The Power of Special Interests

Reviewed by John Samples

LOBBYING AND POLICY CHANGE: Who Wins, Who Loses, and Why
By Frank R. Baumgartner, Jeffrey M. Berry, Marie Hojnacki, David C. Kimball, and Beth L. Leech
360 pages; University of Chicago Press, 2009

THE CASE FOR GRIDLOCK: Democracy, Organized Power, and the Legal Foundations of American Government
By Marcus E. Ethridge
223 pages; Lexington Books, 2010

Interest groups have not always been as American as apple pie. James Madison's Federalist No. 10 focused on factions, "a number of citizens, whether amounting to a majority or a minority of the whole, who are united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interests of the community." Surely such a group should be suppressed. But no; Madison believed the costs of suppression in liberty would outweigh any benefits. He argued the size of the new nation and competition among groups would preclude the dangers of a majority faction. Madison believed majorities would vote down any malign proposals by minority factions.

The public and some scholars have disagreed with Madison on the latter point. Surveys indicate the public believes "special interests" have too much influence in Washington. Economists have offered sophisticated analyses supporting a similar normative conclusion. Mancur Olson argued that the economics of organization foster policies that favor particularistic groups over the larger public. The Chicago School emphasized the likelihood that regulated industries would control their regulators. Gordon Tullock and later analysts in the Virginia School proposed that interest group efforts wasted resources by creating monopolies sanctioned by the state. Lobbying itself wasted resources in the struggle over rents. In general, the economists' critique of interest groups suggested government failure might be more pervasive than market failure.

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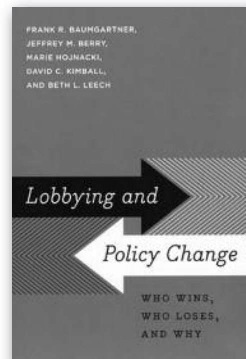

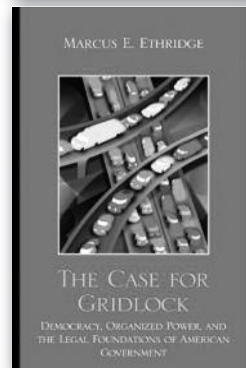

Political scientists have been more divided about interest groups than economists. Pluralists saw politics as a struggle among groups; the winner wrote laws legitimated by government. Pluralists tended to approve of groups as a way to represent citizens and control government. Others argued that lobbyists provided members of Congress with information vital to their re-election efforts. Some critics of pluralism pointed out that not all interests — especially the poor — were represented in the group struggle. The struggle among groups obscured the reality of elite rule. Others argued that pluralism had replaced the rule of law made by legislatures with groups competing for the favor of administrative agencies.

Empirical analysis In *Lobbying and Policy Change*, Frank Baumgartner and his coauthors offer new information about these old debates. They randomly selected 98 issues in which interest groups were involved and followed them from 1999 to 2002. The authors then identified the "sides" on each issue; a side was "a set of actors sharing a policy goal." For the 98 issues, they found 214 sides comprising 2,221 advocates. The data collection involved the authors and dozens of student assistants. Most newspaper accounts focus on anecdotes and particular cases related to lobbying; this study offers enough data on interest groups to support valid conclusions.

Surprisingly, about 40 percent of the advocates were government officials. Some officials may decide who wins the policy struggle, but others are clearly part of the game. Citizens groups "or organizations representing an issue or cause without any direct connection to a business or profession" composed about a quarter of the sample for this study. Such groups were often major players on issues. Trade associations and individual businesses accounted for just over one-third, while trade unions made up six percent of the sample.

Most Washington stories emphasize the victories of individual groups or industries. Baumgartner and his colleagues find that coalitions matter a lot; interests "rarely lobby alone." The urge to association arises from the nature of things: policies have multiple consequences for diverse constituencies. These coalitions comprise strange bedfellows in search of common outcomes. Businesses and citizens groups are not always on opposite sides of an issue. Although businesses have more resources than citizens groups, they oppose each other depending on the issue. Business is not an interest group or a unified force.

Baumgartner and his group are not naïve. Business groups in these data do have more resources in money and lobbyists. Yet their analyses find these resources have little relation to policy outcomes, either for individual groups or for coalitions. They consider several measures of financial power, including campaign contributions and lobbying outlays. This finding counters the expectations of most people, but campaign finance scholars have long found little relation between donations and congressional actions. Baumgartner's group offers the broadest and best support for

that established literature. They do note that while money does not lead to victory or even offer much influence, it does assure a place in the Washington game. The issues of the poor, they argue, are absent from the congressional agenda.

Power of the status quo Baumgartner et al. found for most of these issues that not much happened during the time period they observed. If lobbyists are supposed to foster change, "they are a surprisingly ineffectual lot." The power of the status quo informs almost every page of *Lobbying and Policy Change*. Groups that defend the policy status quo usually have an easy time. Often they need not even mobilize in response to active challenges.

The status quo persists for several reasons. Policymakers have limited attention and hear many arguments favoring changes. Demand for change quickly outstrips supply. Many issues have been fought over for many years; the sides in these struggles are familiar with all the arguments on all sides, creating a gridlock of advocacy as well as lobbying. Defenders of the status quo do well by arguing change will bring uncertain results largely because losses loom larger than gains to policymakers. Policymakers in this study seem to accord the current order a presumption of continuity absent overwhelming evidence of the need for change.

Yet, when the status quo falters, it is "not uncommon for a significant change to sweep aside years of equilibrium." For example, the sulfur content allowed in gasoline changed little over many years. Clinton's Environmental Protection Agency then reduced the standard by 90 percent, requiring new refinery equipment that bankrupted many small refineries in the West. Older theories suggested the cognitive limits of policymakers fostered incremental change. Those theories do not explain what Baumgartner found: pervasive stasis and occasional large changes. The catastrophic possibilities of the latter encourage businesses to keep their lobbying operations going even after years of gridlock.

Baumgartner's book does not support popular prejudices. It finds few special interest demons perverting politics for their narrow ends. Most people who follow politics often bemoan the gridlock Baumgartner sees as endemic to American politics. Baumgartner offers no normative evaluation of the power of the status quo. The book's analysis indicates that complexity and multidimensionality of issues, combined with limited knowledge, preclude most change in policies.

