of the FCIC). Wallison holds those “on the left” in greatest contempt and ire, noting that “they have no data, no policy arguments, just a virulent denial that anything other than the private financial sector could possibly be responsible for the financial crisis.”

Turning his attention to the FCIC, the official arbiter of the causes of the crisis, he cites a range of sins visible to him as an insider to the process: just one staff member from a total staff of almost 80 was provided to support the minority's research; the executive director was on loan from the Federal Reserve and thus was potentially conflicted in her investigation of that agency's role in the crisis; the chair of the commission did not solicit the views of the minority or keep them informed on details of the FCIC investigations; and Pinto's work was never formally made available to the other members of the FCIC and the majority essentially dismissed his research out of hand.

I have always been of the opinion that the FCIC's report included some useful information and that the interviews it conducted and the never-before-released emails it made available were some of the few avenues to get detailed information out of the financial agencies (which were not willing to release much information voluntarily). But Wallison's conclusion about the politicization of the FCIC's policy conclusions seems about right:

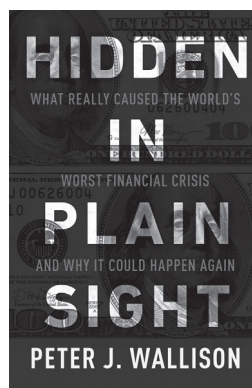
As far as I could tell from the witness interviews I was able to get, no one conducted any cross-examinations, and no one used any documents to question the witnesses' statements or otherwise test their veracity. The process simply validated the conventional view of the financial crisis that the media had already accepted and repeated.

**Federal policy** / Wallison traces through an exhaustive review of the history of the build-up of the bubble, from the state of housing finance before the affordable housing goals were implemented; the ratcheting up of the goals; the political calculations regarding taking credit for homeownership increases (both during the Clinton and George W. Bush administrations); through the steady deterioration of credit standards during the 1990s and how that ultimately precipitated the crisis. The breadth of research throughout this history is incredible, including material from a Federal Housing Authority underwriting manual from the 1930s; internal Housing and Urban Development Department memos, reports, speeches, and testimony; homeownership strategies; and Fannie and Freddie 10K and 10Q reporting.

One truly unique chapter in the book is on fair-value accounting and its role in the dissemination of information regarding the financial posi-

tion of financial institutions. I don't recall any other book on the financial crisis going into such detail on this issue and it is an excellent summary of the topic. A discussion of each of these historical issues and related documents cannot be undertaken in this brief book review, but Wallison always seems to find just the right documented evidence to support his argument.

The last section of the book details the government response to the crisis, or what Wallison calls the “panic and bungling of the officials who handled it. Then, in trying to minimize or justify their own mistakes, these officials claimed that they had insufficient authority to deal with the crisis.” He walks through a number of the narratives put forth by the authorities to justify their response. The interconnectedness fallacy that was used to justify the bailout of Bear Stearns? He rightly speculates that it was



**Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again**

By Peter J. Wallison  
386 pp.; Encounter Books, 2015



“dreamed up in either the Federal Reserve or the Treasury to justify saving Bear Stearns, and it was easily swallowed by the media at the time.” The Federal Reserve’s authority to rescue Lehman? “It does not take much detailed analysis ... to find that the story Paulson and Bernanke used to explain their failure to rescue Lehman has no basis in fact.” The dramatic zigs and zags of different and inconsistent policy responses? “Instead of a sense that the U.S. government knew what it was doing and had settled on a policy, there was now a sense that the government was winging it

or simply incompetent.”

I believe this will be one of the best policy books of 2015, and one of the best books on the crisis since it ended. For readers who have been critical of government housing policy and response to the crisis, *Hidden in Plain Sight* will provide you with more ammunition than you can ever hope to use. For readers who bought into the narrative of the media and the FCIC and are in denial that government policy caused the crisis, get ready to become so frustrated by Wallison’s mountain of contrary evidence that your head may explode. **R**

and even maintenance of the existing capital. The population began to decline, as did the median income. Curley’s political success came at the price of setting his city on a downward spiral.

Boston kept sinking until Massachusetts voters enacted a property tax limitation measure, Proposition 2.5, in 1980. The measure had been frantically opposed by both city and state politicians because they were certain that tax limits would “starve” the city. But instead of starving Boston, Prop 2.5 breathed life into it. Ambitious people and investment quickly returned.

Walters emphasizes that Boston’s revival didn’t occur because politicians had solved any of the usual problems that are blamed for urban decay: racism, poor education, crime, and so on. All that changed was a tax limitation measure that kept Boston from strangling itself with high taxes.

Is that a unique case? No; the same scenario has played out in quite a few other cities and San Francisco is a good example. “Progressive” politicians there had played the same redistributive game as Curley in Boston, with the same results. By the 1970s, San Francisco was a dysfunctional mess, mainly because of militant unions that kept striking for higher pay, which the politicians funded with higher taxes.

But in 1978 California voters passed

Proposition 13, despite California liberals’ declaration that it would be utterly ruinous. Almost immediately, capital began flowing back into San Francisco and other cities in the state. As Walters writes, “Prop. 13 increased the return on investments and protected [investors] against further Robin Hood raids.” As with Boston, San Francisco’s revival had nothing to do with the discovery of “solutions” to any of the presumed causes of urban decay.

## Property and Cities

◆ REVIEW BY GEORGE LEEF

**W**hy are some American cities thriving, growing in population, investment, and incomes, while others are in decline with shrinking populations, crumbling buildings, and businesses fleeing?

For the answers, read *Boom Towns* by Loyola University Maryland economics professor Stephen Walters. Based on his years of study of cities, he concludes that the key to a successful city is to protect property rights and otherwise leave people alone. “The record is clear,” he writes, “cities grow and prosper when they encourage the formation of capital in its many forms by securing the returns that flow from it.”

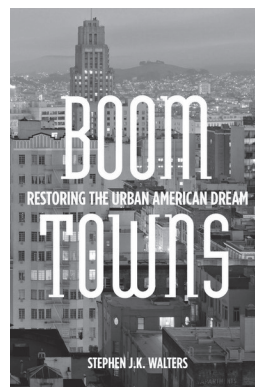
What causes cities to go into decline is equally clear: it happens when government stops protecting property rights. People and capital don’t stay where they are poorly treated. Walters strongly argues his thesis with cases showing the various ways politicians—often in league with private interests—have turned growth into decay.

Probably the most widespread threat to a city’s continuing success is redistributive taxation. Accumulated wealth in the hands of business people and professionals is a tempting target for politicians who figure they’ll gain far more votes than they’ll lose by

imposing high property taxes. The wealthy owners will have no choice but to pay and the increased revenues can be used for projects and programs most of the voters like. These programs can also help to buy favor with important interest groups.

### *Boston and San Francisco* /

One of America’s most notorious practitioners of the redistributive strategy was Boston mayor Michael Curley, who governed the city for four nonconsecutive terms (between terms in Congress, the governor’s mansion, and prison) between 1914 and 1950. The masses adored this “man of the people” who kept increasing property taxes on the rich, but few could see the slow-motion deterioration of the city produced by his redistributive policies. High taxes repelled new investment



**Boom Towns:**  
**Restoring the Urban**  
**American Dream**

By Stephen J. K.  
Walters

210 pp.; Stanford Business and Finance, 2014

*Baltimore and Detroit* / Baltimore serves as an instructive case for precisely the opposite



## IN REVIEW

reason. It's a city where there has never been a reduction in taxes. For decades, city leaders have placed their bets on big, splashy government-led projects to revive it, but those "investments" have been failures.

Walters writes about one of them, the Charles Center development: "Upon its completion in the early 1960s, press coverage was adulatory and opinion leaders praised those behind the thirty-three-acre project for their good intentions, brilliant vision, bold artistic sense, and deft political touch." Over the decades, city officials kept pouring money into similar "renaissance" projects, but "few noticed that [Charles Center] is actually a failure both within its borders and beyond them."

Because of the high-tax, government-centered philosophy that has held sway in Baltimore (and the state of Maryland), most of the city is decaying. Instead of encouraging small capital investments that really would radiate jobs and prosperity, city officials have tried to use big government as a catalyst, and failed. Baltimore's unhappy experience strongly supports Walters' overarching point that cities do well when spontaneous, bottom-up development is not discouraged and they do poorly when politically planned, top-down development takes over.

Redistributive taxation isn't the only way that cities turn against the sources of prosperity. Another is to embrace the union movement, whose short-sighted actions siphon away a large portion of the return to invested capital and thereby set in motion private responses that slowly de-capitalize a city to the detriment of nearly everyone.

Detroit is, of course, the prime example. Walters gives readers an intriguing history of the city that became the center of the auto industry. It grew at a dazzling pace from 1900 to 1950, by which time it was the nation's fourth-largest city, boasting a median family income second only to Chicago. A true boom town, the good wages available in its many industries attracted people of all races.

During Detroit's fabulous growth, unions represented no more than 10 percent of the workers in the city's many factories—a strong refutation to the frequently

made claim that unions created America's middle class. But that was in the days when unions were treated no differently than other voluntary organizations under the law. That changed with the enactment of the National Labor Relations Act in 1935 (upheld against constitutional challenge by the Supreme Court in 1937).

The United Auto Workers promptly used their muscle to organize General Motors and Chrysler in 1937; Ford held out until 1941. (Walters provides the

*For decades, Baltimore leaders have bet on big, splashy, government-led projects to revive the city, but their "investments" have been failures.*

intriguing back-story on the reason for Henry Ford's capitulation.) Unionism now seemed to be an easy way for workers to get higher wages and it spread rapidly.

The long-run effect of the alliance between unions and politicians was similar to high tax rates. Investors stopped putting money where the returns were expropriated. Between 1947 and 1958, manufacturing employment fell by 40 percent; Detroit went into a tailspin from which it has never recovered. Although Walters does not cite the work of economist W. H. Hutt (his 1973 book *The Strike-Threat System* [Arlington House] in particular), his argument dovetails with Hutt's that unions can only exploit capital in the short-run, after which it departs for greener pastures. Detroit is proof of that.

**Inviting signals** / Walters includes an analysis of the effects of right-to-work laws. He argues that they mainly are a signal to businesses that they will find a welcoming climate. States that allow compulsory unionism hurt their cities' ability to compete for investment by sending the opposite signal. I think he's correct.

By themselves, right-to-work laws don't change matters much. They can't forbid unionization, but only allow workers to refuse to pay union dues. That doesn't save companies any money and costs the unions

only a little at the margin. But the right-to-work law is a signal that public policy is not dominated by the redistributionists, and that is a very important signal.

Speaking of signals, a bad one that cities can send is that they are willing to use eminent domain to seize property from homeowners and small businesses, and redistribute that land to big companies. Walters writes that there has been a "hundred-year war" between eminent domain and private property, with private property constantly

in retreat. When cities play that game, he writes, "The mere threat of such takings will have a chilling effect on private owners' plans to upgrade residences and businesses in areas targeted for 'rescue'

by planners." Also, eminent domain-based development tends to misallocate capital because it distorts price signals and substitutes the tastes of the planners for those of market participants.

Another way cities can damage themselves is by caving in to "green" interests. Portland, Ore., is the best illustration, with its Urban Growth Boundary. The rationale behind the meddlesome law is that saving space for nature is so important that the city's growth has to be walled in. The consequences might please the environmentalists, but affordable housing for lower-income families has disappeared.

*Boom Towns* is full of helpful ideas for officials who would rather preside over a growing, increasingly prosperous city than one they could milk for short-run political benefits. For example, Walters focuses on the pro-competition, pro-market policies implemented by a line of mayors in Indianapolis, which is one of America's most successful big cities.

