IN REVIEW

How Regulators Play the Rulemaking Game

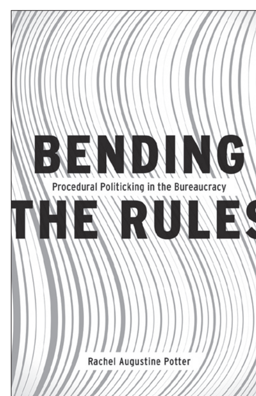
REVIEW BY SAM BATKINS

How many books on regulation put forward a public choice theory for regulators? Rachel Augustine Potter's *Bending the Rules* touches on many of the same themes that James Buchanan did decades ago. Do regulators respond to incentives? Are they motivated to increase the costs of third-parties scrutinizing their controversial rules by writing more words and making rules more complex? Perhaps regulators are far wiser than the public gives them credit for—at least in using procedure to induce self-interested outcomes.

Potter's book is part Rulemaking 101, along with a series of detailed empirical studies to explain the tools and methods regulators deploy to ensure their work results in final rules. Many of the tools studied—the too-short public comment period, for example—may be familiar to many, but the book relies on a comprehensive data set to explain how each agency differs and how effective each tool is at staving off political scrutiny.

The book is basically a study of how regulators employ procedural tools to insulate their rulemakings from sabotage by third-parties. Naturally, anyone who spends two to three years shepherding a rule through the notice-and-comment process, OIRA review, media scrutiny, and Capitol Hill hearings will have plenty of motivation to ensure a proposed rule eventually becomes a final rule. Agencies not only wield incredible substantive power—given the broad latitude Congress typically concedes to regulators in legislation—but also procedural power to craft how many words are in a rule, how long the public has to comment, and when a rule is published.

Consider that, for many career regulators and even political appointees, there is notable scrutiny for a substantial number of major rules. If Congress is controlled by a different party than the presidency, for instance, expect frequent oversight hearings. Every controversial regulation will generate tens of thousands of comments (if not millions) from proponents wishing to finalize the rule and opponents hoping to defeat it. For some rules, press coverage will be sufficient to give the agency and the rule a national profile. *Bending the Rules* demonstrates regulators shrewdly respond to this outside pressure by using all of the procedural tools at their disposal to make substantive changes to the regulatory state.



Bending the Rules: Procedural Politicking in the Bureaucracy

By Rachel Augustine Potter

244 pp.; University of Chicago Press, 2019

Mightier than the sword / Potter, a University of Virginia political scientist, argues that regulators' "writing tool kit" is far more powerful than many realize. For example, agencies can frame a potentially controversial regulation in less contentious terms. For instance, they can place their fingers on the benefit–cost scale, deciding which costs and benefits to consider in an analysis. Who could oppose a rule with $2 billion in net benefits to the economy? Political allies and many in the press seize on these agency-generated figures to help usher a proposed rule to final form.

Also, regulators can write a ton of words, employ legal and technical jargon, and make the rule as "inaccessible as possible." In a town with overworked congressional staff, a complicated rule raises the cost of oversight. That extends beyond Capitol Hill; many interested trade associations and corporations that have to comply with the rule sometimes must hire outside experts to digest the complicated wordsmithing of agencies.

Rather than just explore these phenomena on a surface level, Potter does the reader and the regulatory community a favor by quantifying the biggest offenders of the incomprehensible rule trend. To do so, she compiles a dataset of more than 11,000 proposed rules issued between 1995

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and 2014. Roughly 84% were eventually finalized.

One of her analyses focuses on the complexity of rules. To quantify "complexity," she develops two measures. The first is length of the preamble, which is what many of us consider to be the actual rule. This is the section of the proposal that explains the rule and precedes the text that will actually be codified in the *Code of Federal Regulations*. She finds a typical preamble is roughly 6,300 words, or 25 double-spaced pages. The second measure she uses revolves around the clarity of the text itself. Instead of relying on a single readability metric, Potter employs 28 widely used measures of readability.

The book convincingly demonstrates how agencies use complexity to ward off opposition and get the rule to final publication. For example, judicial oversight can also be a key driver for how agencies manipulate rulemakings. For agencies subject to frequent legal challenges, the average preamble increases to more than 10,100 words, roughly 41 pages. Likewise, when there is substantial public opposition, agencies increase the length of the preamble by an average of 6,200 words.

