READINGS

Excessive Merit

Everything for Sale:
The Virtues and Limits of Markets
by Robert Kuttner
(Alfred A. Knopf, 1997). 410 pp.

Reviewed by William A. Niskanen

Robert Kuttner may be the most thoughtful, best informed writer about economics on the American left. He is also profoundly wrong about many issues. Those who would argue with him, however, need a much better understanding of the economy than is characteristic of new Ph.Ds in economics. Kuttner is correct to observe that, "In sharp contrast to Adam Smith, many advanced students of economics in this century have been startlingly innocent of the actual institutions of commercial life; they were simply virtuosos at the math."

Like others who share his political views, Kuttner has several concerns about market economies. Those concerns involve the "moral limitations" of markets, the occasional failure to equilibrate aggregate demand and supply, and the inequality of income. This book—however, is about the more broadly accepted role of the market—the organization of production and the allocation of goods and services. Kuttner acknowledges that many markets work quite well when the government plays no role beyond providing and enforcing the general legal framework—except, by his judgement, the markets for labor, health care, finance, innovations, telecommunications, air travel, electricity, safety, and the environment. In each case, Kuttner claims that specific and detailed government regulations, or other interventions, are necessary to achieve allocative efficiency in those markets. And he proposes his own *dirigiste* policy agenda for each market. No single review of Kuttner's book could respond to each of his market analyses, but I encourage students and specialists in each market to evaluate Kuttner's analysis and proposed policies to test their own understanding and policy perspective. You will surely learn something though, by my guess, you will not be convinced.

From the beginning, Kuttner states that "this is not a book about economic theory or one primarily for the professional economist." His statement is a bit deceptive, because Kuttner's broader targets are mainstream microeconomic theory and economists who base their policy advice on that theory. The special villains of his story are: the Chicago school, benefit-cost analysis, public choice, law and economics, and libertarianism. As a graduate of Chicago, an occasional contributor to each of the suspect subfields, and the chairman of the Cato Institute, I do not recognize any of the straw men that Kuttner describes. But he is no more forgiving of economists such as Arthur Okun, Charles Schultze, and Alfred Kahn who served as appointees under Democratic presidents.

His argumentative technique is to identify the simplifying assumptions that are characteristic of economic theory, correctly point out that those assumptions are seldom realistic, and then dismiss any policy position based on the theory. His technique is either naive or deceptive, because it misrepresents the role of assumptions in economic theory. Such assumptions are the beginning, not the conclusion, of economic analysis, and are not meant to be directly tested. Kuttner correctly observes that many participants in the market are not fully informed, rational, and narrowly self-interested. He also correctly observes that many markets have some transaction costs and are not perfectly competitive. But that is irrelevant. The test of economic theory is whether the behavioral hypotheses developed from the analysis are broadly consistent with the available evidence, not whether the assumptions are realistic. On occasion, in fact, economists are all too quick to modify their assumptions when the preliminary empirical tests are not satisfactory. Occam's razor, which Kuttner dismisses as, "the most overrated tool in the scholarly medicine cabinet," is an essential characteristic of any successful broad-based theory. A proposed policy, in turn, must meet a double standard: whether the effects of the policy change are likely to be consistent with those claimed and whether those effects are consistent with the values of the policymakers.

On net, although I would like to believe otherwise, Kuttner has overstated the influence of the free market, limited government advocates; maybe to energize his own coalition. He claims, for example, that marketization, of late, has swamped the polity. The dynamics are cumulative. Government has less popular legitimacy, and fewer resources with which to treat escalating problems. A more accurate perception is that the left has made some rhetorical concessions to secure their policy base. In fact, the left maintains a near monopoly of the policy debate in the academy and the national media. Few spending programs have been reduced and fewer have been terminated. The regulation of health, safety, and the environment has nearly broken any restraints based on scientific evidence and net benefits. American government has never commanded more resources, even in wartime. But the end of the Cold War, a broadly healthy economy, and a temporary lull in the dependency rate, make it difficult to convince the broad American public that we face escalating problems.

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In a comment in the *Washington Post*, Suzanne Garment writes: "To understand the economic policy debate that will take place in the next few years, you can't do better than to read Kuttner's spirited book." She is half-right in her judgement. This book should give ample warning of the next round of assaults on personal liberty, a market economy, and constitutional government. Read it and weep. Better yet, read it and prepare.