Urban theorists in the "progressive" tradition insist that the problems that plague our cities can only be solved through massive infusions of government money and expert planning. Walters' book persuasively makes the opposite case: protect people's property rights, then leave things to the spontaneous order of the free market. **R**

# You Had Me at Page One

◆ REVIEW BY DAVID R. HENDERSON

“I’ve always had trouble succeeding along traditional Bush family lines.” So writes Jonathan Bush on p. 1 of his book, *Where Does It Hurt?* With that one sentence, he had me. Bush is a nephew of George H. W. Bush and a cousin of George W. Bush. I’m not a fan of politicians and those two, especially George W., rank low on my list. So when a Bush tries to make it in the private sector rather than in government, I’m already somewhat of a fan.

Of course, Jonathan could have blown it by having nothing important to say in his book. But on the nuts and bolts of health policy, and even on what his uncle called the “vision thing,” he has a lot to say.

I have been around health economics a long time, having been the senior economist for health policy at the Council of Economic Advisers under Ronald Reagan from 1982 to 1984. I’ve tracked the issues since then, and so I’ve read a lot of health care studies. Bush’s book, co-authored with Stephen Baker, is one of the best I’ve seen in a long time.

**Entrepreneurial alertness /** Bush is cofounder and CEO of Athenahealth; Baker is a former senior writer for *Business Week*. They bring a deep appreciation of the entrepreneur to their analysis of health care. “Entrepreneur” and “health care” in the same sentence? Really?

Yes, really. They write, “From an entrepreneur’s point of view, there’s something highly appealing, almost intoxicating, about waste and dysfunction in the industry.” They continue, “Those who can dig down through the morass of rules, paperwork, and bureaucratic obstacles can find

new markets.” That last sentence got me thinking back to Austrian economist Israel Kirzner’s discussions of “entrepreneurial alertness.”

In this digging, Bush does not disappoint. In chapter after chapter, he and Baker not only show how dysfunctional the health care system is, but also discuss ways

that entrepreneurs can make it better. For example, after noting that a magnetic resonance imaging scan (MRI) at Massachusetts General Hospital would be billed at \$5,315 to an insured patient, Bush runs the numbers and concludes that a business that did three images an hour and was open 12 hours a day could charge \$99 per MRI and make huge profits.

He goes beyond such stories of possibilities and tells of *actual* successes. A doctor named Arnold Milstein, for example, had worked with Unite Here, a union representing Las Vegas hotel and casino workers. After analyzing the data, he eliminated the most expensive 10 percent of doctors from the union’s health plan, resulting in a \$55 million reduction in health care expenditures. Amazingly, many of those doctors picketed the hotels where the union members worked! Milstein believes that the \$55 million reduction was due partly to the disciplining effect on the doctors who remained in the plan. And after being stuck at \$13 an hour for the previous few years, the workers’ average wage rose by \$1.10. This shouldn’t be sur-

prising because, as economists well know, the cost of benefits is borne largely by the beneficiaries in the form of lower pay.

**Birthin’ babies /** Bush’s first big entrepreneurial venture was in birthing. He calculated that more extensive use of midwives could save a lot of money and that if he set up a string of birthing centers, he could split the gains with insurers. So he and a business partner named Todd Park started Athena Women’s Health and set up some birthing centers in San Diego, with the plan of ultimately going national.

The system worked—for the pregnant women. Bush writes:

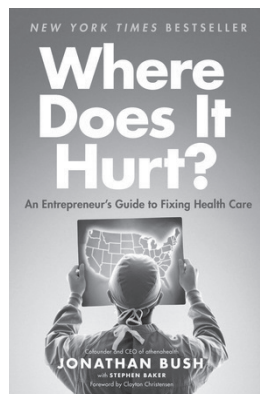
Only 10 percent of our births were delivered by C-section, about one-third of the national average. Ninety percent of the mothers who gave birth in our centers breast-fed their babies, compared to the 67 percent national average at the time. (Now it’s close to 80 percent.) We avoided the common widening incisions called episiotomies, which are expensive, horribly uncomfortable for the mother, and statistically counterproductive.

Unfortunately, it didn’t work for Athena. Why? Their popularity hurt them. Such is the weird structure of health care and health insurance. Bush writes:

It was the opposite of the way a sane market operates. Because we were popular, we attracted customers for what to most women is the most expensive medical procedure of their pre-Medicare years. Increasingly, health plans that offered Athena would receive three or four months of premiums and then pay claims that averaged \$12,000—and then lose the customer. The insurers began to view us as toxic. A s\*\*t magnet. Growing numbers of health plans fired us by kicking us out of their networks.

The result: most of their remaining clients were on Medicaid or were uninsured and paid cash.

What Bush doesn’t tell you, perhaps because he doesn’t know, is that in a world without insurance regulation, Athena



**Where Does It Hurt?**  
By Jonathan Bush with  
Stephen Baker  
224 pp.; Portfolio/  
Penguin, 2014

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probably would have made money. Why? Because without insurance regulation, most insurers would probably not have covered delivery, and people who wanted babies would have paid for birthing directly. As actuaries can tell you, for something to be an insurable event, it must typically have two characteristics: large loss and low probability. Because delivering a baby is expensive, the first criterion is covered. But in this era of birth control and legal abortion, a very large percentage of pregnancies brought to term are planned. So baby delivery does not fit the second criterion. Insurers started to cover it in states in which the state government required such coverage. Insurers not in those states started to cover it only when the federal government started requiring it in employer-provided health insurance with the Pregnancy Discrimination Act of 1978. Without that law, most people would do what my very modest-income parents did: save money to pay for delivering a baby. Under that model, Athena might have been a roaring success.

**Beyond birthin' babies** / Of course, that decades-old law was not something that Bush could change, even had he known about it. But, true entrepreneur that he is, he realized his mistake.

In building the business, Bush's firm had developed software to help the company get paid by insurance companies. Specifically, Park's brother Eddie built software that incorporated each insurer's idiosyncratic rules. The software worked well. A venture capitalist to whom Bush was appealing for funds to save his birthing business cut him off. "I'm not interested in your birthing business," he said. "But I can get you \$11 million for rights to your software."

So Bush's company pivoted. In 1999, when the dot-com boom was at its height, "the new Athenahealth was reborn as an Internet company."

**Put the Uzi away** / The company moved back to the Boston area and did great,

even after the dot-com bust. But there was one fly in the ointment: President George W. Bush. Jonathan writes, "My cousin, the forty-third president of the United States, was about to sign a bill that could destroy us."

How? A long-time "antikickback law" prevented hospitals and doctors "from exchanging services, information, or products of value with each other," considering all such exchanges to be unethical. In 2004, a bill started working its

*A single detail in a law, he writes, "can throw lives or entire companies into a tailspin." Elsewhere he writes, "Government is like a giant with an Uzi."*

way through Congress that would give "safe harbor" from that law to hospitals so that they could provide doctors with digital technology. But it didn't give safe harbor to hospitals that bought Internet services.

So Bush flew to Washington to lobby Congress. It won't surprise anyone who has seen complex laws being made that few members of Congress even knew what was in the bill. In the office of Rep. Nancy Johnson (R-Conn.), chair of the health subcommittee of the House Committee on Ways and Means, Bush watched the congresswoman page through the bill and find the relevant section. He pointed to where it said "computers and software" and asked her to add "and Internet services." He writes, "She did."

Bush got to see the ugliness of government up close. A single detail in a law, he writes, "can throw lives or entire companies into a tailspin." In one of the most memorable lines in the book, he writes, "Government is like a giant with an Uzi."

**Conclusion** / There is so much more of value in the book. One striking section is five pages of excerpts from a conversation that Bush had with Bob Kocher, who "worked for the Obama administration and wrote most of the original Affordable

Care Act." Kocher went all Milton Friedman on the skewed incentives in the medical system that existed before the ACA and then admitted that the ACA didn't do much to make that better. I wish that Bush had asked him whether he thought the ACA made it *any* better.

Unfortunately, amidst all his great insights and stories, Bush forgets everything he learned on his trip to Washington and wimps out. "I don't intend," he writes, "to spend this chapter pounding on the government, or proposing a rapid shift to a private health care economy." While, to his credit, he wants "only a fraction" of the regulations we have today, he does want "smarter"

regulations.

He does understand that the more competition there is in health care, the better. How do you get more competition? One way is to get more insurance companies in the business. But he claims that this "is one area where the government could help, perhaps the way it does with Fannie Mae and Freddie Mac in real estate." Really? Because Fannie Mae and Freddie Mac worked so well? Say it ain't so, Jonathan.

There's a much more straightforward way to get more competition in insurance, and it's one of the few good ideas that many of the Republicans had during the ACA debates of 2009 and 2010: allow people to buy insurance across state lines, with the rules dictated by the state in which the insurer is located. This is done with credit cards now, which is why it's so much easier to get a credit card than it was in the early 1970s. Such a solution is not only good economics but also good federalism. State governments should not be able to restrict interstate commerce. I was disappointed that, although Bush earlier had recognized the problems with state regulation of interstate commerce, he failed to apply that insight here.

Still, this is a great book. I'm glad that Jonathan chose his career rather than of his uncle and cousin. R



# Do Good Names Bring Great Riches?

◆ REVIEW BY ART CARDEN

Some great artists work with oils. Some work with stone. Gregory Clark works with data. *The Son Also Rises* is an excellent example of careful and creative inference from an incomplete historical record, namely the history of family social mobility.

Clark offers detailed studies of the modern United States, modern Sweden, medieval and modern England, India, China, Taiwan, Japan, Korea, and Chile to show that patterns of social mobility are remarkably similar across societies. He deals with exceptions and anomalies toward the end of the book, and while there are unanswered questions and clear directions for further research, his treatment of the subject is impressively comprehensive.

**Tracking surnames** / He diverges from the usual studies of social mobility by using a novel approach. He “estimates social mobility rates by measuring the rate at which surnames that originally had high or low social status lose that status connotation.” That idea was inspired by a *New York Times* reviewer of his 2007 book *A Farewell to Alms* (Princeton University Press). Clark does this by assembling a wide range of data sources and looking to see whether names that appear in high-status probate records and income tax lists later appear among lists of people in high-status occupations (like doctors and lawyers), lists of students enrolled at elite universities, and other measures of status.

One of his most impressive contributions is his finding that societies differing

widely in their institutions—from modern Sweden to medieval England to Maoist China—exhibit remarkably similar patterns of social mobility: slow regression to the mean over generations. His findings are robust to different measures of status like income, education, and representation in high-status professions like law and medicine. He explores this empirically by looking at the changing positions of surnames across different markers of status (income and education, for example) for different societies. The surname Pepys, for example, is over-represented in the medical field and in Oxford and Cambridge admissions, though ironically the most famous Pepys of them all—Samuel Pepys, the diarist—left no heirs.

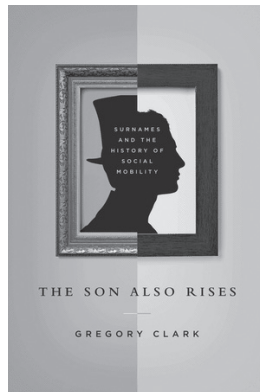
Clark argues for “a law of social mobility” whereby a family’s position in society is determined by its members’ underlying “social competence.” It is an attractive and intuitive theory, but while this is distinct from inherited wealth or inherited ability, he nowhere defines exactly what this social competence is. At this stage in the research program, “social competence” is an *X* factor (literally—see the equation on p. 125) that explains trends in social mobility but that so far remains undefined and unmeasured. Rather, it is inferred from the patterns Clark identifies in the first half of the

book for Sweden, the United States, and England and then tests in the second half of the book for India, China, Japan, Korea, and Chile. He claims to have discovered an element of “social physics” governing social mobility over time. If we may extend the analogy to the physical sciences, “social competence” is his Higgs Boson: predicted by the theory and essential to the argument, but not actually observed.