Which agencies make life easier or more difficult for those who must actually comply with rules? On readability, the Food and Drug Administration fares poorly. On the average preamble length, both the Environmental Protection Agency and the Centers for Medicare and Medicaid Services will bury readers in technical rhetoric. Anyone who has ever had the displeasure to read an entire EPA or CMS rule will understand Potter's results.

Diminishing readability confers two advantages on agencies. First, as mentioned, the media and Capitol Hill must devote more time and resources to understanding the rule. Second and perhaps less obvious, a detailed and complicated rule might help with compliance. There are firms that prefer more detailed measures to spell out exactly what they must do to achieve compliance. Many companies have a cadre of in-house and outside lawyers who charge a small fortune to help companies understand regulation.

A more detailed preamble might score low on the readability scale but it might also ensure the rule survives a court challenge. As Potter demonstrates, there are plenty of incentives for agencies to continue cranking out longer rulemakings. What's worse, few regulatory reform proposals even scratch the surface of addressing this problem.

Timing is everything / On paper, the 2012 presidential election was supposed to be a close affair. Incumbent Barack Obama had a narrow lead in the polls, but challenger Mitt Romney was believed to be close enough to make election night interesting. It didn't turn out that way, though; as the returns came in, Obama easily pulled away.

There are plenty of incentives for agencies to continue cranking out longer rulemakings and few reform proposals scratch the surface of this problem.

In the months leading up to the election, regulators and Obama's administration were busy deploying a procedural tool to help grease the wheels of his reelection: delay. As followers of the regulatory world are well aware, rules can fly out of the administration after election day and before inauguration of a new president: the so-called "midnight" period. On the flip side of this phenomenon, regulators can temporarily halt rules to diminish political backlash. For instance, regulators decided to sit on an EPA regulation that would have slightly increased the price of gasoline until after the 2012 election. (They weren't the only ones; the *Washington Post* only reported on the rule a year later.) Although the White House officially claimed that the delay in announcing the rule and other measures was merely coincidental, interviews with seven administration officials confirmed that politics played a role.

As Potter notes, regulators have a "timing tool kit" that complements the writing tool well. The timing kit includes deciding when to publish a proposed or final rule. It can also include the length of the comment period. Rules with a 90- or 120-day comment period often take longer to finalize than rules with just a 30-day period. Another tool is manipulating the time between when OIRA releases a final rule and when it actually appears in the *Federal Register*. Research by the American Action Forum shows that these maneuverings go beyond delays or expedited publication to actual strategic publication of new rules. For instance, August is a popular month to publish regulation. That Congress takes the month off is probably more than just a coincidence.

The timing tool kit also includes determining the effective date of a rule, including postponing it until well after the rule is published. Incoming administrations often use this delay to review the recent rules from their predecessors. As Potter notes, regulators use these tools to limit the amount of scrutiny—both political and legal—a regulation receives.

The dataset in *Bending the Rules* also helps to understand the regulatory timing phenomenon. Potter finds that while 60 days is supposed to be the norm for comment periods, there is considerable variance among the agencies. For example, the Federal Aviation Administration, FDA, and Office of Energy Efficiency and Renewable Energy often have the longest comment periods. On the other side, the National Oceanic and Atmospheric Administration and Office of Personnel Management typically have fast turnarounds for their rules. These may seem like trivial stats, but regulated companies must marshal considerable resources quickly to comment in just 30 or 60 days. A lot is on the line. Sometimes regulated entities can be barred from raising an issue in court if they failed to do so during the rulemaking process.

As Potter notes, regulators are well aware of this reality and manipulate it in their favor when possible.

Conclusion / *Bending the Rules* is a fascinating and well-researched dive into an often-overlooked area of regulatory policy. Many scholars are determined to study the substantive effect of a regulation and how it affects economic growth, prices, and employment. These are important topics, but as Potter demonstrates, understanding the steps regulators take before a proposed regulation becomes a final rule is just as important.

One of the book's main benefits is its accessibility for those just learning about regulatory policy and its ability to contribute novel research to this underappreciated area of study. Few will look at an August recess final rule or a comment period of 30 days again without thinking about the regulatory motivations that went into those pivotal decisions. R

Was the Panic of 1819 America's First Great Depression?

REVIEW BY VERN MCKINLEY

Five years ago, I read *America's First Great Depression*, about the Panic of 1837, by political scientist Alasdair Roberts. This year, historian Andrew H. Browning argues in *The Panic of 1819* that that downturn deserves the grim "First Great Depression" title. Which author is correct?

