Political Bubbles: Financial Crises and the Failure of American Democracy
Nolan McCarty, Keith Poole, and Howard Rosenthal
Princeton, N.J.: Princeton University Press, 2013, 368 pp.

The majority of books on the recent financial crisis tend to be written either by economics/finance experts or by journalists. While the journalistic accounts occasionally focus on political actors, it is usually in the manner of "bad people doing bad things" rather than with a theoretical framework. The economic accounts, with some exception, rarely incorporate the politics of finance. It is this vacuum that *Political Bubbles* attempts to fill.

The authors are three prominent political science professors whose work will be familiar to many *Cato Journal* readers. Poole and Rosenthal's previous joint works have made significant contributions to the Public Choice literature on economic legislation. All three authors can rightly be called pioneers in the modern academic literature on ideology. Readers of Poole and Rosenthal's *Congress: A Political-Economic History of Roll Call Voting* (1997) and *Ideology and Congress* (2007) will recognize much of that work here. Chapters 2, 3, and 4 of *Political Bubbles* are largely an introduction to the authors' previous work. Those already familiar with this work can either skim or skip these chapters.

The framework outlined in these early chapters focuses on what the authors call the "Three I's": ideology, institutions, and interests. That framework is used to explain the development of "political bubbles," which are defined as "a set of policy biases that foster and amplify the market behaviors that generate financial crises." It should be clear from this definition that the authors begin with the premise that financial crises are the result of markets. By relying on this definition, the authors rule out the possibility that government itself can be a generator of financial crises. From this starting point, the authors ask which ideologies are likely to constrain government from controlling financial markets. Not surprisingly, the authors quickly conclude that free-market conservatism is the "belief structure most conducive to supporting political bubbles." The rest of the book is spent trying to show how Congress became more free-market oriented and adopted deregulatory policies that contributed to the recent bubble.

The foundation of the analysis is a spatial model of voting, which the authors developed in previous works. Based on this model,

members of the House and Senate are assigned an "ideology score." The scores are calculated upon actual roll call votes, where "yeas" and "nays" represent different ends of a two-dimensional scale. The authors impose these vote scores on the traditional "liberal" and "conservative" positions. The authors claim these scores are consistent predictors of voting behavior. Positions that do not fit into this framework, such as a libertarian one, are shoehorned by excluding noneconomic roll call votes. False predictions that are out of the sample, such as Senator Russ Feingold's vote against Dodd-Frank, are simply explained away in an ad hoc fashion.

These scores were previously used in the three authors' 2006 book *Polarized America*. With a title like that you can perhaps guess that the authors blame political gridlock for much of the cause and "lack" of response to the crisis. As someone who spent the years leading up to the crisis on the staff of the Senate Banking Committee, I can certainly say that gridlock, or rather needing to reach 60 votes in the Senate, was a significant obstacle to reforming Fannie Mae and Freddie Mac, as well as hampering attempts in 2006 to bring more competition to the credit-rating agencies. The authors' thesis is consistent with my experience but for different reasons than the authors suggest, which I will return to. The remaining chapters essentially apply the authors' previous work to the particulars of the recent financial crisis.

Despite chapters on the role of interests and institutions, the bulk of *Political Bubbles* is dedicated to ideology. A brief chapter only illustrates that (1) campaign contributions from the financial services industry have been increasing, and (2) a handful of members of Congress have a concentration of financial services employment in their districts. We are also shown that members of the relevant congressional committees receive more contributions from finance than members not on those committees. None of this is really new or shocking, and the authors do not demonstrate the importance of these findings. As is often the case, the mere suggestion of money is supposed to be damning. Those requiring a higher level of proof will be left disappointed.

The discussion on institutions is only slightly more in-depth, which is particularly surprising given this is a book by three political scientists. After a very cursory overview of features such as the filibuster, the presidential veto, and the review function of the courts, the authors conclude that our system requires supermajorities and that those

supermajorities can shift dramatically with relatively small changes in the makeup of Congress—what the authors label "pivot points."

As an example of a pivot point, they cite the special election of Massachusetts Senator Scott Brown. I agree with the authors that Brown's election shifted the balance of ideology within the Senate. I disagree about Brown's impact. Much is made of Brown's objection to a prefunded resolution mechanism in Dodd-Frank's Title II, which would have assessed an insurance fee on financial institutions (something like a FDIC for nondeposit creditors). Senator Brown viewed it as a tax, and in order to gain his support the fund was dropped. Instead, Dodd-Frank has a postfunding mechanism. The authors paint this as a huge ideology swing.

Which brings me to my biggest criticism of *Political Bubbles*: relatively minor, even trivial, policy differences are presented as massive ideological canyons. Because of the institutions not mentioned by the authors, such as agenda control by the committees, Scott Brown's election had a relatively minor impact on Dodd-Frank. That Dodd-Frank does not fix the causes of the crisis has little to do with Scott Brown and everything to do with the disinterest of the relevant committee chairs in addressing those issues.