The story would be much more complete if he had defined and described social competence in greater detail, but this failure is an opportunity for further research rather than an irremediable flaw in his overall argument. Social competence will necessarily be a moving target, dependent on economic, political, social, and cultural contexts in society that are always shifting. Identifying the characteristics of the highest status people in a particular data set and then constructing a social competence index that measures a family’s social competence as a weighted average of the differences between a particular family and the highest-status family strikes me as something Clark could try, but such a measure is likely beyond the capacity of currently available data (and, for me, certainly beyond the capacity of a book review).

**Resistant to manipulation** / People who appreciate the dismal aspects of economics will welcome some of the book’s conclusions. First, social mobility patterns are basically the same across the societies Clark studies and are stubbornly resistant to attempts to create new societies through social democracy (as in Sweden) or violent communist revolution (as in Mao’s China). Second, attempts to redress historical injustices through programs like the reservation system in India that reserves spots in universities and public jobs for people from historically oppressed castes actually work to the detriment of the poorest people in society. Clark’s work suggests there is more than political will standing in the way of greater social mobility.

It is not clear, however, that social mobility should be at or near the top of the



**The Son Also Rises: Surnames and the History of Social Mobility**

By Gregory Clark, with Neil Cummins, Yu Hao, and Daniel Diaz Vidal

364 pp.; Princeton University Press, 2014



## IN REVIEW

the public policy agenda. In a rhetorical flourish, he refers to the bottom of a society as a “squalid netherworld.” If incomes and educational opportunities up and down the rungs of the social ladder were fixed, then social mobility would be a cause for great concern; that a person could be mired in a squalid netherworld through nothing more than an accident of birth offends many people’s sensibilities.

Incomes and educational opportunities are not fixed, however, and there is no reason the bottom of the income status distribution should be squalid or a netherworld. In a growing economy, people up and down the income distribution will have more and better opportunities for flourishing and self-authorship even if we hold the income distribution fixed and completely eliminate social mobility. If people are confronted with ever-expanding opportunities to obtain food, clothing, shelter, and enlightenment, I don’t see why we should treat social mobility as an issue that requires corrective public policy even if we could do something about it. This isn’t to say that people should accept that they are like George Lucas’s droids or Akira Kurosawa’s peasants—“made to suffer”—but it isn’t clear that desire for status is a morally praiseworthy trait or a legitimate demand upon society.

Our demand for status raises another important issue that was not necessarily germane to medieval English peasants and lords, but that is becoming more important with the rapid improvement and diffusion of communications technology. We get to choose our own “societies” in ways that were impossible to previous generations. This isn’t just because we can sort into political jurisdictions that best match our preferences with our constraints. The Internet has given us the ability to join or even form an infinite array of new societies. At the margin, the physical, material, and political societies in which we live become less relevant when we can choose to spend less time interacting with a society centered around geography (say, people who live in the United States) in order to spend more time interacting with a society centered

around common interests.

Here’s an example: Andrew Reams is one of my 6-year-old son’s heroes. To most people, Reams is just a guy who lives in Roanoke, Va. To people like my son who love elevators, though, he is YouTube celebrity “DieselDucy,” who takes followers on tours of landmark elevators, carwashes, arcades, and other mechanical marvels. People have always had hobbies and have always sought out others with common interests, but the Internet has made it much easier for people to craft their own societies centered around common interests or common networks. For instance, Reddit contributors who earn more “upvotes” than “downvotes” for their submitted links and comments earn “karma” that cannot be redeemed for anything, but that measures one’s standing within that community. The caption on one of my favorite *xkcd* cartoons reads, “Human subcultures are fractally nested.

There is no bottom.” As better communications technology makes it easier for new subcultures to emerge, it will be interesting to see the degree to which people value status within the different “societies” to which they belong. And in 2115, I expect that one of Clark’s academic descendants will write a dissertation about it.

In fact, I anticipate that a lot of future dissertations—probably from Clark’s academic home at the University of California, Davis—will extend his insights and methods to other cultures, contexts, and data sets. Clark-inspired investigations of the former Soviet Union and African countries, for example, would be extremely useful complements to this book. And some interesting debate about the minutiae of his data and methods will find homes on the specialized pages of journals like the *Journal of Economic History*, *Economic History Review*, and *European Review of Economic History* (which Clark edits). R

## Finance According to Non-Academics

REVIEW BY VERN MCKINLEY

Over the past year, my reviews in *Regulation* have concentrated on books by academics expounding their views on the causes of and responses to the 2007–2008 financial crisis. This time, I’m reviewing three books on the crisis and other financial policy issues that have been written by non-academics: Nomi Prins, a journalist and former Wall Street analyst currently affiliated with Demos, a progressive public policy group; Steve Forbes, chairman and editor-in-chief of Forbes Media, and co-author Elizabeth Ames, a communications executive, speaker, and author; and Michael Lewis, a former Salomon Brothers bond salesman and best-selling author of the books *Liar’s Poker* (W. W. Norton, 1989), *Moneyball* (W. W. Norton, 2003), and *The Big Short* (W. W. Norton, 2010).

**Presidents and bankers** / There is much to be said for Prins’ book, *All the Presidents’ Bankers*. It is a well researched and annotated history of the interconnections between U.S. presidents and private bankers from the days of President Teddy Roosevelt and the Panic of 1907 through President Obama and the Great Recession of 2007–2009. The book’s endnotes reveal a painstaking journey through a wide range of contemporary books, articles, and original documents drawn from the deep bowels of the archives of numerous presidents.

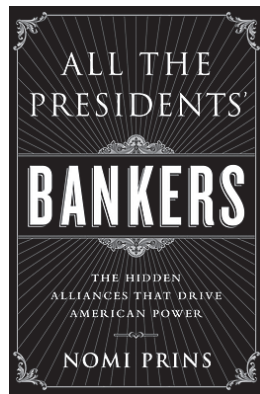
VERN MCKINLEY is a visiting scholar at the George Washington University Law School and author of *Financing Failure: A Century of Bailouts* (Independent Institute: 2012).

Much of the book focuses on the “Big Six,” a group of leaders of the largest banks that first came together in 1929 with representatives from Chase National Bank, Bankers Trust Company, Guaranty Trust Company, National City Bank, Morgan Bank, and First National Bank. Prins very ably traces the evolution of this group over time all the way through the megamergers of the 1990s and the financial crisis of the 2000s into today’s

“permutations of the original Big Six”: J.P. Morgan Chase, Morgan Stanley, Citigroup, Goldman Sachs, Bank of America, and Wells Fargo.

Prins chose to undertake an unbroken history of modern U.S. banking. The upside of this approach is that, with a few exceptions, there is a feeling of completeness to the work spanning over 100 years. However, to me a downside of this approach is that some of the narratives are far afield from matters of banking, finance, and the financial industry. For example, the author chronicles a range of foreign policy issues, oftentimes simply because a key banker is involved in them in some official or unofficial capacity. An example of this is a section on the Shah of Iran seeking political asylum in the United States, which was included because it involved bankers John McCloy and John Rockefeller.

This approach made me curious about what methodology Prins used to choose the hundreds of topics that she covers in the book. She explained to me that the process started with each of the presidents and key administration figures and worked outward to the individual bankers whose names appeared in the presidential archives. Because this search led to an enormous amount of material, the analysis was then narrowed down to those individuals



**All the Presidents' Bankers: The Hidden Alliances That Drive American Power**

By Nomi Prins

521 pp.; Nation Books, 2014

and events, domestic or foreign, where the strongest associations were apparent over time. (McCloy is a perfect example of this.) This is probably not how I would have approached this history, as I would have tended to focus more on key domestic banking events and the bankers' influence upon them, but such decisions are the prerogative of the author.

One reason I would have focused on key domestic banking events would be to give more attention to important financial events of the past century that Prins largely ignores or treats only superficially. For instance, in her book the War Finance Corporation—a bank bailout program during World War I—only rates a very brief reference to

its chairman, Eugene Meyer. The saga of Continental Illinois and its near collapse and rescue by the federal government during the mid-1980s does not even get a mention. And Fannie Mae and Freddie Mac are only briefly discussed as part of the string of bailouts in 2008–2009.

In some cases the analysis of the book appears to be based on innuendo rather than fact. For example, during the Panic of 1907 a number of significant financial institutions were on the brink of failure after experiencing a run on their deposits. Ultimately, the authorities facing tough choices on New York institutions closed down Knickerbocker Trust while other institutions such as Trust Company of America were bailed out by a consortium of banks. One history of the crisis explains that these decisions were based on a detailed review of the financial position of the firms, overseen by J.P. Morgan and undertaken by Benjamin Strong (who would later become the first president of the powerful Federal Reserve Bank of New York). Strong's analysis determined that Knickerbocker was insolvent; Trust Company of America was solvent and worthy of backstopping. (For more on this, see Robert Bruner and Sean Carr's *The Panic of 1907* [Wiley, 2007].) Prins implies that

the Trust Company of America decision was not based on an objective analysis of solvency, but rather that the firm was saved because it had “more substantive ties to the major banks” and “had been blessed by the sponsorship of the Morgan team.” In contrast, Knickerbocker “had not garnered similar banker support.” The precise meaning of those phrases, as well as any underlying analysis, is not well documented by Prins.

In other cases, she makes very clear her views of the lucrative nature of the connections between bankers and their presidents:

During the postwar phase of the 1940s, [Winthrop] Aldrich traveled the world in a triple capacity: as chairman of the Chase Bank, president of the International Chamber of Commerce, and chairman of the Committee for Financing Foreign Trade. The impact on the bank's bottom line was substantial....

The volume of business handled in all divisions of the foreign department increased enormously. Chase commercial loans in London doubled that year. Aldrich's dual work as public servant and private banker was reaping rewards for his firm, and for his status as a diplomat. His partnership with [President Harry] Truman assured him of both.

Like many progressives, Prins repeatedly stresses the deregulation bogeyman at numerous points throughout the 1980s, 1990s, and 2000s under presidents Jimmy Carter, Ronald Reagan, George H. W. Bush, and Bill Clinton, and blames this phenomenon for the “meltdown” of 2007–2008. Yet she offers little consideration or scrutiny of the bubble-inducing housing and loose-money policies in the lead-up to the crisis.

The detail on the 2007–2009 recession and financial crisis is not very deep. In a mere 4.5 pages, Prins addresses the full range of bank bailouts, from Bear Stearns in March 2008 through TARP and the bailout of Bank of America in early 2009. In her preface, she cites the information challenges of modern times and that the relationships

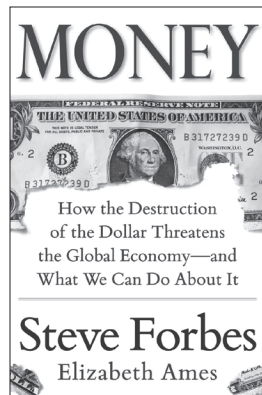
## IN REVIEW

between George W. Bush and Barack Obama and the leading bankers of today are just not as readily available because of the nature of modern communications. (“Bankers don’t put much in writing anymore, and there have been no tapes of White House conversations since Nixon.”) She also notes that a number of Freedom of Information Act requests at the Reagan, George H. W. Bush, and Clinton libraries were not responded to in time for the release of the book. As someone who has filed many FOIA suits to undertake my own writing projects, I can bear witness to these facts on information availability. I would add that the Obama administration, which had vowed to be the “most transparent administration in history,” is not really very transparent after all and its immediate predecessors would also not be in the running for that honor.