The National Bureau of Economic Research's recession-dating only goes back to the 1850s, so the Panics of 1819 and 1837 have not been officially adjudged recessions, let alone depressions. This does not mean that they were not severe. As Browning explains, "It is impossible to measure the damage done by the Panic of 1819—too few statistics were kept to allow detailed comparisons with later depressions—but the evidence we have is sobering." Economist Murray Rothbard, in his 1962 book also titled *The Panic of 1819*, agrees, opening with the line, "The Panic of 1819 was America's first great economic crisis and depression."

Bank of the United States / Browning spends the first part of *The Panic of 1819*, nearly a third of the book, providing historical background before addressing the instability of the era's banking system. These chapters drag a bit, as it is sometimes unclear how these topics weave together into the narrative of the Panic. Browning addresses the aftermath of the Napoleonic era and the related sale by the French of the Louisiana Territory; revolutionary advancements in markets and transportation, as well as the form of corporations; the so-called "year without a summer" of 1816, in which worldwide cold temperatures (induced by aerosol from the eruption of Mount Tambora in modern-day Indonesia) resulted in an intercontinental agricultural disaster; and the Alabama Fever, which was one of many land booms of the time that led to a bubble.

These developments put enormous pressure on the era's banking system, which was localized and fractured by state regulations. The megabank in the early 19th century was the federally chartered Bank of the United States (BUS), with an initial charter lasting from 1791 to 1811 (the First Bank of the United States) and a second charter beginning in 1816 in the run-up to the Panic and expiring in 1836 (the Second Bank of the United States).

The BUS had special status in that it was allowed to have multiple branches across state lines and was the main depository and lender to the United States. Private, state-chartered bank competitors were not so endowed and, as a result, the BUS had a dominating presence in the developing U.S. economy. "The [BUS] was the only true national corporation in the country, and it dwarfed not only every other bank but every other business," Browning notes.

During the BUS's interregnum from 1811 to 1816, hundreds of private banks were formed, but many struggled when it re-entered the market. Browning traces the growth of the U.S. banking system from 29 banks as of 1800 to 90 as of 1810. When the BUS closed down in 1811, it left a vacuum for private banks to fill, and by 1820 those banks numbered more than 300. This all happened at a time when the state-chartered banks should have had specie (silver or gold) to back their notes. Browning writes:

> Local banks proliferated throughout the states, all printing their own banknotes—and usually far in excess of any specie reserves they might have.… When the [BUS] was incorporated in 1816, its charter required that its notes be redeemable in specie.… [The BUS's] cashiers were understandably reluctant to accept deposits in the form of unfamiliar, distant banks' notes when withdrawals could then be made in gold or silver, especially when overextended local banks began refusing to redeem their notes in specie.

According to Browning, the state banks were also very loose with their lending standards. He writes of "loans that would never be repaid and banknotes that would never be redeemed, issued by banks that might be unknown outside of their own neighborhoods."

Despite its size and federal charter, the BUS was similarly troubled. William Jones, president of the bank during the run-up to the 1819 Panic, was a well-respected naval officer and statesman, and even briefly the

acting treasury secretary, but he "had neither experience nor training as a banker." Jones was said to have had a halting regime, during which he "proceeded to run the economy into the ground by first extending far too much credit, then quickly restricting it."

Jones's fellow BUS directors were a sad lot:

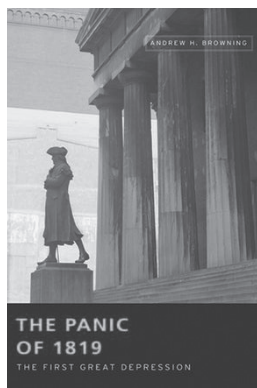
> During the first year of operation its directors appeared to see themselves as no different from the officers of any other bank, making incautious loans to other banks, to businesses, and to individuals—notoriously to select politicians, editors and, of course, themselves.... Senator George Poindexter received a $10,000 loan from the Bank shortly before voting for its re-charter.

Rothbard contended that the BUS was almost entirely to blame for the Panic, but Browning doesn't go that far:

> [Rothbard has] blamed "central bank" intervention in a free financial market, but the BUS was hardly a central bank in the modern sense.... Indeed, it was itself a part of the working of the free market.... The Panic was too complex—and far too extensive—to blame solely on the [BUS].