Constitution vs. Progressivism In *The Case for Gridlock*, Marcus Ethridge describes other virtues of this stasis. Ethridge contrasts American constitutionalism with its Progressive critics. The former made it difficult to legislate as a way to control government. The latter denounced gridlock and looked for ways to circumvent the constitutional design. Progressives hoped for a politics of expertise in which men of science molded society from Washington bureaus. The rule of experts would be in service to the public good, where gridlock was said to advance only selfish interests.

Baumgartner's rather benign view of interest groups contravenes Ethridge's emphasis on rent seeking.

Ethridge argues, in contrast, that interest groups have more influence over policies made in administrative agencies. Organization counts, and the general public is unorganized. Inevitably, interest groups seek and obtain privileges from agencies staffed with Progressive expertise. The Progressive effort to circumvent gridlock to attain the common good actually serves special interests. Progressives realized the gap between their aspirations and reality and sought successive reforms in administrative law and procedures to mend this failure of representation. Ethridge shows how these reforms have failed.

Interest group focus For Ethridge, the Framers designed the U.S. Constitution to foster struggle within Congress and between the branches of government. This design fosters gridlock as Progressives believed, but gridlock becomes virtue by complicating rent-seeking. Power divided among factions, not unified in expert hands, serves the public good as well as is humanly possible. Baumgartner's analysis supports Ethridge's conclusion. Baumgartner's picture of gridlock suggests the constraints on powerful interests imposed by divided government.

Yet Baumgartner's rather benign view of interest groups contravenes Ethridge's emphasis on rent seeking. The two may be talking about two different arenas of politics. Baumgartner's sample of interest groups focused on Congress, although perhaps half of their issues involved an agency official. Ethridge emphasizes the damage done in administrative venues. Certainly more data-intensive research should be done on administrative venues. Perhaps such arenas do not attract the broad "sides" in struggle that Baumgartner found. If not, and if powerful groups dominate agencies, Ethridge's call for a return to the Constitutional Principle (and gridlock) looks all the more convincing.

These books have different strengths. Baumgartner and his colleagues have collected more and better data on interest groups than we have had before. This foundation lends credibility to their analysis and conclusions. Ethridge offers a good analysis of an overlooked topic — administrative law — and its importance for public policy. Both books persuasively challenge what most people believe about politics. For that reason, both deserve readers concerned about the origins and consequences of regulation in the United States. R

Readings

- "Economic Models of Interest Groups: An Introductory Survey," by William C. Mitchell and Michael C. Munger. *American Journal of Political Science*, Vol. 35, No. 2 (May 1991).
- *Gaining Access: Congress and the Farm Lobby 1919-1981*, by John Mark Hansen. University of Chicago Press, 1991.
- *Mobilizing Interest Groups in America: Patrons, Professions, and Social Movements*, by Jack L. Walker. University of Michigan Press, 1991.
- *The End of Liberalism: The Second Republic of the United States*, second ed., by Theodore J. Lowi. W.W. Norton, 1979.
- *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities*, by Mancur Olson. Yale University Press, 1982.
- "The Welfare Costs of Tariffs, Monopolies, and Theft," by Gordon Tullock. *Western Economic Journal*, Vol. 5, No. 3 (1967).

Who Failed? Whose Crisis?

Reviewed by Richard L. Gordon

A FAILURE OF CAPITALISM: The Crisis of '08 and the Descent into Depression
By Richard A. Posner
346 pages; Harvard University Press, 2009

THE CRISIS OF CAPITALIST DEMOCRACY
By Richard A. Posner
402 pages; Harvard University Press, 2010

For over four decades, Richard Posner has made major contributions to the case for limited government, particularly in the regulatory realm. He is one of the most economically literate lawyers in the law-and-economics movement. However, the financial shocks since 2007 have produced in him a crisis of confidence — and, apparently, a decline in his economic acuity.

He therefore did his usual thing: he wrote (two books and apparently much else) on the subject. The books adopt the contagion theory pushed by one of his arch villains, Federal Reserve chairman Ben Bernanke. Unfortunately, Posner's efforts display every possible inconsistency — with prior writings and between the two books, and even within the 2009 book itself. In short, both books are uncharacteristic and unworthy of him.

Overview The first book, *A Failure of Capitalism*, is a hastily written, short effort padded by small pages, large type, and wide line-spacing. The result is mainly a recitation of pro-intervention arguments that were used to defend government-bailout actions that were then being implemented.

The book is confusing about the cause of the crisis. On p. xii, a sentence asserting a market failure is inserted into a paragraph devoted to government errors. The book stresses the role of loose Federal Reserve policy and asserts that supposedly excessive risk-taking by financial institutions was a rational response to loose money and inadequate regulatory controls. Only scattered, inadequately developed sentences note the role of home ownership–promoting government policies. What dominates is the revival of questionable macroeconomic theories and a muddled argument about tightening financial regulation.

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Given the poor effort of the 2009 book, it is not surprising that Posner would make a second attempt a year later. *A Crisis of Capitalist Democracy* is better developed but ultimately more unsatisfactory. The old Posner is present in it, but in unresolved conflict with the new. Over half of *Crisis* is devoted to a revised and updated review of the crisis. The rest consists of ruminations on related topics, such as the Obama administration's financial regulatory reforms (which Posner rightfully deems misguided), an explanation of the crisis that is entitled "The Fragility of Finance," a rambling effort to revive Keynes' reputation, a similarly problematic review of uncertainty, another attack on macroeconomics, Posner's alternative "Reforms You Can Believe In" (some of which, he concedes, he does not fully believe in), and the implications of globalization. He also writes of his concern that the Obama administration's ambitious program will produce unmanageable strains on the nation's economy.

Playing economist In *Crisis*, Posner poorly develops two of his own insights. The first is one that brought him fame: that because of both inherent limitations of government and political pressures, regulation and other interventions are questionable exercises. Finally, on p. 173, he digresses to apply his skepticism to the Obama administration's financial regulatory reform proposals, but he does not appreciate that this skepticism should extend to many of his arguments in the book.

He presents a long list of valid criticisms of regulation. However, worse than ignoring the inherent problems of information, Posner keeps calling for better information. In parallel, he combines concerns about the drawbacks of creating new organizations with proposals for adding more government agencies. This shift of policymaking to agencies was discredited in the 1970s energy debates in which I was involved. Back then, the solution to the nation's energy woes was said to lie in the creation of a new department, complete with an "independent" data-gathering agency. It proved worse than nothing.