If you are drawn to the concept of a century-long walk through the relationships between U.S. presidents and bankers, I think you would enjoy *All the Presidents’ Bankers*. If you are looking for a history of those events with extended analysis of the policy-based decisionmaking process, I think you would be disappointed.

**Glory of gold** | *Money: How the Destruction of the Dollar Threatens the Global Economy—and What We Can Do about It* is predominantly a blend of history and economic policy analysis on the state of money, which includes a detailed analysis of a proposed gold standard for the 21st century. Near the end, it morphs into a personal finance book à la Suze Orman, diving down into detail on what the discussion of money means for investors on an individual basis.

The initial chapter of *Money* is an exploration of our current state of affairs with regard to the economy: we may be over the so-called “Great Recession” for now,



**Money: How the Destruction of the Dollar Threatens the Global Economy—and What We Can Do about It**

By Steve Forbes and Elizabeth Ames

250 pp.; McGraw-Hill, 2014

but we have a pitiful and fragile recovery as evidenced by feeble growth, misallocation of credit through government policies, skyrocketing debt, and ongoing economic and financial volatility.

Forbes and Ames lay much of the blame for this state of affairs on unstable money:

Unstable money is a little bit like carbon monoxide. It’s odorless and colorless. Most people don’t realize the damage it’s doing until it’s very nearly too late. A fundamental principle is that when money is weakened, people seek to preserve their wealth by investing in commodities and hard assets. Prices of things like housing, food, and fuel

start to rise, and we are often slow to realize what’s happening.

The authors offer detail in rapid-fire succession on a number of diverse topics at the core of our financial and monetary system:

- **A detailed look at money and its three roles:** measure of value, instrument of trust that permits transactions, and a system of communication. Most of this is basic Economics 101 and can be skimmed by most readers.
- **Money and trade:** The authors assess the distortive approach that many economic analysts take in addressing this topic by focusing solely on the level of the merchandise trade deficit. Again, this is basic Economics 101, updated for many of today’s monetary and financial events.
- **Why inflation is not a good thing:** addresses the phenomenon of quantitative easing (“The biggest monetary stimulus ever had produced the weakest recovery from a major downturn in American history”) and the question of why there has not been more infla-

tion, notwithstanding all of the monetary easing. The authors’ answers to these questions focus on weakness in the methodology for the calculation of inflation; recent increases in the prices of commodities, in particular gold; and the fact that we are now in “uncharted territory” with regard to quantitative easing. The last point is the most important, as the jury is still out on the risk of inflation. Forbes and Ames properly focus on the economy in 2000 and the recession that began in 2001 as an inflection point for the monetary strategy that has so greatly contributed to the churning and volatility in the economy for the past 14 years of uncertainty. They end this chapter with the right question, “Should the Federal Reserve really be in the business of fine-tuning the economy?”

- **Money and morality:** chronicles the social unrest and instability that historically flows from debasement of currencies. Forbes and Ames note the oft-told story of the German Weimar Republic and draw from John Locke to support their contention that “the debasement of money drives a fissure into the core of society by defrauding both lender and borrower.” They then bring the moral issues to the most recent financial crisis, citing the social unrest in countries throughout Europe, tensions in the Middle East during the Arab Spring protests, the Occupy Wall Street movement in the United States, the expansion of government corruption, and the breakdown in what they call “trust assurance mechanisms” like credit review procedures and bond credit ratings. The authors complete this chapter on an ominous note by returning to a historical example:

By 476 A.D., when barbarians wiped the empire from the map, Rome had committed moral and economic suicide. Romans first lost their character. Then, as a consequence, they lost their liberties and ultimately their civilization. Will that be us?



For those who regularly follow the economic and financial industry (through the *Wall Street Journal*, Bloomberg, CNBC, etc.), most of this early analysis will be familiar and not particularly earth-shattering. But it represents a good review in preparation for the core of the book, which is the argument for a 21st century gold standard:

We need gold because, as we've emphasized throughout this book, gold is the best and the only way to achieve truly stable money. Relinking the dollar to gold would eliminate the economic volatility and monetary crises that have been the consequences of fiat money. It would stop the erosion of our wealth that is taking place today as a result of Fed-engineered inflation. With a gold standard, *there would be no inflation.*

The authors then summarize their ideas for a gold standard in list format, addressing in turn: four options for the gold standard, the recommended features for a gold standard for the 21st century, and some myths and misconceptions about the gold standard. The last section is probably the most useful as it counters gold standard critics by addressing one-by-one many of the common criticisms of the gold standard: the extent of price volatility for gold, limitations on the supply of gold to sustain a gold standard today, the gold standard being among the causes and prolongation of the Great Depression, and the ability of speculators to undermine a gold standard.

I should note that some of the authors' responses to those concerns are not completely satisfying. For example, they lay the blame for the Great Depression on the Smoot-Hawley Tariff Act, which is a tremendous oversimplification.

The most convincing of their arguments for a gold standard relates to politics:

Gold takes decisions about the value and supply of money out of the hands of bureaucrats whose judgment is too often in error or driven by politics... A gold standard puts the lid on the shenanigans politicians like to use for

political gain. We've all seen the effects of leaving monetary and fiscal discretion in the hands of politicians and their appointees: chronic inflation and chronic government debt.

A few final comments on the overall style of Forbes and Ames are in order at this point.

It is hard to measure with any type of metric, but the authors rely on the opinions of others a great deal, quoting them at length and to what seems an outsized extent. As a reader I generally expect authors to predominantly present their own interpretations and opinions on the topic at hand.

Additionally, the topic of money itself can be dense. Presenting the material in a variety of formats—not only with words but also with tables and graphs blended in—is ideal. Economist Alan Blinder effectively uses graphs and tables, although I do not agree with him on policy. However, Forbes and Ames almost exclusively describe matters of money through words. In fact, I could find only one graph and not a single table in their book.

**Tales of HFTs** / *Flash Boys: A Wall Street Revolt* is another in a series of Michael Lewis's trademark genre of financial journalism. Like his classic book *The Big Short*, he absorbs himself in a topic by interviewing a myriad of people working in the industry segment under scrutiny and then weaves a narrative of the most interesting characters into an entertaining, humorous, gripping, and profanity-sprinkled read. It should be noted that Lewis's stories are not heavy on financial sector policy; in fact, I purchased and began reading *The Big Short* back in 2010 when I was writing my own book on the financial crisis, but abandoned Lewis's book less than halfway through.

His new book places the strategy of "high frequency traders" (HFTs) in the worst of lights. HFTs are traders who use

algorithms to trade securities and, according to Lewis, "front-run" the trades of others—this is where traders are tipped off to the demand for a stock on one exchange and buy it at a lower price on another and arbitrage. Those who follow this strategy make mere pennies per trade, but cumulatively make massive profits in essentially

risk-free trades. Lewis argues through his storytelling that because of HFTs, the market is "rigged" and is essentially a "fraud." He puts the story in an "us against them" construct, where "ordinary investors" are getting screwed by the HFTs. This is ominously stated on the book jacket, which warns "if you have any contact with the market, even a retirement account, this story is happening to you."

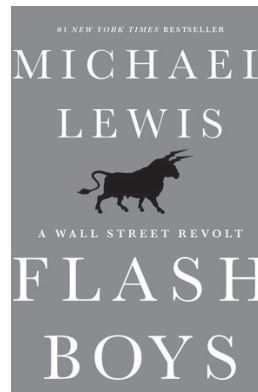
According to Lewis, HFTs dominate the market, not because they are doing a better job of delivering their services like true capitalists, but

because of the convoluted business model and technological basis for HFTs' trading. That supposedly gives an advantage to those firms who figure out how to cut milliseconds off trading times through time-staking placement of servers and fiber optic cable wires. As Lewis summarizes it:

The U.S. stock market was now a class system, rooted in speed, of haves and have-nots. The haves paid for nanoseconds; the have-nots had no idea that a nanosecond had value. The haves enjoyed a perfect view of the market; the have-nots never saw the market at all.

The heroes in Lewis's one-sided saga are a motley crew of characters who work on putting together a platform to counteract the convoluted strategies of the HFTs through a competing stock exchange:

- Brad Katsuyama, the book's lead character and a former trader for Royal Bank of Canada (RBC), who after years of working in the market had an epiph-



**Flash Boys: A Wall Street Revolt**

By Michael Lewis

274 pp.; W. W. Norton, 2014



## IN REVIEW

any regarding the inherent unfairness in the market:

That's when I realized the markets are rigged. And I knew it had to do with the technology. That the answer lay beneath the surface of the technology. I had absolutely no idea where. But that's when the lightbulb went off that the only way I'm going to find out what's going on is if I go beneath the surface.

He later led the creation of the IEX in 2012, an exchange that is now competing head-to-head with the other exchanges tainted by HFTs, by leveraging its distinct business model.

- Rob Park, a former co-worker of Katsuyama's when they developed RBC's trading algorithm. He was hired by Katsuyama to help him investigate what was "beneath the surface."
- Ronan Ryan, an Irish immigrant, who stayed behind in the United States after his dad returned to Ireland following a work stint here. A self-described "tech guy" who always had a desire to work on Wall Street, he joined Katsuyama's cause because of his knowledge of "the frantic competition for nanoseconds."

An additional featured character not connected with Katsuyama is Sergey Aleynikov, a Russian computer programmer who immigrated to the United States and ultimately worked at Goldman Sachs, patching up their old trading platform. He departed Goldman to work for a new hedge fund in order to develop an entirely new trading platform. He was later arrested by the Federal Bureau of Investigation and charged by the government with stealing code from Goldman Sachs. Lewis explains his focus on Aleynikov

I'd thought it strange, after the financial crisis, in which Goldman had played such an important role, that the only Goldman Sachs employee who had been charged with any sort of crime was the employee who had taken something from Goldman Sachs.

Lewis does not directly delve into the policy implications for HFTs, but it is clear from his narrative that he thinks something needs to be done about them. Throughout the book he takes shots at HFTs on a number of fronts: the two-tiered system that they reveal, the role of HFTs in causing so-called "flash crashes" where there is a dramatic drop in the stock price of a single firm or the market as a whole, and their role in undermining market integrity. Despite his complaints, I find Lewis less convincing than Holly Bell's July 2013 *Cato Policy Analysis* ("High Frequency Trading: Do Regulators Need to Control this Tool of Informationally Efficient Markets?" #731) argument that HFTs in general are not bad things and they cannot be blamed for Lewis's list of market ills.

Not surprisingly, Lewis's book has caused a divide on Wall Street. The response of William O'Brien, president

of BATS Global Markets, in a debate with Lewis and Katsuyama is typical ("The Great HFT Debate with Michael Lewis on CNBC," available on YouTube): "The first thing I'd say is, Michael and Brad, shame on both of you for falsely accusing literally thousands of people and possibly scaring millions of investors in an effort to promote a business model."

But Katsuyama gets it right when he responds that the "market [is] providing the solution," as demonstrated by his IEX. If HFTs really are a problem, IEX will prosper and be copied; if not, it will fade away.