Browning's explanation / So, according to Browning, what was the primary cause of the Panic and how did the BUS and other banks fit in? One trigger for the downturn had its genesis in the decision to purchase Louisiana from France. He writes:

> Over $4 million in Louisiana bonds would come due in 1818 and 1819—most owed to foreign creditors, and all promised in specie.... The [BUS] saw no choice but to demand some of the millions of dollars owed to it—in specie—by the hundreds of state banks whose notes made up the bulk of its deposits.



The Panic of 1819: The First Great Depression

By Andrew H. Browning

450 pp.; University of Missouri Press, 2019

About the time the BUS began restricting credit, the private banks began failing at an alarming rate, first suspending specie conversion and then closing their doors. Browning writes:

> It is impossible to say how many banks failed in the wake of the Panic. In 1830, [former treasury secretary Albert] Gallatin declared that at least 165 banks had failed since 1811. Since ... no more than 400 were chartered by 1819, and very few failed before the Panic, that suggests a proportion comparable to the wave in the early 1930s—perhaps 40 percent.

The affected / There were knock-on effects from the bank failures to those of modest means. Browning relies on the vivid anecdotes available to him through his deep research to describe what contemporaries called hard times:

> Earlier panics had injured only well-to-do investors; in 1819 the humble suffered along with the well-to-do.... [A] writer for the *Federal Gazette* was appalled by the number of beggars in the street, and found "every feeling of my soul harrowed up by a sight most shocking to humanity, age in rags, in want, in pain, homeless, friendless, penniless."

Those of greater means moved to the South and took on debt in the hope of striking plantation riches. In some cases, this yielded riches-to-rags stories, including this news item that Browning relates:

> [Llewellyn Jones] had come south in 1809 from Tennessee.... Six years later he owned one thousand acres, two town lots, and thirty-four slaves.... Jones put a period to his existence last night by hanging himself.... [He] had taken his life in despair at a bad bargain he had made in a land purchase he now could not pay for.

Often such purchases were financed through the federal government for land in the South and West.

Many people know that Thomas Jefferson died in dire financial straits, but they may not know the role the Panic of 1819 played in that. In an apparent quid pro quo for Jefferson's personal loans, the BUS's Richmond branch president asked Jefferson to cosign $20,000 of the bank president's own notes for speculative land purchases. Those notes then turned sour:

> [Jefferson's] mounting debts and the unexpected failure of a friend whose notes he cosigned would force his heirs to sell his beloved mountaintop plantation.... Jefferson had begun borrowing from the BUS as soon as it opened an office in Richmond. Already chronically in debt to creditors, ... in June 1817 he borrowed $3,000 from the BUS, adding another $3,000 the following spring.... [By 1819, with the BUS tightening,] Jefferson tried to sell land to pay the Bank but was shaken to discover how low the price of land had now sunk and how little demand there was at any price.

Relief? / We know how the federal government responded to the recent financial crisis. But in the early 19th century, the federal government did not make a habit of intervening in the economy during peacetime. Browning speaks of the "near absence of references to the economic crisis in the annual messages of President James Monroe," the president whose term was nearly coincident with the Panic.

Pleas for relief at the state level were in the form of ending debtor imprisonment and imposing stay laws against the sacrifice of property. At the federal level, the main target was addressing the "enormous debt run up by Americans who had bought land from the United States on credit."

Conclusion / Browning makes a strong case that "the Panic of 1819 was different; it struck all economic classes and all regions." The book is well-documented, as Browning's endnotes reveal an extraordinary cache of documents from newspapers, periodicals, archives, government sources, contemporary books, and ex-post historical analyses.

As for the disagreement between Rothbard and Browning on the role of the BUS, I must side against Browning. The BUS was hardly a free-market institution as he contends, given its special government-granted status that led to its market dominance, akin to Fannie Mae and Freddie Mac in today's mortgage market. One would be hard-pressed to argue that the BUS was not at the center of the Panic, abetted by government decisions such as buying Louisiana through issuance of debt and fueling a broad-based land bubble through its provision of easy credit. R

Carbon Trading and International Trade

REVIEW BY GREG KAZA

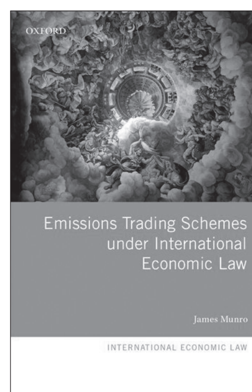
Emission trading schemes (ETS) for greenhouse gases continue to develop, employing "market-based mechanisms" to "achieve environmental outcomes in the most cost- and resource-efficient manner." Yet elements of ETS are problematic under international law because they can be deemed tariffs and thus a form of protectionism. This book, by James Munro of the Melbourne Law School and World Trade Organization, explores the legal nuances and market applications of these schemes.