Unfortunately, the book is marred in several places by occasional outright factual errors. For instance, the authors claim that Fannie Mae and Freddie Mac were not allowed to acquire risky subprime mortgages (p. 131). As I've explained elsewhere (Cato Institute Briefing Paper No. 120, March 7, 2011), this is false, as is clear from the both the regulatory and statutory language governing their allowable purchases. As I also document, Fannie Mae and Freddie Mac did purchase subprime loans. The authors also claim that Fannie Mae is in receivership, which is also incorrect (both are in conservatorship). Finally, they also claim that the Community Reinvestment Act (CRA) prohibited banks from redlining but did not require banks to make risky loans. Again the authors simply have their facts wrong. There's no prohibition on redlining in CRA, and the 1995 regulatory changes to CRA implementation encouraged banks to lower underwriting standards. While many academics have an allergic reaction to actually reading statutes and regulations, that is no excuse for not at least consulting a legal expert in this area. Such simple errors undermine confidence in the authors' knowledge of financial regulation.

Beyond the handful of objective factual errors, the authors make a number of assertions that are at least debatable (and in my opinion

outright false). For instance, they dismiss objections to the Dodd-Frank Act as a "bailout bill" as "dubious." An objective reading of Dodd-Frank would conclude otherwise, but there is little evidence that the authors actually have read Dodd-Frank. Of greater relevance to the authors' framework is their use of ideology in describing individual politicians. For example, the former chair of the House Financial Services Committee, Mike Oxley (of Sarbanes-Oxley fame), is described as a "free market conservative advocate." However, there is no credible definition of free-market advocate that would include Oxley.

This is where *Political Bubbles* falls most flat. In constraining their definition of "ideology" to a one-dimensional measure, the authors cannot distinguish actual free-market advocates from crony capitalists. In fact, they explicitly say they see little difference, claiming that free-market advocates and crony capitalists have bonded (p. 270). One could as easily take the case of Fannie Mae and claim that progressives and crony capitalists bonded, but such would undermine the authors' thesis that activist government is the solution.

Despite the brief chapter on interests, *Political Bubbles* downplays the role of special interests in the financial services industry, attributing the vast majority of legislative changes to "ideology." In my seven years as a Senate staffer working on these issues, I found that almost all of it is driven by interests with very little role played by ideology.

Political Bubbles contains a number of policy recommendations. Some of these are related to the arguments advanced by the authors, such as filibuster reform; others, such as limiting bank activities, feel tacked on. The financial rules they suggest mirror conventional wisdom and seem to be included largely for that reason. Their more interesting recommendations, such as set rules that account for political risk, are useful considerations. Overall, the recommendations are a mixed bag—something for everyone to agree with and object to, but little in the way of convincing argument.

I've quipped in many presentations that one cause of the financial crisis is that "democracy loves a bubble." By this I mean that the people generally enjoy the appearance of expanding wealth that accompanies a bubble. Few politicians can successfully lean against the wind. With that in mind, I greatly looked forward to *Political Bubbles*. I was sadly disappointed that the role of democracy is never really addressed, nor is the authors' theory really applicable beyond the recent crisis. The authors are ill informed on issues of finance and

do not consider alternative theories, even within political science, as an explanation of the crisis. Despite these flaws, *Political Bubbles* is an important book. I would include it in any seminar on the crisis, as it injects an analysis into the discussion that is all too often missing. I would also hope that *Political Bubbles* spurs other scholars to plow this field.

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The Bet: Paul Ehrlich, Julian Simon, and Our Gamble over Earth's Future
Paul Sabin
New Haven, Conn.: Yale University Press, 2013, 304 pp.

Yale historian Paul Sabin's *The Bet: Paul Ehrlich, Julian Simon, and Our Gamble over Earth's Future* is worth a read because of its detailed tour through the world of environmental doomsaying. Yet, in the end, I was profoundly disappointed, consigning this book to my very large Cassandra File because Sabin endorses that doomsaying as expressed by dreaded global warming.

The Bet is about a very public wager between economist Julian Simon and the serial apocalypse predictor Paul Ehrlich (cosigned with John Holdren, President Obama's science advisor). Ehrlich bet that the price of five key metals would rise between 1981 and 1990, and Simon bet they would decline (in constant dollars). Ehrlich was spectacularly wrong, but nonetheless continued, and continues, to enjoy a substantial public presence despite virtually none of his predictions coming true.

Simon, who died in 1998, was very poorly compensated and couldn't even get the University of Maryland to give him a secretary. He found it increasingly hard to publish in the academic literature, and he was confounded by the durability of the environmental apocalypse meme. In 1995, he wrote in the *San Francisco Chronicle*: "After 25 years of the doomsayers being proven entirely wrong, their credibility and influence waxes ever greater." Indeed. Ehrlich has been showered with goody-goody prizes around the planet. He's still a staple on the dinosaur media. Being fundamentally wrong has been very, very good to him, and being right bought Simon virtually nothing.