In *Failure*, Posner observes, "The very existence of warring schools within [macroeconomics] is a clue that the field is weak, however brilliant its practitioners." Yet he ignores that warning sign, and in both books dabbles in macroeconomics, presenting controversial macroeconomic positions as clearly valid, and arguing vigorously for interventionist countercyclical policy. His discussions neglect the several schools of macroeconomics that stress the inherent limitations of knowledge, and their corollary skepticism of government's ability to anticipate and counteract fluctuations. *Crisis* does criticize the Federal Reserve for bad action, but never recognizes that this may be an inherent fault that supposedly better policymakers could not correct.

Posner does not help his discussions by claiming that economists who support countercyclical policies do so because they are "liberals," while other economists who oppose such policies do so because they are "conservative." The other two possibilities are at least as plausible — the position defines the ideology or the appraisal of instability determines ideology.

His review of macroeconomics worsens the situation. He botches treatment of comments given him by Robert Lucas, who won the Nobel Prize in Economics for

his work on the implication to macroeconomics of the assumption of rationality. Posner joins the crowd in misunderstanding Lucas's point that no pure theory can ever capture the complexities and misunderstandings that occur in practice. Thus, a curious situation prevails in which Lucas and similar writers thought that they were strengthening the case for Milton Friedman's call for reliance on automatic rules, but even Friedman thought they were exaggerating rationality. Exaggerated rationality, in fact, is the crux of coherent economic theory. Only empirical analysis can handle the complexities in practice. Friedman, who preferred incremental changes, called for preserving central banks but wanted them to follow rigid rules on monetary policy. Friedrich Hayek advocated allowing competitive money issue by private banks, so that success would depend on providing money of dependable value. Others call for the specific monetary rules of the gold standard.

A related problem is that Posner adopts and runs with another dubious Bernanke concern: deflation. Economies can adapt to predictable changes in price levels, but the concern is that individual wages and prices will respond too slowly to unexpected price changes, resulting in reduced output and employment. Deflationophobes like Posner rarely distinguish between the price drop itself and the *possible* resulting impacts.

Government to the rescue Posner in both books adopts the positions that capitalist economies are unstable; crises are contagious and must be stopped before the economy collapses; and, with proper guidance, governments can and will adopt sound corrective policies. His skepticism about macroeconomics and intervention should have inspired more caution.

Crisis more clearly expresses the position that officials such as long-time Federal Reserve chairman Alan Greenspan and academic economists are the true culprits. While the attack on government is correct but too narrow, Posner's scapegoating of the economics profession conflicts with his recognition of the diversity of academic views. Over the past decade, those views have ranged from calls for more vigorous stimulative measures to warnings of a housing bubble. Politicians would thus have to choose which of those views is correct, and what policies would be appropriate and effective. The anti-intervention case is that politicians lack the information and motivation to select correctly.

Particularly in *Failure*, Posner spins a largely mythical tale of deregulation as the chief cause of the financial crisis. The factually valid part of his story is that Depression-era limitations on specific practices of financial institutions were lifted. He omits that these restrictions were unwise and, as usually occurs, had already been circumvented by the time they were withdrawn. Thus, in a case mentioned by Posner, restrictions on interest-paying bank accounts inspired the mutual fund industry to develop money-market funds with check-writing privileges, a close substitute for interest-paying bank accounts. Lifting that restriction was appropriate. The other part of the charge, right from Obama's campaign rhetoric, was that the supposed free-market outlook of the Bush administration produced increased laxness in regulation. Yet Posner (and President Obama) does not consider the alternative that regulators are inherently incapable of recognizing and alleviating dangers.

Moreover, it is not until p. 254 of *Crisis* that Posner discusses direct government influence on the mortgage debacle — a topic the he ignored in *Failure*. He starts with an unnecessary disparaging remark: "[I]t is at this point that the political right swings into action." (In both books, Posner tends to use "conservative" and "right wing" to describe advocates of limited government, whom he consistently disparages.) He finds mortgage intervention unwise, but not a key factor. This is inconsistent even with what he presents, let alone what others have concluded.

In both books, Posner's dedication to calling the downturn a "depression" aggravates misunderstanding of established procedures. The National Bureau of Economic Research produces a chronology of economic turning points — the start and end of downturns. As Posner eventually notes (*Crisis*, p. 218), the dating of recessions is based on informed appraisal by an NBER committee of prominent economists of critical economic data, rather than a mechanical rule. The NBER and other observers measure the severity as well as the duration of these downturns. However, no effort is usually made to distinguish between "ordinary" recessions and depressions, or to characterize explicitly when the upturn in any sense is "sufficient." Thus, Posner was free to develop criteria for what constitutes a depression. In *Failure*, he is content with a single concept: an anxiety-producing downturn; in *Crisis*, he argues that "depression" is preferable to "recession" as a term because "recession" is a euphemism; in a footnote, he reiterates 10 justifications for this view that he had published in previous work. This seems a way to justify his hasty use of "depression" in *Failure*. He undermines his case by the silly analogy that the wars in Korea and Vietnam were called "fights." The correct euphemism was "conflict," and even that was not widely used.

Such little lapses are too frequent. For example, he twice mentions the U.S. adoption of tariffs on tires from China and, in the second discussion, claims they were based on "a heretofore unused law" on which, in fact, an extensive literature exists because of the law's frequent misuse.

Politics and Posner His worst is near the end of *Crisis*. He gratuitously attacks the belief of "right-wing extremism" that Keynes was a fascist. As Posner observes, these attacks on Keynes are based on one sentence in the foreword to the German edition of the *General Theory* observing totalitarian states were better positioned to implement Keynes' ideas. This clearly was meant as a statement of fact, not of approval. Regardless, Posner's concern is irrelevant. It alternatively may be a means subtly to discredit the free-market economists whom he cites and their rejection of Keynes. However, these economists have nothing to do with terming Keynes a fascist. Few of these truly extremist Keynes bashers are professional economists — the chief exception being the notoriously extreme Murray Rothbard. By reviewing this, Posner comes perilously close to using the same tactic on free-market economics.

The more fundamental problem is that Posner attacks fringe hysteria about Keynes while evading essential problems. The *General Theory* is notorious for its rambling, unsystematic approach. Observers have seized on parts of the arguments as particularly essential and, depending upon their inclinations (which often are not

always ideological), decided that this justifies either praising or damning Keynes. Posner, for example, likes Keynes' advocacy of active countercyclical policy and the stresses on psychology and its shifts.