For me, the policy divide over HFTs is much ado about nothing. As a small, individual investor, I don't feel like I have been cheated by the HFTs, as I am in the market for the long run. The best way to look at *Flash Boys* is that it is an entertaining read—but not an important policy analysis. **R**

## Adam Smith's Guide to Living

◆ REVIEW BY DAVID R. HENDERSON

The great 18th century economist and moral philosopher Adam Smith published two major treatises during his lifetime. The better-known *Wealth of Nations* (*WN*), published in 1776, is one of the first landmark economics books and some claim that it was the start of political economy. In it, Smith argues that for the well-being of the vast majority of people to improve steadily, the government must play a limited role: providing defense and protection, building some infrastructure, and not much else. He also argues that economic freedom harnesses self-interest, so that by doing well for ourselves, within the bounds of justice, we do good for our fellow man.

His earlier book, *The Theory of Moral Sentiments* (*TMS*), published in 1759, is different. In it, he discusses how we should behave toward each other. He puts much less weight on self-interest and highlights beneficence toward our fellow humans.

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](http://www.econlog.econlib.org).

Did the 17 years between the books cause him to become less optimistic about the fundamental nature of human beings? One might think so. But in *How Adam Smith Can Change Your Life*, economist Russ Roberts makes a persuasive case that Smith did not change at all, but was merely addressing two different questions. In *WN*, Smith explains that an increasingly extensive division of labor, which causes us to depend more and more on the actions of strangers who are more and more distant from us, makes us better off. The self-interest of these strangers causes them to work for us even if they never hear of us. According to Roberts, *TMS* by contrast "is overwhelmingly a book about the people closest to us, the ones we can actively sympathize with—

our family, our friends, and our immediate neighbors.” George Mason University economist Daniel Klein, whom Roberts references, believes *TMS* is about political ethics as well as private morals. Nevertheless, they both agree, as did the late Ronald Coase, there is no contradiction between *WN* and *TMS*.

Roberts’ goal, at which he succeeds admirably, is to elaborate on Smith’s insights in *TMS*, explaining many passages from the 1759 book and making the insights vivid through contemporary examples from his own life and the modern world. Toward the end, Roberts shows that even in *TMS*, Smith had some things to say about how intrusive governments can cause problems.

**Being lovely** / Roberts does a marvelous job of explaining Smith’s insights about humans. Nine of the 10 chapters are on particular themes in Smith’s book, including how to know yourself, how to be happy, how not to fool yourself, how to be loved, and how to be lovely.

In one chapter, Roberts introduces his own law, “The Iron Law of You.” It states that you care more about yourself than you do about others and that others care more about themselves than they do about you. We can offset this, Roberts writes, by paying attention to the person whom Smith called “the impartial spectator.” Who is this spectator? God? No. Roberts writes that it’s a kind of human being looking over our shoulder, one who thinks beyond us and our narrow concerns.

How do we become happy? Smith wrote, “Man naturally desires, not only to be loved, but to be lovely.” If we figure those two things out, we will be happy. And by being lovely, Smith meant being worthy of being loved. If we strive to be lovely, Roberts writes, then we will be loved.

That raises the question, how do we become lovely? There are two important

elements. The first is to observe propriety. This means, according to Roberts, meeting the expectations of those around us: acting in the way they expect, which makes it easier for them to interact with us. Roberts gives many examples, ranging from saying “please” and “thank you” to sympathizing with people in their moments of grief.

But what if people’s expectations of us are improper? Roberts doesn’t raise this question explicitly, but he addresses it using Smith’s conception of virtue. Virtue, for Smith, involves prudence, justice, and beneficence. In modern terms, writes Roberts, prudence means “taking care of yourself”; justice means “not hurting others”; and beneficence means “being good to others.”

The prudent man, claims Roberts, does not smoke, is “physically active and keeps his weight under control,” and “works hard and avoids debt.” On debt, I must part company. It was by taking on what seemed like a massive debt at the time—1986—that my wife and I managed to buy a house in coastal California. I doubt that Roberts would have criticized our decision even prospectively. So I think he must mean something like “avoids too much debt” or “consistently spends beyond his means.”

Being just is relatively easy to understand: don’t cheat. It’s important, note both Roberts and Smith, not to cheat in even little ways. If we do, there will be, writes Smith, “no enormity so gross of which we may not be capable.”

Beneficence is harder to define. According to Smith, the rules of beneficence are “loose, vague, and indeterminate.” Roberts writes that some of its aspects are “friendship, humanity, hospitality [and] generosity.”

He discusses his challenges in following these rules while raising four children. One beneficent rule he created was always to take his daughter’s or son’s hand when offered. A

rule I created for myself before my daughter was a year old was, when she asked me to play with her or do anything with her, to say yes at least 90 percent of the time.

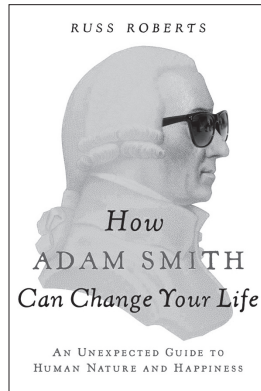
**Good and bad systems** / The two chapters most directly relevant to readers of this magazine are “How to Make the World a Better Place” and “How Not to Make the World a Better Place.” In the former chapter, Roberts discusses a range of phenomena, from the evolution of language, to men wearing hats, to traffic patterns—all of which Adam Ferguson, a Scottish contemporary of Smith, called “the result of human action, but not of human design.”

In Roberts’ view, thinking “clearly about the complex interaction of individual actions that lead to unintended patterns of predictable and orderly outcomes” is “the single deepest contribution of economics to understanding how the world works.” Roberts notes the irony that Smith’s most profound thoughts on the ways in which we benefit others without particularly intending to do so are found more in *TMS* than in *WN*. The bottom line here is that to make the world a better place, we need to be good people. We are not likely, on our own, to make the bigger world much better, but we should do our share.

To take an example from my own life, I don’t believe that the few hundred dollars I give to each of four or five charities every year will have a noticeable effect on the world. And yet I do give because I feel an obligation to give to charities that do good. As Roberts writes, “When you behave with virtue, you are helping to sustain” a system of norms and informal rules.

In “How Not to Make the World a Better Place,” Roberts highlights Smith’s criticism of what he called “the man of system” and what I call “the life arranger.” Smith writes that the man of system

seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. He does not consider that the pieces upon the chess-board have no other



**How Adam Smith Can Change Your Life**

By Russ Roberts  
251 pp.; Portfolio/  
Penguin, 2014

## IN REVIEW

principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might chuse to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably, and the society must be at all times in the highest degree of disorder.

Roberts gives examples of “men of system,” ranging from extreme mass murderers—Pol Pot, Stalin, and Mao (I would have added Hitler)—to the less extreme

examples we see in the United States: those who decided to invade and try to remake Iraq and those who think the government can achieve good results with the drug war.

Roberts writes that people often “have trouble remembering that there are other ways of changing the world than using legislation.” He takes the example of smoking. Per-capita consumption of tobacco in the United States “fell by 50 percent in the last half of the twentieth century.” Admittedly, some of this was due to higher taxes on cigarettes and restrictions on where one can smoke. But most of those restrictions came along within the past 20 years, by which time much of the decline had already occurred. Roberts writes, “Smoking is no longer cool or hip.” Great change happened because individual people decided to change.

Men of system, take note. And get lost. **R**

new goods. Instead of merely “adding more to something familiar,” of going from one to some finite number on an allegorical scale of innovation, they go from zero to one, approaching infinite growth.

**Entrepreneurial reflections** / Business management theory is a very soft field, often based on slogans and fads. Looking over the past decades, think of such management-techniques-cum-mantras as “management by objectives,” “the pursuit of excellence,” “employee empowerment,” “business process engineering,” “core competencies,” and “six sigma,” not to mention the Japanese model, business ethics, “corporate social responsibility,” and corporate governance.

Thiel should not be held to standards that full-time management gurus do not reach. Moreover, he is more interested in entrepreneurship and the creation of new businesses than in dry management of established dinosaurs. The entrepreneurship he practices and preaches resembles the Kirznerian type (after Austrian School economic theorist Israel Kirzner), defined as the mysterious alertness and ability to see opportunities that nobody else notices. You need to “have secrets,” writes Thiel—that is, “specific reasons for success that other people don’t see.”

It follows that entrepreneurship is not teachable: “The paradox of teaching entrepreneurship is that such a formula necessarily cannot exist.” It is no surprise then that *Zero to One* has problems explaining it.

Thiel’s musings are often original. For example, “a valuable business must start by finding a niche and dominating a small market.” Grand missions and big plans are necessary. Founders should be “unusual individuals” who “lead companies beyond mere incrementalism.” But even if an entrepreneurial company should mimic a cult, “you also need a structure to keep everyone aligned for the long term.” “A bad plan is better than no plan” (emphasis in original).

The reader may find some of Thiel’s management principles a bit too obvious, like “sales matter just as much as prod-

## From More than Zero to Less than One

◆ REVIEW BY PIERRE LEMIEUX

Peter Thiel co-founded PayPal in 1998. The intention was “to create a new internet currency to replace the U.S. dollar ... [with] a digital currency that would be controlled by individuals instead of governments.” After selling the company to eBay, he became a very successful venture capitalist, including being the first outside investor in Facebook. Another startup in which he has invested is SpaceX, the private space flight company whose reusable rockets are “the key to making human life multi-planetary,” according to the company’s website. He is now a billionaire.

Thiel is also an avowed libertarian. He expounded his version of libertarianism in “The Education of a Libertarian,” published in the April 2009 *Cato Unbound*. Unlike most Silicon Valley entrepreneurs, his political contributions go to Libertarian and Republican candidates. He has financially backed the Seasteading Institute, which aims to

create autonomous communities on man-built structures at sea.

Now he has published *Zero to One*, a book in which he offers insights into business innovation and economic growth. It is more than the typical billionaire’s ghost-written book: it is based on the notes taken by a student—Blake Masters, the book’s co-author—in a class Thiel gave at Stanford University in 2012.

In the book, Thiel explains how successful startups—those that change the world—are created and managed. He argues that they are monopolies and that, in terms of economic growth, monopolies are preferable to market competition because successful monopolies typically create completely



ucts,” or “creating value is not enough—you also need to capture some of the value you create.” But perhaps obvious things need to be repeated.

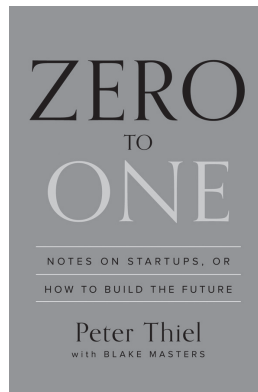
Yet Thiel yields to the management guru’s temptation. He has seven questions that, if all answered positively, will ensure that you “master fortune and succeed.” His venture capital fund claims to “never invest in a tech CEO that wears a suit.” (Applicants for Thiel’s venture money take notice!) In a new venture, “working remotely should be avoided.” He postulates that “a startup messed up at its foundation cannot be fixed.” Obscure

rhetoric is just around the corner: “no company *has* a culture; every company *is* a culture.”

Sometimes, he pushes his ideas too far and spreads them too thin. He seems to favor a very nonevolutionary vision of progress: “How can the future get better if no one plans for it?” He criticizes the use of Darwinist evolution “to build a better society,” apparently unaware of Hayek’s argument that Darwin borrowed the concept of evolution from social scientists, not the other way around.

It is fashionable to criticize economists and they sometimes deserve it. Thiel falls prey to a strand of libertarian thinking that rejects rational choice. “In economics,” he argues, “disbelief in secrets leads to faith in efficient markets.” He ignores that markets tend to be efficient precisely because intuitive and enthusiastic entrepreneurs go against conventional wisdom, incorporate new information in prices, and push the market closer to its equilibrium.