NEW LIGHT ON HOMELESSNESS

Making Room: The Economics of Homelessness
by Brendan O'Flaherty
(Harvard University Press, 1996) 349 + xi pages

Reviewed by William T. Bogart

Homelessness is no longer the policy flavor of the month—it doesn't even have a colored ribbon associated with it. And a consensus seems to have developed that homelessness is just a symptom of extreme poverty, rather than a separate subject of interest. So why should anyone read a book—especially one written by an economist—analyzing homelessness as a housing market phenomenon? Because Brendan O'Flaherty presents three important contributions: a coherent model of homelessness containing clear and testable implications, new data with which to test those implications, and a reasonable set of guidelines for developing and evaluating policies to alleviate homelessness.

The strong suit of most economists lies in analyzing sources of problems, while their weakness lies in prescribing policies to alleviate those problems. O'Flaherty is, in that sense, a typical economist. In his book, he effectively analyzes the explanations for the increase in homelessness in the 1980s. His solutions, though, are not as convincing as his criticism of others' solutions. He is an atypical economist because he is able to convey the nuances of economic analysis without resorting to either jargon or unnecessary mathematics.

O'Flaherty's book begins with an extended discussion of what it means to be homeless. In addition, he tries to identify why homelessness is a problem worthy of attention. The answers he gives are unconvincing, possibly leading the reader to question the value of pursuing the subject. However, his inability to identify reasons why homelessness per se is especially troublesome foreshadows his later emphasis on not discriminating between the homeless and others when designing policy. Had he expressed his intention more explicitly, he could have averted confusion.

The real strength of the book lies in its presentation of the economics of the housing market. O'Flaherty observes that homelessness has increased in the 1970s and 1980s. He then asks an interesting question: if increased poverty is the cause of homelessness, why did rents for poor people who were not "on the street" increase at the same time as homelessness? One would expect lower incomes to depress housing prices.

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O'Flaherty uses the "filtering model" of housing markets , a model familiar to most economists, to explain the higher renting costs. According to the filtering model, housing is constructed for relatively affluent people and then deteriorates, passing to lower income households, until it is eventually demolished or abandoned. The price for housing of a given quality depends on the supply and demand—the supply is a function of the rates of construction and deterioration; the demand is a function of household income. Homelessness represents either excess demand for housing of the lowest quality or insufficient income to afford housing of the lowest quality.

Given that framework, O'Flaherty presents a simple thesis. The income distribution in America changed; specifically the number of middle-class households decreased. That meant that less middle-class housing was constructed and that thus there was less to filter down to the poor. The decrease in the supply of lower quality housing in the market meant increased prices for such housing and thus an increase in homelessness. After homelessness increased, more homeless shelters were constructed. By providing an attractive alternative to rental housing, the shelters led to further increases in homelessness. That thumbnail sketch does not do justice to the facility with which O'Flaherty translates the mathematically sophisticated models of the modern economist into understandable ideas for the lay reader.

O'Flaherty also marshals an impressive array of evidence, especially from detailed case studies of New York, Newark, Chicago, and Toronto. He includes London and Hamburg as comparison cities, but the data are so sparse, especially from Hamburg, as to obviate their usefulness. The evidence is used to evaluate "the usual suspects" who are commonly blamed for homelessness: a smaller middle-class, gentrification, more poor people, higher interest rates, more shelters, and differences in household preferences. As already noted, he finds the evidence consistent with an explanation of homelessness resulting from a smaller middle-class, exacerbated by the resulting increase in the number of shelters. In an interesting twist, he turns his lack of data from Western Europe into an advantage, arguing that the system of rent support used there essentially removes homelessness. Even if that is true, it does not mean that there is no way of evaluating the low income housing market there—which is where the people who would otherwise be homeless should be found.

O'Flaherty's main policy focus is the "principle of nondiscrimination," by which he means that there should not be special policies applied to the homeless that are not applied to other groups. That idea has great appeal, but it runs counter to the liberal remedy of developing special programs for the homeless. Unfortunately, O'Flaherty does not explain how the Western European countries developed the housing allowance that he hails as a positive step, so it is not clear how such a proposal would fare in the United States political process.