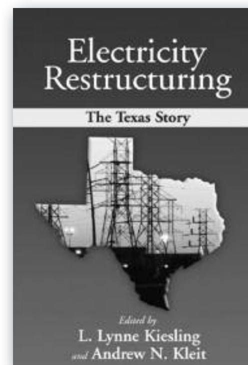
Posner puts himself in an uncomfortable balancing position. He fears the instability of free markets. He also has deep concerns about the reliability and competence of government and about a White House that systematically rejects such worries. He inadequately treats the long-term problems of the expectational and financial implications of the intervention. The apparent, but underdeveloped, argument is that economic instability is so great that even defective governments can and should intervene in a crisis. He recognizes the unrealism of those confident in the effectiveness of government. The strong argument that market adjustment works better than feasible government intervention is summarily rejected. As noted, no attention is given to arguments about the impossibility of successful active management and the desirability of stable, automatic policies. In a throwaway line in *Crisis*, he notes his views "are not definitive." While true, it is totally inconsistent with the bulk of both books.

The two books, then, are botched efforts by Posner to adjust his outlook, unjustified by either the events treated or his exposition of them. The vigorous interventionists whom he criticizes simply assume away poor performance. Advocates of limited government then validly counter that this ignores the inherent drawbacks. Posner is attempting to reconcile such skepticism with a desire for action. If this is not an impossible task, Posner has not proved otherwise. R

Uniqueness Squared?

Reviewed by Timothy J. Brennan

ELECTRICITY RESTRUCTURING: The Texas Story
Edited by L. Lynne Kiesling and Andrew N. Kleit
244 pages; AEI Press, 2009



The movement to deregulate prices, invite entry, and let markets balance supply and demand that began in the late 1970s has been both politically and economically successful to the point that it came, for a while, to seem inexorable. Benefits to consumers and the economy from opening markets in transportation, communications, oil and natural gas, and (leaving aside recent questions about investment banking) finance have been substantial.

The glaring exception has been electricity. At the retail level, efforts across the country to allow buyers to get electricity from new competitors to traditional utilities more or less ground to a halt after the California debacle in 2000–2001. Buyer reluctance has been particularly pronounced in the third of the market that is residential. In my home state of Maryland, which nominally has open retail markets, only about 7.6 percent of residential electricity was supplied by entrants in April 2010, compared to 92.5 percent of the electricity used by large commercial and industrial users. And a good bit of that 7.6 percent was likely supplied by affiliates of incumbent electricity or gas utilities.

The wholesale market, where generators sell electricity to distribution utilities or, in open states, their competitors, has avoided disaster for the most part, leaving aside the August 2003 blackout that took down most of the Northeast. However, despite operating under Federal Energy Regulatory Commission regulations going back to 1996 to open transmission grids to independent generators, the nation as a whole has not opened bulk power markets. Some regions of the country retain the old vertical monopoly structure. Others have opened markets, but with different rules — all FERC-approved — for how prices are set, sales are made, and capacity costs are covered. FERC and congressional attempts to bring uniformity to this disparate process have been blocked, likely by local regulators and utilities that do not want to cede their political turf.

It don't come easy One might think opening electricity markets would be simple; I certainly did when I first began to look at the grid after having studied telecommunications. Nothing is less differentiated than the electrons flowing through a wire. Its use seems no more complicated than flipping a switch so the light or TV can come on.

So why has opening electricity markets been so difficult? Fundamentally, it is because electricity uniquely combines three attributes: First, it is crucial; even a minimally developed economy cannot function without it. Second, it is fragile; because storage in meaningful quantities is prohibitively expensive, supply has to be kept exactly equal to demand essentially continuously. Third, avoiding this fragility by making the grid reliable is a public good. Transmission networks that deliver power are interconnected to improve the overall efficiency of the system, but unlike telephone traffic, it is somewhere between costly and impossible to route high voltage current over specific lines. As a consequence, electricity takes multiple paths to get from generators to customers, making the grid, even if parts are operated separately, essentially a single big energy system. If one supplier fails to meet its customers' demands because of unanticipated surges, inadequate capacity, or equipment failures, not only are its customers blacked out, but everyone is.

The tension between central control to protect this reliability and the entrepreneurial independence needed to realize the promise of competition is exacerbated by natural monopoly characteristics of the wires. Laying multiple local distribution grids to get power to all but the largest users would be wasteful; one grid can do the job. As just mentioned, interconnect-

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Brennan provided commentary on some of the work in this book at an AEI symposium in early 2008.

ed transmission grids are essentially single entities. Fostering competition on the generation and sale of electricity requires that the interface be managed to ensure access to the wires on reasonable, non-discriminatory terms. But the separation of generation ownership from control over transmission and distribution lines may itself inhibit efficient grid operation. Peter Van Doren and Jerry Taylor of the Cato Institute have suggested that the costs of separation are less than the benefits, concluding that deregulation of wholesale markets should be reversed if transmission and distribution cannot or will not be deregulated as well.

Dynamic prices, static consumers Electricity markets are further complicated by the enormous variance in wholesale prices over time. Because capacity has to be in place to meet demand at any time, some capacity is used only during a few critical hours a year, e.g., to power air conditioners on the hottest, most humid summer afternoons. It is not uncommon to find that 10 to 15 percent of capacity may come into service less than 1 percent of the time. Covering the cost of that capacity implies that at those critical hours, the wholesale cost of electricity can easily be 50 to100 times the off-peak price. But when capacity is tight, individual generators could find it profitable to reduce supply, especially when the absence of effective meters and monitors offers no incentive to users to cut demand. If regulators limit wholesale prices out of fear of market power, as they have, there might not be enough money to cover the cost of critical peak generation. A typical response has been to set up "capacity markets" to provide revenues to cover generation costs that peak prices cannot.

This is not all. The homogeneity of electrons that should make competition simple also makes it difficult for new entrants to come up with ways to persuade consumers to switch away from incumbent utilities. This is especially so for residential consumers, for whom a relatively small savings on monthly electricity bills may not be enough to make it worthwhile to evaluate the merits of different offerings from suppliers they may never have heard of.

Consumer resistance to shopping for electricity, after decades of having to give it no more thought beyond paying the monthly bill, undoubtedly plays a role. Policies to hold down incumbent prices as part of political bargains to open markets surely have not helped, leading to low residential adoption rates in most of the states that bothered to open markets at all. Moreover, electricity prices have risen during the last 10 to 15 years, during the open market era. The degree to which this is just a correlation — other energy prices have risen dramatically as well — or whether higher prices encouraged open markets, or vice versa, remains hotly debated.