He also seems under the influence of another, sometimes parallel, strand of populist libertarianism that rejects the usefulness of formal, standardized learning in favor of practical deeds and traditional knowledge. He offers fellowships



**Zero to One: Notes on Startups, or How to Build for the Future**

By Peter A. Thiel with Blake Masters

224 pp.; Crown Publishing, 2014

that pay chosen students *not* to go to college. There may be a contradiction here between the espousal of populism and the implicit elitism of contrarian entrepreneurs and thinkers, but Thiel does not explore the issue.

**Competition and monopoly** / Thiel, whose formal training is in law, seems to hold economics in high suspicion. He gets many things right when he stays close to what he knows—when he defends the usefulness of technological progress, for example. But economic analysis would have saved him from some errors—or, at least, would

have helped him argue his case better.

Consider his take on competition, monopoly, and capitalism. We can summarize his argument in four points:

- Economics puts too much emphasis on competition, “the ideal and the default in Economics 101.”
- Monopoly, not competition, is the goal of business: “*Monopoly is the condition of every successful business* [emphasis in original]. ... All failed companies are the same: they failed to escape competition.”
- “Most businesses are much closer to the extreme of monopoly than we commonly assume.”
- “Capitalism and competition are opposites.”

These statements are either incomplete or incorrect, for the following reasons:

**Not all of economics overemphasizes competition.** Many economists, no doubt, have mistakenly taken the explanatory model of perfect competition as an exact ideal to be imposed onto real markets, as in antitrust crusades. Yet, there is a positive reason for sticking to competition as an explanatory model: it often provides the best model to describe what happens in

the real world, just as a Euclidian line with zero thickness is useful to measure real-world lines. At the normative level, competition does have large benefits: the tendency toward a competitive equilibrium allows consumers to get what they want at the lowest possible price.

Perhaps it is true that monopoly “can allow a business to transcend the daily brute struggle for survival.” But a free economy works for the benefits of consumers, not producers. Of this, the competitive model serves as a constant reminder.

**It is because businesses want monopolies that competition exists.** Thiel himself seems to understand this: “The dynamism of new monopolies itself explains why old monopolies don’t strangle innovation.” So why the criticism of competition? When “monopolies” compete or face potential competitors, we have a competitive system, not a monopolistic one.

**There are no monopolies on a free market.**

The problem with Thiel’s focus on monopolies might be a matter of definition. But some definitions are more fruitful than others. It is useful to view a monopoly as a single firm protected from competition by legal constraints to entry in its industry. Thiel correctly opposes such constraints and emphatically states that the good monopolies he argues for are not the state-protected variety. But then he tends to forget that there is no monopoly when many firms compete, even if they are not equal.

There is a more fundamental argument against seeing monopolies everywhere. As Thiel himself suggests (without following through on the idea), determining whether there is competition or monopoly depends on how one defines the relevant markets. Google has 68 percent of the search-engine market, which it uses for advertising, but only 3.4 percent of the global advertising market and only 0.24 percent of the consumer tech market (the figures are from Thiel). How one defines a market is essentially arbitrary, so each firm can be thought of as either a tiny monopoly or an atomistic competitor in the larger market. What



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Thiel call “monopolies”—Google, Apple, PayPal, etc.—are only large companies that have dominant positions in some markets.

**The opposition of capitalism and competition is not useful.** One can define capitalism and competition as one wants, including in opposition to each other. But defining capitalism as an economic system where there is no competition easily leads to many errors. One is to forget the consumer in favor of the producer. Another error is to underplay the importance of freedom to enter markets and freedom to compete—those freedoms being what really matters if we are interested in economic efficiency and consumer welfare.

**Poor economics** / In his 1973 book *Capitalism and the Permissive Society*, Samuel Brittan expressed dismay at how inefficient capitalists were at defending capitalism, but noted that “businessmen are paid to operate the system rather than understand or expound it.” I would add that great entrepreneurs get their money for the new opportunities they offer to consumers, but their economic and social theories are not necessarily outstanding.

*Zero to One* does have the benefit of emphasizing entrepreneurship, but one would not use the book to teach either political philosophy or economics. Consider the nature of value. Why does something have value? Thiel makes the strange claim that Google creates less value than the airlines. To reach that conclusion, he equates a firm’s value with its revenues or profits. A few centuries of economic analysis teach that value is the “utility” (satisfaction of preferences) that individuals get from exchange. If we use a partial equilibrium framework, we can (conceptually) calculate value as the consumer surplus—that is, the difference between what consumers would have been willing to pay for something and what they actually have to pay. Profits or rents translate into value only because they allow their recipients to get their own consumer surpluses when they spend their money as consumers. It is thus very likely that

Google creates much more value than Thiel assumes.

To take another example, he compares the revenues of venture capital-backed companies with gross domestic product, of which the companies represent “an astounding 21 percent.” This is only astounding because it compares revenues (total sales) of some companies with value added (profits) in the whole economy, GDP being the sum of the latter, not of the former.

## Sunstein’s Knowledge Problem

REVIEW BY PHIL R. MURRAY

In the layman’s way of thinking, a regulation that saves just one life is worthwhile regardless of its costs. In the economic way of thinking, a regulation that saves just one life is worthwhile only if it costs less than the value of a life. Cass Sunstein expands on this economic way of thinking in his new book, *Valuing Life*. In it, he documents his experience overseeing the Office of Information and Regulatory Affairs (OIRA) in the early years of the Obama administration, explains how the regulatory apparatus works, and shares his views on “humanizing” the process.

By “humanizing the regulatory state,” Sunstein wants to accomplish four objectives. The first is to justify a widespread application of cost-benefit analysis. He puts it this way: cost-benefit analysis “should see costs and benefits not as arithmetic abstractions, but as efforts to capture qualitatively diverse goods and to promote sensible trade-offs among them.” His second objective is to recognize “nonquantifiable” factors such as “dignity,” “equity,” and “privacy.” The third is to incorporate behavioral economics into cost-benefit analysis, and the fourth is “to collect the dispersed information held by a nation’s citizenry” and use that to formulate regulations.

**OIRA’s work** / Sunstein wants to remedy the

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*Zero to One* is a small, easy-to-read book in which the reader will learn about what a great entrepreneur and libertarian visionary thinks. Some of this is interesting but intellectually light. There is not a single footnote in the book, so the reader cannot check sources. On the positive side, Tyler Cowen endorsed the book. But I suggest that it will, at best, only take your social and economic understanding from more than zero to less than one. R

“poorly understood” operation of OIRA, which neither originates nor rubber-stamps regulations. “It would not be excessive,” in his view, “to describe OIRA as, in large part, an information aggregator.” By gathering this “specialized information” and “dispersed information,” he sees OIRA trying to overcome the “knowledge problem” outlined by Friedrich Hayek.

OIRA aims “to promote a well-functioning process of public comment, including state and local governments, businesses large and small, and public interest groups.” Sunstein describes this as “regulatory due process.” There are four essential aspects of OIRA procedure:

- OIRA incorporates “interagency views.”
- The discussion of these interagency views explains why the OIRA procedure may be long and drawn out.
- Even though OIRA focuses on costs and benefits, it concentrates more on “interagency concerns, promoting the receipt of public comments (for

proposed rules), ensuring discussion of alternatives, and promoting consideration of public comments (for final rules).”

- OIRA’s work is “technical,” relating to economics, science, the law, etc.

*Valuing Life* is not a manual with detailed instructions on how to calculate costs and benefits. Sunstein presents dozens of “highly stylized problems” with the costs and benefits given, and tells us how the process will continue from there. The simplest problem he presents is a regulation that costs \$200 million per year and generates \$400 million in benefits per year. “In the process of OIRA review, the numbers will be carefully scrutinized, and many questions will be asked about their accuracy and meaning,” he assures us, “but if those questions have good answers, this is an easy one in favor of proceeding.”

As part of that work, government agencies estimate a “value of a statistical life (VSL).” Sunstein explains: “Suppose that workers must be paid \$900, on average, to assume a risk of 1:10,000. If so, the VSL would be said to be \$9 million.” For an alternative approach to reach the same VSL, suppose that one in 10,000 firefighters will die on the job and the typical firefighter is willing to pay \$900 to eliminate that risk. Multiplying \$900 per firefighter by 10,000 firefighters yields \$9 million, which is the value of eliminating the risk necessary to save one firefighter’s life. The simplest problem Sunstein presents that involves a life-saving regulation costs \$300 million per year and saves 40 lives. Using the \$9 million VSL, the benefits of the regulation amount to \$360 million and “the regulation will likely go forward.” Note that if this regulation were to save just one life, it would be a mistake to implement it because the costs would exceed the benefits.

**Humanizing regulation** / What circumstances make a problem more challenging? Take a regulation that costs \$200 million per year. The agency proposing it estimates that it will save 24 people from dying of cancer, and the VSL is \$8 million. Although the benefits in this case in terms of lives saved (\$192 million) are less than the costs, “it will be acceptable for the agency to do a sensitivity analysis in which it increases the VSL because cancer is involved.” This is one instance in which Sunstein advocates “humanizing” regulations.

Consider his reasons for humanizing regulations related to cancer. “For example,” he reports, “some evidence suggests that people are willing to pay high amounts to avoid cancer risks, and hence there is reason to think that people’s VSL is higher for cancer risks than sudden, unanticipated deaths.” Perhaps a greater aversion to death from cancer than, say, a heart attack is rational. Sunstein adds that “all cancer fatalities are

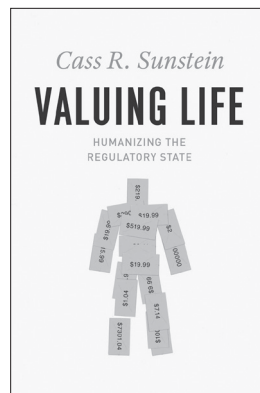
not the same; informed people would surely make distinctions between those that involve long periods of suffering and those that do not.” Despite people’s greater willingness to pay to avoid some risks over others, OIRA does not “distinguish among mortality risks” and never has. However, an agency may do “sensitivity analysis,” add a “cancer premium” to the VSL, and possibly “conclude that the benefits ‘justify’ the costs.” That would amount to the same thing as computing different VSLs based on different risks, would it not?

Sunstein is well known for using insights from behavioral economics to shape public policies. In *Valuing Life*, he describes a behavioral slip-up dubbed “probability neglect” that relates to cancer risk. “People fall victim to probability neglect,” he explains, “if and to the extent

that the intensity of their reaction does not greatly vary even with large differences in the likelihood of harm.” Take the results of an experiment Sunstein and a colleague conducted with their law students. They queried a first group “to state their maximum willingness to pay to eliminate a cancer risk of 1 in 1 million.” They put the same question to another group but increased the risk of cancer to one in 100,000. A third group faced the same question as the first, plus “the cancer was described in vivid terms, as ‘very gruesome and intensely painful, as the cancer eats away at the internal organs of the body.’” The fourth group faced the same question as the second, along with the “emotional description” of cancer.

If the subject of cancer causes people to neglect probability, their willingness to pay to eliminate a risk of one in 100,000 will be less than 10 times that for a risk of one in 1 million. That is what Sunstein and his colleague found when asking questions both with and without the “emotional description” of cancer. They also expected that adding the emotional description would cause greater probability neglect, and confirmed that, too. Subjects who heard the emotional description stated a mean willingness to pay of \$211.67 to eliminate the one in 1 million risk of cancer, compared to \$250 to eliminate the risk of one in 100,000. “When the cancer was described in emotionally gripping terms,” in other words, “people were insensitive to probability variations.”