The international carbon market includes private investors, financial traders, and emitters with liabilities under domestic regulatory schemes. Other market participants include government units, though their activity is "peripheral," and "carbon funds" that simply see carbon units as another tradable asset. The core activity is trade and investment in units that represent the annual right to emit a specific amount of greenhouse gas. Munro brings needed clarity to the question of whether these activities are subject to international economic law.

His book is divided into three parts: conceptual ETS foundations, a description of carbon units, and the consistency of trading schedules.

Internationalizing a global cost / In part one, Munro notes that three international agreements comprise the climate regime under international law: the United Nations Framework Convention on Climate Change (UNFCCC), the Kyoto Protocol, and the Paris Agreement. The UNFCCC's goal is to stabilize greenhouse gases in the atmosphere at a certain level, but leaves unresolved how the burden should be shared between countries. Kyoto "enshrines legally binding quantified targets and timetables for emissions reductions" in 35 developed countries. Paris reorients the regime to the principle that "all countries must adopt verifiable measures to mitigate climate change."

ETS are based on the idea that economic growth and environmental protection "are presumed to be mutually supportive." This approach, Munro writes, is intended to correct a "tragedy of the commons" by internalizing the cost of using a resource and creating a market price signal. Its key advantage lies in "allowing the market to discover the most economically and technologically efficient means of sustainably managing the resource." An "important element" is "the characteristic of private ownership of property," which "facilitates trade and investment in permits by private actors, the core function of a transferable permit scheme."



Emissions Trading Schemes under International Economic Law

By James Munro

224 pp.; Oxford University Press, 2018

Tradeable carbon units take two general forms: allowance units and offset units. Allowance units are created by a government or regulator operating an ETS and are distributed through auctioning, selling, or freely allocating units. Governments effectively control the amount of greenhouse gases that may be emitted by allocating a limited number of units. Offset units are created by private economic agents. These represent the reduction of greenhouse gases outside of an ETS, usually as the outcome of a project that removes carbon from the atmosphere (planting trees) or avoids emissions (cleaner technology).

Some schemes expressly designate carbon units as property rights. By contrast, according to Munro, Kyoto explicitly clarifies

> that its carbon units do not "create or bestow any right, title or entitlement to emissions of any kind." Similarly, the California ETS scheme states that carbon units are not property rights. California's government reserves "the right to cancel carbon units without the consent of their owners for any reason."

Munro observes, "There appears to be a marked lack of consistency across different jurisdictions as to how carbon units are legally classi-

fied." The World Bank counted 24 ETS as of 2017, with most comprising cap-and-trade schemes. There is also a voluntary market that serves individuals, companies, and governments that voluntarily reduce their carbon footprint by "purchasing and cancelling" units. This market is smaller ($191 million in 2016) than the compulsory ETS market.

International trade / In the book's second part, Munro examines whether carbon units constitute financial derivatives, transferable securities, negotiable instruments, financial assets, or other financial products. Concerning their international trade, he notes that the General Agreement on Tariffs and Trade (GATT) contains no express definition of the terms "goods" and "products," and so it's unclear whether ETS fall under the treaty. Munro contends GATT "paints a convoluted picture." He offers two readings, first a narrow one that applies to "only mass-produced, physically tangible objects intended for commercial consumption that have been manufactured or processed in some way and in which property rights subsist," and then a broad one that includes "anything of value that is capable of being possessed and traded." Carbon units appear to qualify as goods and products under the broad reading but not the narrow one. Yet the answer is more complex, "somewhere in the midway between the narrowest and broadest possibilities."