Don't mess with Texas By and large, many states are not opening markets, and some that did in the 1990s are reversing course. But as co-editors Lynne Kiesling and Andrew Kleit say in the introduction to *Electricity Restructuring*, "No state, that is, except Texas." The subject of their important book is why Texas appears to have succeeded where the rest of the country has failed.

Texas stands out from other states for numerous reasons. When it comes to electricity, far and away its most distinguishing feature is that it is the only state in the continental United States that is essentially not under the jurisdiction of the federal government. Unlike the other lower-48 states, the Texas grid, under the control of the Electricity Reliability Council of Texas (ERCOT), is essentially not connected to the rest of the United States. David Spence and Darren Bush note in their chapter that the history is minimally more complicated because of two "asynchronous connections" between transmission lines in Texas and Oklahoma, but as Jess Totten notes in his chapter, these connections avoid the multiple-path effect that justifies treating connected transmission grids as single entities. The result is that Texas's transmission grid and wholesale markets are regulated by the same entity that sets its distribution policies. This has helped to avoid jurisdictional disputes regarding authority over market design and access — even if the ERCOT grid operates under rules similar to those FERC applies nationwide, as Totten also describes.

The most substantive innovation in Texas is that it covers generation costs through an "energy-only" market. That this is innovative should be puzzling to those familiar with markets for anything else, in which production costs are covered by revenues from sales of the products. But in electricity, as mentioned above, capacity markets are commonly used because of the view that electricity rates cannot be allowed to go high enough to cover the costs of peaking units. Some in Texas wanted to go that route but, as Eric Schubert, Shmuel Oren, and Parviz Adib describe in the most thought-provoking chapter in the volume, by the time capacity markets could be implemented, ERCOT had been working on an interim basis with energy-only cost recovery, and similar markets in Australia and Alberta had been working well for some time.

Market power mitigation remains a concern. Kleit notes that, at peak demand periods when generation capacity is at its limit, an electricity generation company with a relatively small market share might nevertheless be able to raise price by withholding output. He also suggests that other nominally independent wholesale market operators may help energy suppliers suppress competition. Caps on prices are projected to rise in 2011 to $3,000 per megawatt hour or $3 per kilowatt-hour, roughly 27 times the current average retail electricity price, with some adjustments if annual returns exceeded an estimate of revenues needed to cover capacity costs. Kleit describes a specific episode in which TXU, the largest supplier, operated a "rational bidding strategy" that included fixed cost recovery. He suggests that this practice would trouble economists, but I would add that it should bother only those who do not think prices should be high enough to cover long-run average costs as well.

A last question is why Texas bucked the trends against legislative adoption and consumer acceptance of retail entry. Former Texas Public Utility Commission chair Pat Wood and co-author Gürcan Gülen of the University of Texas portray the political development consistent with the view that Texas's culture was a prime contributor. Co-editor Lynne Kiesling finds that despite extensive consumer education and a decision of the incumbent utilities to keep retail prices high — even after the price of natural gas, the marginal fuel, had fallen — only 40 percent of residential customers had switched. The importance of this should not be exaggerated. Overall, only about 35 to 40 percent of load is residential, and much if not most of the ben-

efits of open markets go to large commercial and industrial buyers, for whom it pays to shop and sellers want to compete. Opening electricity markets can be successful even if most of the public is unaware that it has happened.

Inside baseball Informative as this book is on these important topics, it is often limited to those in the know, with regard to both authors and audience. Having insider insights from such people as the Texas Public Utility Commission's past and present chairs, market monitor, director of its Competitive Markets Division, and leader of its wholesale market design proceedings, along with a former commissioner and senior policy adviser, make the book useful and frequently entertaining. More outside academic assessments, along the lines of Steven Puller's chapter on competition in wholesale markets, would complement the insider perspectives. Moreover, in a sector as complex as this, as evidenced by the distinctiveness of the Texas experience, there must have been dissenters who would put different spins on the institutional developments and evidence supporting the generally favorable assessments in this volume.

One missed opportunity was to revisit the debate in Texas between paying for transmission at rates set for traversing a relatively small number of geographic zones or charging prices at every node in the network. Although nodal pricing sounds much more complicated, it has received the lion's share of academic support, allows more efficient management of congestion in the grid, and proved workable in other wholesale markets. Texas initially adopted a simpler zonal system, which Eric Shubert and Parviz Adib report was on the advice of the Texas Public Utility Commission's Market Oversight Division, chaired by Shmuel Oren of Berkeley, one of the leading electricity economists. This approach was later rejected in favor of the nodal approach, but in the following chapter on supply reliability, Oren (with co-authors Shubert and Adib) passes on the opportunity to let readers know the basis for his unorthodox view.

This "zonal vs. nodal" debate represents another insider bias. The editors implicitly assume that readers will be familiar with the fundamental issues associated with opening wholesale and retail electricity markets. Impediments to opening electricity markets go beyond bureaucratic rent extraction, special interest protection, and naïve aversion to markets. From some of the chapters, readers might get some sense of the legitimate complexities in balancing efficient coordination and entrepreneurial independence or price flexibility and mitigating market power, but there is no overview of the issues to provide context to the less informed reader. Leaving the book's audience to presume that deregulation ought to work undercuts its central message of just how special Texas is. The book also lacks a short description of the Texas market itself — e.g., which suppliers sell in which area, market shares, wholesale and retail pricing over time — to give readers their own sense of what is working.

Finally, the book shares a flaw inevitable in any review of electricity markets (one I know well, having co-authored a couple of them): it can be only, in Kiesling's apt phrase, a "current snapshot." The book does not cover the leading issues of the present, driven largely by climate policy. These include obligations to use non–fossil fuel generation such as solar and — as T. Boone Pickens reminds us in his television commercials — wind. Many states are looking at measures to improve energy efficiency, often predicated on beliefs that consumers systematically make "wrong" choices. The book also does not discuss what Texas is doing regarding a "smart grid" that would allow time-varying prices, reduce the need to construct peaking plants used only a few hours a year, and facilitate the use of renewable energy sources that tend to have highly variable output.