This reviewer doubts that we should attach much weight to a single experiment involving 67 students at Harvard Law School. Nonetheless, Sunstein draws from it “two implications for the public reaction to emotionally gripping events.” One is that “simply because such events arouse strong feelings, they are likely to trigger a larger behavioral response than do statistically identical risks that do not produce emotional reactions.” This is the rationale an agency uses when considering a “cancer premium” along with other benefits of a regulation designed to



**Valuing Life: Humanizing the Regulatory State**

By **Cass R. Sunstein**  
248 pp.; University of Chicago Press, 201

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reduce the risk of cancer. Another implication is “that probability neglect might well play a role in the government’s reaction to emotionally gripping events, in part because many people will focus on the badness of the outcome, rather than on its likelihood.”

This point raises the question of what the government should do when events such as terrorism raise the public’s alarm. On the one hand, it would be wise to do nothing. “There is a strong argument that government should not respond,” Sunstein reasons, “if the relevant risks are very small and if the requested steps have costs in excess of benefits.” There is also a role for the government “to inform and educate people” whenever the probability of a tragic event is low. “But if information and education do not work,” Sunstein continues, “government might be willing to consider regulatory responses to fears that are not fully rational, but real and by hypothesis difficult to eradicate.”

He is not using probability neglect as an excuse to open the door wide for more regulations. He warns that “a special difficulty here consists in the problem of quantifying and monetizing fear and its consequences.” Quantification and monetization are more ways of “humanizing” regulations.

He presents a scenario in which the costs of a regulation “to make buildings more accessible to people who use wheelchairs” exceed the “monetized benefits.” Officials proceed with the regulation, nevertheless, by making a case that the value of “human dignity” to wheelchair users makes up for the deficiency of monetized benefits. Sunstein cites the actual reasoning of Justice Department officials from a document pertaining to the Americans with Disabilities Act: “Dividing the \$32.6 million annual cost by the 677 million annual uses [of water closets with doors that open outward, making them more accessible], we conclude that for the costs and benefits to break even in this context, people with the relevant disabilities will have to value

safety, independence, and the avoidance of stigma and humiliation at just under 5 cents per use.” It seems plausible that this lower bound on the value of human dignity would justify the costs of modifying such water closets. Sunstein recognizes “objections” to quantifying or monetizing benefits, though he continues to advocate those practices.

**Moral heuristics** / I had suspected that Sunstein was eager to regulate. In *Valuing Life*, however, his presentation of behavioral economics causes me to reconsider.

“Heuristics” are “mental shortcuts” that people use when making decisions. Even though they may be reliable sometimes, they may also produce bad outcomes. For anyone who ever asked whether behavioral economists ever cite the anomalies they are so fond of to make a case *against* regulation, Sunstein’s explanation of “moral heuristics” is evidence that he, for one, does.

Take the “Precautionary Principle,” which according to Sunstein “is designed to insert a ‘margin of safety’ into all decision making, and to impose a burden of proof on proponents of activities or processes to establish that they are ‘safe.’” (See “The Paralyzing Principle,” Winter 2002–2003.) That idea sounds reasonable initially. But Sunstein deems it “incoherent.” “The reason,” he explains, “is that risk regulation often introduces risks of its own.”

His critique is so effective that this reviewer wonders why the Precautionary Principle is not less popular. “For example,” he continues, “regulation of nuclear power might increase the likelihood that societies will depend on fossil fuels, which create air pollution and emit greenhouse gases.” The following point not only goes against the Precautionary Principle, but too much regulation in general: “By its very nature, costly regulation threatens to increase unemployment and poverty, and both of these increase risks of mortality.”

Heuristics explain the principle’s intuitive appeal. One is the “act-omission distinction,” whereby regulators prohibit

endeavors with visible risks (such as the Keystone XL pipeline) even though prohibition entails less visible risks (war over oil in the Middle East). To be clear, Sunstein does not recognize moral heuristics in order to reduce the number of pages in the *Federal Register*. His goal is to refine cost-benefit analysis. Whether his acolytes show as much restraint when applying behavioral economics to formulate regulations remains an open question.

**Conclusion** / *Valuing Life* contains no battle stories involving regulators, politicians, and lobbyists arguing over any regulation. There are a few glaring errors that may be excused. Pertaining to “a regulation designed to reduce the incidence of prison rape,” Sunstein writes, “If a single rape is valued at \$500,000, the rule would be easily justified if it prevented only 1,600 rapes.” It is safe to assume that he intended to write “if *preventing* a single rape is valued at \$500,000.” Likewise when he wrote “a dollar today is worth less than a dollar tomorrow,” he intended to write “a dollar today is worth *more* than a dollar tomorrow.”

Readers might be surprised to learn that OIRA listens to “businesses and others” who resist regulations on more occasions than it listens to “public interest groups” who favor them. Sunstein claims that OIRA avoids politics. “At least in my experience (and some people will find this surprising),” he admits, “‘politics,’ in the sense of interest-group pressures and electoral considerations, usually does not play a significant role in the regulatory process.”

Although he teaches that there may be too much regulation as well as too little, he maintains that “the financial crisis of 2008 and succeeding years was, in part, a product of insufficient regulation, which could have provided safeguards against systemic risks.” Even the Financial Crisis Inquiry Commission Report, which faults free-market ideology for the crisis, also blames regulatory forbearance. Sunstein emphasizes his appreciation of Hayek. “The Hayekian theme,” he explains,



“emphasizes the dispersed nature of human knowledge and OIRA’s role in attempting to acquire as much of that knowledge as possible, above all through careful attention to public comments.” In his conclusion he acknowledges that “it is an understatement to say that [Hayek] would not have endorsed all of the arguments in this book (much less all of the

regulations that the United States has issued in the name of public health, safety, and environmental protection).” Given the knowledge problem, Sunstein believes that OIRA’s role as “an information aggregator” is an appropriate way to deal with it. One wonders whether Hayek would endorse that approach or judge it quixotic. **R**

director’s cheat sheet, and that makes reading his portion of the book a chore for anyone who dislikes hackery. Fortunately, he does ultimately circle back to discussing the idea that data-driven government will make “people’s lives better.”

Of course, Madden and Wolfson are right in theory that both parties have incentive to learn more about government programs and regulation in order to drive better policy. The hurdle for applying Moneyball to government—as opposed to just one or two instances that happen to follow party dogma—is that statistical analysis will sometimes indicate that a strongly favored program is failing. Perhaps politicians of both parties can accept “Moneyballing” USAID, but what about Social Security or defense appropriations?

Rest assured, Madden, Wolfson, and other book contributors are willing to criticize some government programs. But too often their policy recommendations are for more government, such as establishing whole new offices for policy evaluation. There is a call for a “chief evaluation officer” in every federal agency, agencies setting aside up to 1 percent of each agency’s budget for evaluation, and the establishment of “cross-government prizes for innovative approaches to evaluation.” Supposedly, those actions would lead to agency

innovation where before the agencies were content with mediocrity. Whether the benefits of the new measuring devices are worth the costs is up for debate.

From an agency perspective, the biggest obstacle to evaluation may be fear. In previous Moneyball initiatives (and there have been previous attempts), agencies proved reluctant to change, in part because they feared that success would result in budget cuts from appropriators.

The book devotes significant attention to the distinction between data and evidence. There is plenty of

## ‘Moneyball for Government’ Needs ‘Moneyball’ Politicians

REVIEW BY SAM BATKINS

Beginning in the 1990s, Oakland Athletics general manager Billy Beane gained acclaim for using statistical analysis to identify undervalued players and baseball strategies, which he then used to turn the small-budget team into a consistent winner. Since then, all sorts of analysts have proposed applying similar “Moneyball” strategies to other human endeavors, including government.

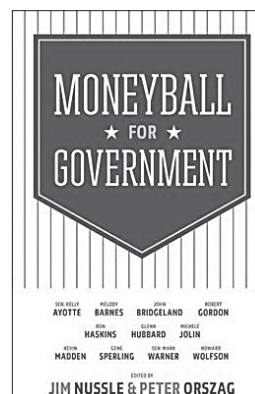
Who could oppose collecting data about government spending, building evidence to implement effective programs, and directing funds away from failing policies? In the new book *Moneyball for Government*, a plethora of writers, policy wonks, and two former heads of the federal Office of Management and Budget make the case that a data-driven approach to government and regulation would create better results at a lower cost to taxpayers.

Data and analytics about how government operates could certainly be improved. But whatever the apparatus that policy-makers establish to measure government, self-interested politicians must still pay attention to the findings and be willing to cut failing programs. Bill Niskanen noted that in these pages many years ago (“More Lonely Numbers,” Fall 2003), and I share his skepticism about that possibility.

But that skepticism may be uncalled for, claim book contributors and political advisers Kevin Madden (a Republican) and

Howard Wolfson (a Democrat). They argue that both sides of the aisle have incentive to play Moneyball with government.

Republicans presumably would benefit by pushing for more efficient government rather than being labeled “antigovernment,” though that distinction may be lost on some Republican politicians. For Democrats, Wolfson proudly trumpets their strong record of fiscal responsibility. He points out that President Obama has recently been reducing the deficit at the fastest rate since World War II—though he doesn’t say that this reduction is from the trillion-dollar deficits Obama rang up early in his presidency. If this represents the authors’ idea of an honest use of data then maybe we should forget the Moneyball endeavor altogether. Wolfson also spouts off standard attack lines on Republicans that sound like they were taken straight from a Senate communications



### Moneyball for Government

Edited by Jim Nussle and Peter Orszag

260 pp.; Disruption Books, 2014

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data on government programs, but as the authors argue, little evidence that demonstrates what is working and what is failing. Initial evidence, through a randomized controlled trial, may reveal that a specific regulation or program is not generating the promised benefits. But even some of the book's contributors don't seem willing to heed such findings, as former agency heads caution that the initial results of such analysis should not portend the end of a program.

That's the problem with policymakers. Scores of analysts can point to failing or wasteful programs, but there will always be a constituency or special interest prepared to defend each program, and they have more at stake in that spending battle than good-government advocates. More data on evaluation will only create a more efficient government if politicians care enough about the data, and there is plenty of evidence today that they do not.

There are several references to the Office of Information and Regulatory Affairs (OIRA) as a paragon for good data and program evaluation. Any critical followers

of OIRA will question that praise. OIRA reviews less than 10 percent of all federal rules each year and while that review might be extensive, political considerations from OIRA's White House overseers are common. What's more, wide swaths of the economy are exempt from its oversight: Dodd-Frank, for instance, is virtually exempt from OIRA review.

More faint praise for OIRA is inspired by its "government-wide" retrospective regulatory review that was done in 2011, and is supposedly continuing today. First, the review wasn't government-wide, as it wasn't mandatory for independent agencies. And while the book's authors may claim that "the lookback process yielded scores of measures to update regulatory regimes," the reality is decidedly different. As Ike Brannon and I have argued in these pages ("First-Year Grades on Obama Regulatory Reform," Spring 2012), many of those updates were in fact just new regulations implementing new programs rather than an honest review of past regimes. Retrospective review has been successful at

increasing the nation's regulatory tab, all under the guise of "reform."

There are dangers in embracing so-called Moneyball for government. New hires designated for program evaluation could face resistance from agencies, just as the Government Accountability Office does currently. One percent budget set-asides for evaluation could evolve into 1-percent add-ons, with few politicians willing to act on the recommendations. And it's hard to see how regulatory capture wouldn't rear its ugly head sooner rather than later in such an arrangement.