O'Flaherty convincingly describes how shelters contribute to rises or falls in homelessness. As is obvious to an economist, a substitute to low quality housing, such as a shelter, leads some people to opt for the shelter instead of the housing. Hence, the presence of shelters can increase homelessness. Further, not all homelessness is a bad thing. Some shelters, such as those for battered women, are meant to remove people from their home. Those types of shelters contribute to the number of homeless people but provide a social benefit. However, the timing of the growth in the number of shelters makes them, at most, a secondary contributor to increased homelessness. Detailed data from New York, Newark, and Chicago are marshaled effectively to make that argument.

The conventional wisdom about homelessness comes from two books by sociologists: Peter Rossi's *Down and Out in America* and Christopher Jencks' *The Homeless*. Both authors characterize homelessness as a condition of extreme poverty rather than a breakdown in housing markets. Rossi emphasizes the idea that there are millions of people who are one bad break away from being homeless and Jencks identifies changes in the treatment of the mentally ill as an important contributor to the rise in homelessness.

O'Flaherty breaks with both authors by focusing on the definition of homelessness as "a condition of lacking housing." He spends a great deal of time distinguishing the condition of being homeless from "colloquial homelessness," characterized by unkempt clothes etc., and finds little overlap between the separate populations. He also argues that even if Jencks' contention is correct, the number of people involved is too small to be a complete explanation of the increase in homelessness.

The main analytical weakness in O'Flaherty's book is the lack of attention to the spatial relationship amongst housing, jobs, and shelters. Homelessness increased at the same time that edge cities grew around previously monocentric cities. The coincidence in timing suggests that "carlessness" and lack of transportation might be the real problem, as entry level jobs become increasingly inaccessible from low income housing without a car.

Zoning codes and building regulations may play a much more important role in causing homelessness in the United States than O'Flaherty assigns them. In fact, the higher density of development and more widespread public transportation in Western Europe are consistent with the hypothesis that the increase in homelessness reflects the increased dependence upon automobiles in the United States. Friedrich Engels, in his 1844 work *The Condition of The Working Class in England*, reported large scale homelessness in English cities during the peak years of the Industrial Revolution, a time when the extent of urbanization in that country grew beyond anything ever before seen in history. The idea that homelessness is a phenomenon associated with large scale changes in urban form deserves further study.

A truly radical idea would be to remove zoning codes and relax building regulations, but that idea is not broached by O'Flaherty, who advocates strict enforcement of building codes against shanties as part of his principle of nondiscrimination. His principle of nondiscrimination could, however, be interpreted as supporting the removal of building code regulations. Certainly relaxing or eliminating building codes would be desirable for the rich. And thus the principle of nondiscrimination could be invoked to argue for eliminating building codes for the poor as well.

UNIVERSAL ACCESS IN HINDSIGHT

Universal Service: Competition, Interconnection, and Monopoly in the Making of the American Telephone System
by Milton L. Mueller, Jr.
(MIT Press and AEI Press, 1996) 213 pp.

Reviewed by Paul Teske

Successful competitive entry into local telecommunications markets is proving to be very difficult, not only for relatively small, new competitors, but also for established long distance giants like AT&T and MCI, and for major cable TV firms. The Telecommunications Act of 1996 was supposed to get the ball rolling. But a recent decision by the Federal appeals court in St. Louis overturned the FCC's attempt to set specific pricing and interconnection rules for local competition. The court interpreted the Act as leaving state regulators with more discretion in that area. Some state officials have already made considerable progress towards establishing the guidelines for competition. But others may well slow the process, favoring their incumbent local carriers with large employment bases and cooperative histories within their states. No one has answered the question of when consumers will have real options for local telecommunications services. Clearly, regulators, analysts, and scholars need a better understanding of and more perspective on local telecommunications competition.

Mueller provides such perspective in his book, with an approach to the history of American telecommunications that is both original and convincing. The book—part of the American Enterprise Institute series "Studies in Telecommunications Deregulation"—is a success on many levels. It provides the best history I have seen of the period of competition around the turn of this century, before the Bell System developed its comprehensive monopoly.