The tale thus has no final chapter in sight. The question for the next few years is not whether Texas can continue to build on its successes, but how it copes with these added pressures. Kiesling and Kleit have assembled a clear and significant introduction to how Texas got to where it is. It will be a useful guide as the story develops in Texas and, whether in contrast or lockstep, across the country. R

Reality-Based Optimism

Reviewed by David R. Henderson

THE RATIONAL OPTIMIST: How Prosperity Evolves
by Matt Ridley
438 pages; HarperCollins, 2010

One of the strongest voices for reason and optimism in a congenitally pessimistic world was the late economist Julian Simon. In his magnum opus, *The Ultimate Resource 2* (Princeton University Press, 1998), he made a powerful case that the world is getting better in almost (he probably would have cut the "almost") every way. Not just the world of the billion or so people living in developed countries, but also the world of the remaining billions who live in poor and even dirt-poor countries.

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, CA. He is the editor of *The Concise Encyclopedia of Economics* (Liberty Fund, 2008). He blogs at www.econlog.econlib.org.

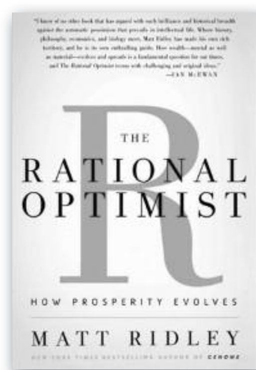
Simon was cut down by a heart attack at age 65. Fortunately, Indur M. Goklany added to the Simon-style literature with his 2007 book, *The Improving State of the World*. And now comes Matt Ridley with his book, *The Rational Optimist*, in which he adds greatly to the evidence that things are getting better virtually worldwide.

Why read Ridley if you have already read and absorbed Simon and Goklany? There are at least four reasons. First, Ridley is an incredible writer who keeps you turning the page to find out what happens next. Second, he gives a lot of evidence and fascinating stories that were not in the earlier books. Third, the book is a numerate delight. His calculations at key points in the argument show just how "ungreen" some supposedly environmental policies are, particularly organic farming and renewable energy. Fourth, Ridley shows, hilariously at times, that pessimism not only is the dominant attitude of today's intellectual

class and much of society generally, but also was the dominant attitude in the last few centuries. I do have some quibbles — more on those later — but the book's strengths more than make up for them.

Progress Ridley starts by dealing a body blow to the idyllic view that so many writers have had of England before the Industrial Revolution. He paints the clichéd scene of the family around the hearth enjoying each other's company, unencumbered by the hassles and luxuries of modern life. Then, with a thud, he makes the family's life painfully realistic. "Oh please!" he writes and then takes apart the idyllic scene frame by frame. Here is a small sample:

> Though this is one of the better-off families in the village, father's Scripture reading is interrupted by a bronchitic cough that presages the pneumonia that will kill him at age 53 — not helped by the wood smoke of the fire. (He is lucky: life expectancy even in England was less than 40 in 1800.) The baby will die of the smallpox that is now causing him to cry; his sister will soon be the chattel of a drunken husband. The water the son is pouring tastes of the cows that drink from the brook.... Candles cost too much, so firelight is all there is to see by. Nobody in the family has ever seen a play, painted a picture or heard a piano.... Father's jacket cost him a month's wages but is now infested with lice.



Ridley then jumps to some astonishing data that show how much better off people are in today's low-income countries as compared to the best-off who lived in the most advanced countries of just a few decades ago:

> The average Mexican lives longer now than the average Briton did in 1955. The average Botswanan earns more than the average Finn did in 1955. Infant mortality is lower today in Nepal than it was in Italy in 1951.

Back to that family in 1800 that could not afford candles: Ridley also reports Yale economist William Nordhaus's ingenious way of measuring real wages: by using light. An hour of work in 1800, he notes, would have bought you only 10 minutes of reading light. Today, that hour would buy "300 days' worth of reading light." That is progress.

Ridley points out that the internal combustion engine was a huge factor in the growth of food production. How so? America's horse population in 1915 was 21 million, and those horses ate a lot. Thus, about one-third of all agricultural land at the time was devoted to growing food for horses. Once the car came along, the horses were not needed, freeing up a huge amount of land to grow food for humans.

Intensive farming, which is due, notes Ridley, to genetic engineering and heavy use of fertilizer, frees up a huge percent of land for other uses. Today, he writes, people farm 38 percent of the earth's land area. If yields from land were at their 1961 levels, before much of this progress, a whopping 82 percent of the earth's land would need to be farmed to feed today's population. Of course, with those lower yields, the price of wheat would be much higher and we would not have today's population. Were we to replace all the industrial nitrogen fertilizer with manure, as many believers in organic farming advocate, we would need an extra seven billion cattle on an extra 47 million square miles of land to produce that manure. That is just five million square miles less than the total land area of the six habitable continents. But we are already farming 22 million square miles of land. In other words, we could not switch to organic farming and still feed the current world's population. As for keeping nature preserves, jungles, and national parks, *fugetaboutit*.

What about renewable energy? To supply the current U.S. population with the same amount of power we use today, writes Ridley, would require "solar panels the size of Spain" or "wind farms the size of Kazakhstan" or "woodland the size of India or Pakistan." Moreover, wind turbines are a Cuisinart for birds. Writes Ridley: "Just one wind farm at Altamont in California kills 24 golden eagles every year; if an oil firm did that it would be in court." He quotes environmentalist Jesse Ausubel: "Renewables are not green."

Doom and gloom One thing I found interesting is that the pessimists seemed prominent in all eras. Ridley quotes Adam Smith's statement in *The Wealth of Nations* that five years do not go by in which someone does not publish a book or pamphlet "pretending to demonstrate that the wealth of the nation was fast declining, that the country was depopulated, agriculture neglected, manufactures decaying, and trade undone." In 1830, British poet Robert Southey claimed that people were worse off than even a thousand years earlier. Fortunately, England had its 1830 version of Ridley in the poet and essayist Thomas Babington Macaulay. Macaulay wrote:

> As to the effect of the manufacturing system on the bodily health, we must beg leave to estimate it by a standard far too low and vulgar for a mind so imaginative as that of Mr. Southey, the proportion of births and deaths.

Macaulay went on to point to the enormous progress by 1830 that no one in 1720 would have imagined.

Exchange and progress One of the most upsetting parts of Ridley's book is his mention of President Obama's science adviser, John Holdren, and his proposal to "de-develop the United States." Maybe that explains the president's economic policies.