That's not to say there aren't good ideas in this book. For one, interagency data sharing that allows the public to view which programs are failing and which are the most efficient will undoubtedly place additional pressure on legislators. But to expect such efforts to result in a government that functions as well as the private sector is optimistic. The federal government is unlikely to function as efficiently as Beane's A's, but performance akin to last season's New York Yankees is within reach. R

## Working Papers BY PETER VAN DOREN

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

### SEC Regulation

"Corporate Governance and the Creation of the SEC," by Arevik Avedian, Henrik Cronqvist, and Marc Weidenmier. September 2014. SSRN #2498007.

"The Costs and Benefits of Mandatory Securities Regulation: Evidence from Market Reactions to the JOBS Act of 2012," by Dharmika Dharmapala and Vikramaditya S. Khanna. July 2014. SSRN #2293167.

**D**oes regulation of stocks and bonds by the Securities and Exchange Commission, with its regime of registration and mandated information provision, create net benefits for investors? In these pages, Michael Greenstone, Paul Oyer, and Annette Vissing-Jørgensen argued in the affirmative ("The Value of Knowing," Summer 2006). They analyzed the effects of

the Securities Acts Amendments of 1964, which extended the registration and disclosure regime to stocks traded "over the counter," and found positive abnormal returns of \$3–\$6 billion. On the other hand, in these same pages Elizabeth de Fontenay compared corporate bonds subject to disclosure requirements with syndicated loans, which are not subject to such requirements ("Putting Securities Laws to the Test," Fall 2014). She found the syndicated loan market to be thriving and growing, suggesting that investors found little value from the registration information requirements.

Now, two new working papers take up this question. The first, by Arevik Avedian, Henrik Cronqvist, and Marc Weidenmier, analyzes the effect of SEC regulation by comparing stocks listed on the New York Stock Exchange (NYSE) with stocks listed on the regional exchanges. The main effect of the 1933 Securities Act was to take NYSE listing standards at that time, convert them into federal law, and apply them to publicly traded firms on regional exchanges. The authors conduct a difference-in-differences analysis of NYSE and non-NYSE firms before and after the act's cre-

ation of the SEC. Their measure is whether a majority of board members are “independent,” meaning they are neither officers nor family members of officers. The authors find a 30 percent reduction in board independence of the regional firms post-SEC, but no change in firm valuation by investors. Firms traded off private and public provision of reassurance. As government supply increased, the private supply of reassurance through board independence was reduced.

The second paper, by Dhammika Dharmapala and Vikramaditya Khanna, examines the effects of the JOBS (Jumpstart Our Business Startups) Act of 2012. The law relaxed disclosure and compliance rules for “emerging growth companies” (primarily those firms with less than \$1 billion in revenue)—whose initial public offering (IPO) of stock was after December 8, 2011. The authors conducted an event study comparing small firms with IPOs between July 2011 and December 8, 2011 to small firms with IPOs between December 9, 2011 and April 5, 2012, when President Obama signed the bill into law. Some 87 firms conducted IPOs between July 2011 and April 5, 2012. The control group contains 33 firms with less than \$1 billion in revenue whose IPO was prior to December 8, 2011.

The authors calculate whether differences in returns between treatment and control firms (so-called cumulative abnormal returns) exist in the event window (February 29 to April 9, 2012) surrounding a prominent March 15 statement by Senate Majority Leader Harry Reid’s (D-Nev.) about the importance of the bill. The event window starts with House Financial Services Committee’s approval of the bill, which included an explicit relaxation of the rules for all IPOs after Dec. 8, 2011, and ends four days after the presidential signing on April 5, 2012. The central result is positive abnormal returns of 3–4 percent for treatment relative to control firms during the event window. Investors reacted as if elimination of the SEC reporting requirements for small firms created net benefits that were reflected in positive abnormal returns.

## Cash Transfers and Educational Attainment

“Human Capital Effects of Anti-Poverty Programs: Evidence from a Randomized Housing Voucher Lottery,” by Brian Jacob, Max Kapustin, and Jens Ludwig. May 2014. NBER #20164.

**W**hy do poor parents have children who also grow up to be poor? One possible explanation is that poor families do not have access to credit that would allow parents to invest more in the human capital improvement of their children. The policy solution that results from this notion is to increase transfers to poor families in order to remove their credit constraints.

The expansion of the Earned Income Tax Credit (EITC)—which uses the tax system to transfer money to low-income households—

has been shown to increase standardized test scores. But critics argue that factors unobservable to researchers but correlated with EITC receipt are responsible for children’s success, not the EITC transfers.

In this study, Brian Jacob, Max Kapustin, and Jens Ludwig use the 1997 housing voucher lottery in Chicago (the first opening of voucher lists in the city in 12 years). They examine the outcomes 14 years later for children whose families won housing vouchers versus children of families that did not. Families that won the lottery received a very large positive income shock—the equivalent of \$12,000 a year—relative to the average income in the sample (\$19,000 a year).

The authors find very few effects on schooling, crime, or health outcomes and none are significant. “Our estimates imply that extra cash transfers beyond the current level provided in the United States are likely to have a smaller impact per dollar than the best-practice educational interventions explicitly designed to improve children’s human capital,” they write. Their results are consistent with the findings of sociologist Susan Mayer, who concluded in *What Money Can’t Buy* (Harvard University Press, 1997) that there is “little reason to expect that policies to increase the income of poor families alone will substantially improve their children’s life chances.”

## Air Pollution Regulation

“Toward a More Rational Environmental Policy,” by Richard L. Revesz. December 2014. SSRN #2534018.

**R**ichard Revesz, professor of law at New York University, describes five principles that should govern environmental policy:

- Environmental restrictions on emissions should be governed by cost-benefit analysis and maximize net benefits.
- Environmental objectives should be achieved at minimum cost.
- Environmental policies should be implemented with market instruments such as emission prices or tradable emission permits.
- Grandfathering of emission sources introduces fatal arbitrage problems into environmental regulation and should be severely constrained. (See “New Source Review: What’s Old Is New,” Spring 2006.)
- The most compelling case for federal regulation is the control of interstate externalities.

From a libertarian perspective, the fifth principle is the most important. And yet one ironic response of states to the passage of the Clean Air Act amendments in 1970 and 1977 and their requirement that states enact plans to reduce stationary source emissions was to mandate taller smokestacks—a cheap solution that solved



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the intrastate problem by creating an *interstate* problem.

Rather than just reverse course and require the shortening of smokestacks to revert an interstate problem back into a local matter that the states would have to address, the federal courts, Congress, and the U.S. Environmental Protection Agency have been wrestling with the upwind-downwind problem ever since. The record of the courts and the EPA in tackling interstate pollution (at least partially created by the Clean Air Act itself) has not been very good. In 1984 the Sixth Circuit Court of Appeals ruled that an upwind Indiana power plant with no emission controls emitting six pounds of sulfur dioxide per million British Thermal Units (BTUs) of coal combustion had not violated the law even though it contributed almost half of the ambient pollution in downwind Jefferson County, Ky., and the power plant in Jefferson County emitted only 1.2 pounds of sulfur dioxide per million BTUs of coal combustion after investing \$138 million in pollution control.

The EPA did not attempt to deal with interstate air pollution until 1998, during Bill Clinton's second term. That effort was halted by the George W. Bush administration, which instead asked Congress to amend the Clean Air Act and explicitly expand the cap-and-trade market for sulfur dioxide (created by the 1990 Clean Air Act Amendments) to include other pollutants such as nitrogen oxides. The congressional reform attempt ended in 2005 when the bill failed to be approved by the Senate Environment and Public Works Committee on a 9–9 tie vote.

Revesz tells the story of how the courts finally allowed the EPA to implement a pollution reduction plan that minimized costs (specifically an emission rights trading regime) even though Congress failed to explicitly grant such permission through an amendment of the Clean Air Act. (See “An EPA War on Coal?” Spring 2013.) Shortly after the failure of the Senate committee to approve the Bush initiative in 2005, the EPA issued the Clean Air Interstate Rule (CAIR) to implement the Bush proposals administratively. In 2008 the D.C. Circuit Court of Appeals struck down CAIR because a strict reading of the statute was thought not to allow a trading program that reduced emissions based on the cost of reduction rather than the amount of pollution generated.

In 2011 the EPA responded with the Cross State Air Pollution rule, which again allowed the trading of emission reduction quotas, but with constraints so that all upwind states would have to reduce emissions rather than simply buy emission rights sufficient to allow their emissions. In 2012 the D.C. Circuit Court of Appeals struck down the Cross State rule because state emission limits were established on the basis of the cost of reduction rather than how much each state's emissions contributed to the downwind ambient result. In 2014 the Supreme Court reversed the D.C. Circuit and concluded reductions could be allocated in a way that minimized aggregate costs.

For Revesz the story is positive because the courts finally allowed policy to be more rational. But that conclusion is possible

only if one thinks that the courts rescuing the legislature from its enactment of “bad” statutes is a good thing and that interstate conventional pollution, itself, was not the unintended result of national attempts to make localities have “better” environments.

## Bank Credit Supply and the Great Recession

“Do Credit Market Shocks Affect the Real Economy? Quasi-Experimental Evidence from the Great Recession and ‘Normal’ Economic Times,” by Michael Greenstone, Alexandre Mas, and Hoai-Luu Nguyen. November 2014. NBER #20704.

**B**en Bernanke's work on the causes of the Great Depression concluded that bank failures were an important contributor to the Depression's length and depth. According to his research, lending was highly localized and the supply of credit to businesses was reduced by local bank failure.

Small firms, which are more reliant on bank lending, suffered disproportionate employment losses during the 2007–2009 “Great Recession.” Mindful of his findings on the Depression, Bernanke and Alan Krueger have both suggested that impaired bank credit markets were a major cause of overall employment losses in the recent recession. Hence, the Bernanke-led Federal Reserve implemented various direct lending programs to financial institutions to “fix” impaired credit markets for firms.

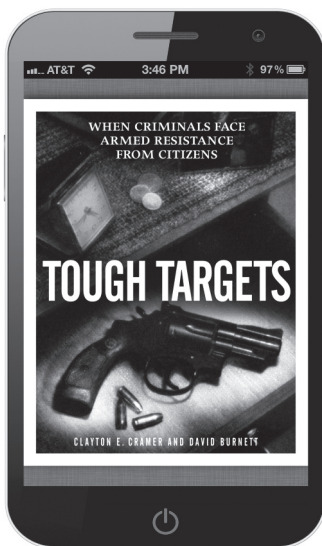
Despite the emergence of a national banking market in recent decades, small businesses still rely heavily on local lenders. The median distance between firms and lenders is only about three miles and only 14.5 percent of firms borrow from a lender located more than 30 miles from the firms' headquarters.

During the last recession, banks reduced their lending to small businesses in widely varying degrees. For example, Citibank reduced small business lending by 84 percent while US Bankcorp reduced its lending by only 3 percent. Michael Greenstone, Alexandre Mas, and Hoai-Luu Nguyen exploit small firms' reliance on local lenders and the differential lending cutbacks among regional banks to create a quasi-experimental research design.

They ask whether counties with more Citibank branches before the crisis experienced a greater reduction in lending and greater economic decline during the recession than counties with more US Bankcorp branches. The answer is yes but the magnitude is small. If you unrealistically consider *all* the lending decline to be supply-driven rather than attributing some of it to a recession-caused reduction in demand, then reduced lending would account for just 0.5 percentage points of the 10 percent decline in small business employment in the recession—about 5 percent of the decline. If you use the upper bounds rather than the average of the 95 percent confidence intervals of the estimated effects, you can explain 13 percent of the decline—a real but small effect. And this is for *small* businesses; larger businesses with access to non-local credit supply would be even less affected, if at all. R

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