Perhaps more importantly, Mueller uses a new interpretation of how and why competition expanded service and lowered prices. He places it in the context of a theoretical development that combines elements of newer economic approaches to network industries (though Mueller is not an economist) with an approach best described as "network theory." Mueller focuses on the critical fact that networks connect customers and shows how many of the traditional tenets of natural

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monopoly theory related to decreasing costs on the supply side are irrelevant or misleading in that context. His basic argument is that competition by a large number of firms to provide network access to a larger range of customers helped produce the near universal access that the Bell system alone could not produce. The Bell System originally focused only on urban areas, utilizing the telegraph model of serving only businesses and concentrated residential consumers. Competitors either reached out to more rural consumers or competed head-to-head with Bell companies in urban areas.

How did other suppliers compete with the Bell System? All else being equal, customers prefer larger networks in which they can make calls to more people. To attract customers and increase network size, suppliers offered low access prices. Thus, government mandates were not responsible for low prices. Mueller argues that both the Bell System and most of its competitors did not want to interconnect their networks until the Bell System saw the possibility of using the goal of "universal service" as an argument for making the system its own monopoly. Rather than a Bell plot or a technical necessity, however, Mueller argues that the telephone system that emerged in the early decades of this century was the result of active government policy choices; choices made without a full understanding of the consequences. Mueller argues that universal service was not the main cause of Bell's regulated monopoly, but rather that the use of that rationale, in retrospect, was used as part of a revisionist attempt to save the Bell monopoly in the 1970s from new competitors.

Mueller also attempts to apply the lessons of history to the current era of federal and state government regulated interconnection of networks and competition. Unfortunately, I finished the book still a bit hungry for clear analogies, due partly to some obvious and important problems in translating Mueller's findings to the current environment. In particular, today one firm already has ubiquitous access to all customers in its service area. That is quite different from the days of network expansion, when the Bell System did not rush to serve all customers, especially those in rural areas.

Mueller provides insight into current issues by emphasizing that today's choices are policy decisions not necessarily dictated by technology or economics, and by stressing that competition sometimes works in surprising ways. Mueller addresses the historical implications for network interconnection pricing, as well as the incentives (or lack thereof) that unbundling of network elements provides for the construction of new network infrastructure. Mueller's history suggests that rural consumers today, thought to be too costly to serve with the most updated technologies absent a government-regulated subsidy policy, are likely to be served in an affordable manner by new competitors, perhaps by using wireless technology.

The policy guidance or recommendations of the book would be strengthened by looking at other countries. Mueller argues that the American telephone system developed as a result of explicit policy choices. In a sense, then, Mueller has provided a careful historical case study of one country. But all other developed countries established telephone networks, admittedly usually after the United States and without extensive competition, though with different policy approaches and effects. Given Mueller's argument about the expansion of American networks, it would have been fruitful to address questions like: why did government-owned monopolies develop in European countries and why did they purport to provide and support universal service goals?

The subtitle of the book is more accurate than the title. This book is really more about network interconnection, not universal service, per se. I note that explicitly because the title may suggest yet another effort to pin down the elusive role of universal service in the current information age, muddling the book's central point about network interconnection and incentives. Nevertheless, Mueller has important points to make about universal service. He notes that what little American "phonelessness" exists, in fact stems more from residential mobility and credit problems than from high network access prices. Perhaps most interestingly, he argues that an attempt to link all Americans together over a single, homogeneous network does not comport with history or even today's realities. Consumers can access different networks, sometimes interconnected and sometimes not, through combinations of regular residential telephones, pay telephones, pagers, cellular and personal communications services, Internet access, local area networks, and wide area networks.

While Mueller generally supports his historical statements well, with citations and footnotes of letters and documents gathered from telephone libraries and other sources, in some cases he makes important assertions that are not directly referenced or supported. That is a relatively minor criticism, as it is difficult to present history in an interesting fashion with too many citations. Still, the book would benefit from more citations to assure readers that Mueller's interpretations are appropriate.

In attending industry and academic conferences, I had long heard that Mueller's work was provocative and could reshape the treatment of networks. Whether or not the reader buys all of Mueller's arguments, they are worth examining, and there is very little stale or unoriginal material in his book. Since this book challenges some longstanding and traditional conceptions about telephone system development, readers who already know something about those topics will probably get the most value from Mueller's work. As the American courts, the FCC, state regulators, and perhaps even Congress again examine issues related to local competition, a sense of Mueller's historical perspective can only improve policymaking.