Seriously, though, why has the world worked out so well, and why does Ridley think it is likely to get even better? A major part of his theory is the powerful role of trade. Trade allows people to produce a good or service in which they have a comparative advantage. Princeton economist Paul Krugman, in his clearer-thinking days, referred to this principle as early 19th-century economist David Ricardo's "difficult idea," one that very few non-economist intellectuals understand. The more extensive the trade, the finer and more productive is the degree of specialization. Also important, writes Ridley, is the role of ideas and technology. In his provocative phrasing, "ideas have sex." Translation: when people have ideas, they often combine those ideas into something better. The telephone, for example, "had sex with the computer and spawned the internet." The capsule endoscope, commonly known as the camera pill, developed out of "a conversation between a gastroenterologist and a guided-missile designer." With the lower cost of transportation and communication, itself due to technology, there are more people with ideas who can get together more eas-

ily and "mate" their ideas. Thus, trade is important even in the realm of technology. (Disclosure: I am slightly biased here because Ridley quotes from Paul Romer's article on economic growth in my *Concise Encyclopedia of Economics*. Romer's article has become a modern classic.)

Given the important role of trade in Ridley's theory, and given his obvious understanding of trade, it is surprising that he makes a jarring misstatement: "For barter to work," he writes, "two individuals do not need to offer things of equal value. Trade is often unequal, but still benefits both sides." The correct statement is: "For barter or trade to work, individuals *must* offer things of *unequal* value." If I valued what I give up the same as what I get in return, there would be no point in trading. Trading is *always* an exchange of unequal values.

Easterly's criticisms In his *New York Times* review of *The Rational Optimist*, foreign-aid critic William Easterly, who I would have expected to like the book, was extremely critical. Why our different reactions? Easterly jumped on Ridley's theory of the interaction between trade and technology. I took Ridley to be suggesting this rather than saying it was the final word on the subject, although I grant that at times Ridley does go overboard. Easterly seemed to get his hackles up because of Ridley's over-certainty.

But that is not all. Easterly gets upset at Ridley for using "the word 'even' when he mentions Africa." For example, writes Ridley: "[E]ven Nigerians are twice as rich" as they were half a century earlier. Directly after criticizing Ridley for this — I am still not sure why — Easterly discloses, "Ridley approvingly cites my own work on aid to Africa." Note to self: make sure you do not cite Easterly's work approvingly.

A related problem Easterly has with the book is that Ridley fails to address inequality. Well, yes. But it seems odd to criticize a book demonstrating that — I'll say it — even Nigerians are getting wealthier, for not noting that Americans' wealth is growing even more quickly. Easterly wants a book, he writes, that "confronts honestly all the doubts about the 'free market.'" Really? All the doubts? I do not know if such a book could be written with the requisite amount of evidence and have under 3,000 pages. And a book that "only" shows us how economic freedom makes most Americans and many people in other countries wealthier in important respects than John D. Rockefeller, a book that "only" shows that we can have somewhat higher population and higher living standards for most of the world, a book that "only" tells us how to have both more food and more land for wilderness, a book that "only" offsets the dreary, people-hating pessimism that is all around us and is now even in the mind of the White House science adviser? That is not worth a lot? Psshaw. But I will end by letting Ridley answer. He writes:

> It is precisely because there is still far more suffering and scarcity in the world than I or anybody else with a heart would wish that ambitious optimism is morally mandatory. R

WORKING PAPERS

Below are summaries of some recent papers that may be of interest to *Regulation*'s readers.

By Peter Van Doren

CATO INSTITUTE

CALIFORNIA'S FISCAL SHELL GAME

Proponents of limited government have long advocated "starve the beast" policies — limiting taxes as a means of limiting government. But do these strategies work? At the federal level, empirical studies by Cato's own William Niskanen and by Christina and David Romer of the University of California, Berkeley have found that cutting taxes does not lead to reduced spending. Uncle Sam can make up for the lost revenue by selling treasuries.

But what about at the state and local levels, where governments have less ability to augment revenue by borrowing? In a new paper, the son-and-father team of Colin and Matthew McCubbins study tax limitations and their effects in California, the birthplace of the tax limitation effort. In 1978, California voters approved Proposition 13, which rolled back property assessments to 1975 levels, limited annual increases in property assessments to two percent, and required supermajority legislative votes in order to increase some other state and local taxes.

So did these measures work — did they keep total California taxes low and slow the expansion of state government? The McCubbins find that, though tax bills initially fell, real total taxes per capita reached and exceeded their 1978 level by the late 1980s. Meanwhile, state expenditures in real dollars never fell. California's state and local governments funded the spending by upping sales taxes, adopting new fees, establishing new service district assessments, and taking on more debt. The authors conclude that the result is larger and less accountable government in the Sunshine State.

Peter Van Doren is editor of *Regulation* and senior fellow at the Cato Institute.

ETHANOL MANDATES AND FOOD PRICES

Federal law requires that a growing amount of ethanol be blended with U.S. gasoline each year. The mandate is for 11 billion gallons this year; under current law, it will top out at 36 billion gallons by 2022.

Meeting this year's mandate requires the fermentation of about 4.2 billion bushels of corn, which is roughly one-third of U.S. production (and 5 percent of the world's caloric production in 2007). As is well known, corn is a major part of the U.S. diet and a growing part of the world's diet. So what is the price effect on food from having so much of the crop diverted to energy?

Using new supply and demand elasticity estimates, Michael Roberts of North Carolina State University and Wolfram Schlenker of Columbia University calculate that the U.S. ethanol mandate increases world food prices between 20 and 30 percent. These price increases, in turn, result in more conversion of forest into cropland, which reduces any carbon emission reduction benefits from biofuels.

INTEL ANTITRUST

As this issue of *Regulation* heads to press, there is news that computer chip manufacturer Intel has agreed to a settlement

with the Federal Trade Commission concerning some of Intel's marketing practices. The FTC charged that the practices, which include bundling and loyalty discounts, violate federal antitrust laws because they are intended to keep competing chip makers like Advanced Micro Devices from achieving sufficient economies of scale.

In 1984, University of Chicago law professor (and later a federal judge) Frank Easterbrook published a highly influential paper concerning such antitrust cases. These cases require courts to determine whether or not the disputed marketing arrangement ultimately enhances consumer welfare. Easterbrook noted that, as with most decisions, judges in these cases are susceptible to making both Type I (false positive) and Type II (false negative) errors. A Type I error occurs when the court incorrectly determines that consumers are being harmed by the practice. A Type II error occurs when the court incorrectly determines that no harm is occurring. Easterbrook argued that Type I errors are more costly than Type II errors. Dynamic markets and innovation offset false negative errors — if a permitted practice gives a firm an unfair advantage, competing firms will continue to search for ways to offset that advantage. But nothing offsets the overreach of government and the judiciary in false positive errors — once a pro-consumer practice is deemed illegal, it is off the table (unless a subsequent court reverses the decision). Easterbrook concluded that judges should consult the economic facts and literature very carefully about the suspect market arrangements and declare a violation only when all the evidence is unambiguous.

Consider the FTC's charges against Intel in light of Easterbrook's paper. Intel's discounts started in 1999; so how has AMD fared since then? In a new working paper, George Mason University law professor Joshua Wright argues that AMD's and Intel's market shares have not really changed since then, and that Intel's cumulative abnormal returns since then are slightly negative. He goes on to say that these facts, combined with the cumulative evidence in the literature that loyalty discounts are pro-consumer, would suggest that there is no basis for the FTC case within the error-correction framework proposed by Easterbrook.

In another recent working paper, University of Michigan law professor Dan Crane examines the same case but makes a different argument: the complaint against Intel would require the chip maker to include some of its fixed research and development costs in the prices it charges for every processor. This would reverse decades of antitrust law that uses pricing below marginal cost as a necessary condition for predation. And it would convert the computer chip industry into a quasi-public utility in which average-cost recovery is guaranteed and innovation and risk taking are retarded.

FDIC SURCHARGES

Since the Great Depression, the Federal Deposit Insurance Corporation has guaranteed the safety of deposits at member banks. In exchange for the mandated insurance, the banks pay fees to the FDIC that are then placed in the Deposit Insurance Fund, which is used to cover liabilities in the event of bank failures.

The recent financial crisis depleted the fund, prompting the FDIC in September 2009 to collect a special assessment of 5 basis points on each insured institution's assets minus Tier 1 capital (comprised mainly of common stock and retained earnings). For the first time, the FDIC assessment was a percentage of total assets rather than just insured deposits. Because larger banks tend to raise funds from sources other than consumer deposits, the surcharge appeared to be an attempt to charge larger banks for the "too-big-to-fail" protection that the federal government extended them during the financial crisis.

However, this extra charge was limited. The FDIC capped the surcharge so that it could not exceed 10 basis points of insured deposits. Thus the cap was operative if insured deposits were less than 50 percent of a bank's liabilities. In a recent working paper, Scott Hein of Texas Tech and coauthors calculate that, of the largest 19 banks that underwent the Treasury Department's 2009 stress testing, nine saved $609 million from the cap. Citigroup alone saved $204 million.

GOOD MONETARY POLICY OR LUCK?

After the agonizing stagflation that plagued the U.S. economy in the 1970s, many macroeconomic data exhibited decreased volatility from 1984 until 2007 — a period that has come to be known as the Great Moderation. Why did it occur?

Conventional wisdom credits Paul Volcker and his successors at the Federal Reserve with better monetary policy that controlled inflation and supplied stimulus (and applied the brakes) as needed. However, some economists now argue that the Great Moderation was more the result of good luck than good Fed policymaking (and the 1970s were more the result of bad luck than bad policy). An early paper in this literature, by Christopher A. Sims and Tao Zha, appeared in the March 2006 *American Economic Review.* A more recent working paper by Jesús Fernández-Villaverde, Pablo A. Guerrón-Quintana, and Juan Rubio-Ramírez goes so far as to claim that "our reading of monetary policy during the Greenspan years is that it was not too different from the policy in the Burns-Miller era; it just faced much better shocks."

BMI OVER TIME

Conventional wisdom holds that Americans have grown more obese over the last 25 years, in part because we eat too much restaurant food. Michael Anderson and David A. Matsa critique the latter part of that narrative elsewhere in this issue (see "Restaurants, Regulation, and the Supersizing of America," p. 40). Critiques of the former part start with the work of Jeffery Friedman, a molecular genetics professor at Rockefeller University. Friedman is well known for discovering leptin, the hormone that regulates food intake in humans.

Friedman argues that, though there has been a dramatic change over the last 25 years in the number of Americans classified as "obese," there has not been nearly as dramatic a change in the typical person's weight. A person is considered obese, he notes, if that person's body mass index (BMI) is greater than 30. (BMI is computed by dividing a person's weight in kilograms by the square of the person's height in meters.) Friedman notes that, in 1991, the average American had a BMI of 26.7 — not very far from the threshold for being considered obese. A small or no change in the average weight of most people, coupled with much larger changes in the weight of very heavy people, resulted in a

dramatic increase in the percentage of the population considered obese.

Friedman's argument is supported by a new working paper by John Komlos of the University of Munich and Marek Brabec of the Czech Academy of Sciences. Komlos and Brabec analyze the U.S. BMI data by birth cohort from 1882 to 1986, breaking each cohort into 10 centile groups (lightest 10 percent, next-lightest, and so on up to the heaviest 10 percent). They argue that BMI has been gradually increasing for the last 100 years. In addition, the weight gains across centiles of the distribution are not uniform. For 50-year-old U.S.-born white men, the lightest 20 percent have had no increase in BMI in the last 55 years. There have been modest increases in the middle 50 percent, and much larger increases in the top 30 percent. The data on the rate of increase in BMI (the first derivative) are even more right-skewed. The rate of increase in BMI for native-born white men has been *decreasing* for the bottom 70 percent of the distribution since 1975, but has been *increasing* for the top 30 percent.

CREDIT CARDS VS. MERCHANTS

Merchants pay fees to banks and Visa and MasterCard for the processing of credit card and debit card payments. Many of these merchants argue that the fees are onerous, and the merchants have organized politically to resist. Their efforts bore fruit in the recently passed financial reform bill, which contains a provision instructing the Federal Reserve to issue rules that regulate the fees associated with debit cards.

But are merchants, in fact, overcharged? In a new working paper, George Mason University law professor Todd Zywicki documents that in the pre–credit card world of the late 1960s, when stores ran their own layaway and credit card systems, stores had an average loss on credit sales of 3.4 percent. In contrast, in 2008 merchants paid $27.5 billion in fees to Visa and MasterCard, while charge-offs were $50 billion. That is, by outsourcing the credit function to banks, merchants sold $50 billion in goods to purchasers who did not repay the bank, but the merchants only had to pay $27.5 billion for that protection. In the pre-Visa system, the entire $50 billion loss would have been borne entirely by the merchants. R

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