There is also disagreement over the status of international trade in specific financial instruments like derivatives. If units can be considered a "derivative product," then trading in them will constitute a "financial service" under the WTO's Annex on Financial Services. "There are some minor variations between the definition of 'financial services' in the Annex and some free trade agreements," Munro notes. "It seems reasonable to conclude that carbon units will also often be regulated by financial services–related obligations under free trade agreements." Some argue carbon units are not derivatives because the latter are based on private law contracts rather than government-issued rights. But the World Bank reports that the lion's share of carbon units trade occurs through derivatives. The Annex covers much of their trade.

Different systems / Some governments, notably California, have refrained from conferring carbon units or similar instruments with proprietary status under municipal law. Economist John Dales, an early ETS proponent, wrote in a 1968 *Canadian Journal of Economics* article that "pollution rights are fully transferable property rights." In the book's third part, Munro notes the "differential treatment" accorded to types of carbon units depending on their jurisdiction of origin. He notes differences in ETS systems in the European Union, Switzerland, New Zealand, Norway, California, Quebec, Korea, and Australia. "Some but not all of the instances of differential treatment … give rise to prima facie violations of non-discrimination provisions," he writes, referring to trade agreements. He singles out California and Australia as examples of ETS systems that appear to act as trade barriers. Munro notes "a deeper tension" between "certainty, predictability, and efficiency in the market" and government regulators that wish to act.

Carbon units exhibit all of the qualities of goods and products. In his conclusion, Munro notes "the volume and extent of prima facie inconsistencies" exhibited by ETS "with international economic law." He cautions "governments and regulators" to "be alert to the prospect that aspects of their schemes violate international economic law." Officials should take heed. *R*

De-Mystifying Market Manipulation

REVIEW BY TIM BRENNAN

Ronald Reagan is credited with the observation that economists are "people who see something work in practice and wonder if it would work in theory." As an economist, I'm guilty as charged. To understand something is to put it into a theoretical framework that shows causes and explanations. Until that happens, that "something" remains a puzzle. "Market manipulation" has been, to me, one of those puzzles.

My puzzlement isn't the product of some simple faith that markets correct all ills. It results from the difficulty of finding a theory that explains how market manipulation would work. To get a sense of why this is difficult, consider a simple information-related malady: person *X* lying to person *Y*. Of course, lying happens, but superficially it is puzzling because it works only if *Y* believes *X* is telling the truth. The economics of strategic behavior typically requires observed behavior to match expectations—"Nash equilibrium," for jargon aficionados. Because it relies on mistakes, lying is "not Nash."

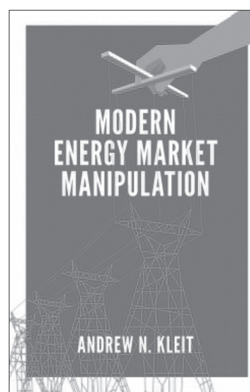
One cannot solve this problem by invoking "asymmetric information." As George Akerlof observed in his Nobel-winning article nearly 50 years ago, the only Nash equilibrium is for everyone to assume the worst. It is not that some get ripped off by assuming better and being disappointed; everyone should assume the worst and thus avoid getting ripped off. But being ripped off is just what a theory of market manipulation needs to explain.

As Penn State economics professor (and—disclaimer alert—friend and occasional collaborator) Andrew Kleit observes

in his cogent, accessible, and informative book *Modern Energy Market Manipulation*, the first step is to define what one means by "market manipulation." He begins by taking care to distinguish market manipulation from speculation or hedging. Like most economists, he recognizes that speculation and hedging are good for an economy. The former brings more information into markets and improves the value of prices as signals of expected future worth, and the latter minimizes the cost of uncertainty by exploiting negative correlations to reduce or eliminate risk. But Kleit goes further by identifying the focus of market manipulation not just as harmful practices but as those designed to change price rather than arbitrage price differentials or exploit price correlations.

Manipulations / Some practices that might fall under "market manipulation" in this sense are not mysterious. Cornering supplies of a resource, input, or complement drives up prices and is at the core of antitrust complaints based on "raising rivals' costs." Kleit wants to focus on prices of financial assets, however, and offers four candidates:

- *Taking a long position in an asset and then releasing "allegedly factual information that increases 'artificially' the price of the asset."* An example of this that comes to my mind is the artificial orange crop forecast used to bankrupt the bad guys in the Eddie Murphy movie *Trading Places*. This implies that the manipulator has a monopoly over the information that influences the asset price. Otherwise, it is not conceptually distinguishable from Kleit's next category.
- *Reporting false trades that influence the price of an index that determines the settlement price of an asset.* This comes closes to the "lying" story above. Kleit reports that indexes settled this way are now "rare" following market "learning," although they may have been present in early electricity and natural gas commodity markets.
- *Withholding supplies purchased in advance to drive up the spot price.* This seems the easiest type of manipulation. But Kleit points out that this strategy requires that one first corner futures contracts without driving up their price, and then liquidate those contracts at some point without causing the price to plummet.
- *Driving up the contract price by buying up assets during the settlement period.* This seems to me to combine the previous two strategies. Kleit notes that this requires surprise because "no one will go short if they think the [commodity] price will be manipulated upwards." But, as noted above, it is the requirement of surprise that makes market manipulation mysterious. Is it reasonable to think that those who invest substantial amounts in commodity futures markets are susceptible to surprise?



Modern Energy Market Manipulation

By Andrew N. Kleit

240 pp.; Emerald Publishing, 2018

Kleit differentiates his definitions from those of Shaun Ledgerwood and others (second disclaimer: I'm an academic adviser to the Brattle Group, where Ledgerwood is a principal) in not requiring that manipulation activity be unprofitable but for gains from manipulation. This is surely right, but as with predatory pricing, a requirement that such activity be below the alleged perpetrator's cost may be a useful rule to avoid chilling efficient conduct when enforcement is unlikely to be error-free. A below-cost pricing rule could also help distinguish manipulation from generally beneficial speculation or hedging. But Kleit, following decisions in leading manipulation cases, seems to prefer to use the intent of the alleged manipulator to sort bad conduct from good. However, he finds quantitative tests to challenge allegations in manipulation that were more likely hedging or speculation.

Kleit reviews the apparently limited theoretical literature on manipulation, but those models don't offer much help. Two similar models, based on whether the manipulator forces down the price through selling contracts or the commodity itself in the spot market, appear to assume a manipulative effect of these sales on prices without explaining how that effect arises. He then models Ledgerwood's characterization of index manipulation, finding that it works only if, in effect, the manipulator owns more of the asset than is used to set an index price—Kleit calls this a "direct effect"—or if the manipulated price changes the price of other transactions that set the index—called a "cascade effect." He argues that the existence of cascade effects is uncertain at best and that only traders capable of surprise would use an index where a manipulator could profit from a direct effect. Because surprise is just the way normal people say that realized behavior differs from expected behavior, the challenge of explaining market manipulation within the standard economic Nash framework remains. (For a clue on how to get around this, see the end of this review.)

Tales of manipulation / Even if we don't seem to know how this works in theory, we still want to know how it works in practice. This brings us to the entertainment portion of the program: Kleit's always-illuminating and frequently revisionist recounting of a number of alleged manipulation episodes.

One example is the (in)famous Hunt brothers' alleged manipulation of silver in 1979–1980. (See "Silber on Silver," Summer 2019.) While, as he puts it, "everyone knows" the Hunt brothers manipulated that market, Kleit tells a different story. In the 1979–1980 timeframe, with inflation looming, brothers Nelson, William, and Lamar purchased silver as an inflation hedge. They were so desper-

ate to do so that they bought on margin, ran up against limits set by the Commodity Futures Trading Commission on market positions, and fanned the ire of stakeholders who had sold silver short. However, when Paul Volcker became chair of the Federal Reserve, the likelihood of inflation fell, leading to the Hunts' bankruptcy. In Kleit's view, this may have been unwise speculation or hedging, but not manipulation. He points out that while some found that the Hunts' silver holdings were up to 80% of annual production, the relevant comparison is to the stock of silver, of which the Hunts held no more than 1.5%.

Kleit's attention to critical facts plays a role in his assessment of the CFTC's seminal *DiPlacido* case involving electricity contracts. According to Kleit, the conduct at issue was likely driven only by hedging and the need for liquidity. The allegedly manipulated price is a calculated closing price on an asset—in this case the average price of a particular electricity contract—in the last two minutes of the trading day. The crucial difference between hedging and manipulation is whether the alleged manipulator had sufficient share of these two-minute settlements to influence the calculated price and a large enough position of assets priced at, but not influencing, that level.

Kleit reports that what little evidence there was did support hedging, and that the manipulation finding required the CFTC to be "both the prosecutor and the judge." The CFTC constructed a manipulation case largely by claiming that the alleged manipulator created an artificial price by "violating bids"—that is, not accepting the best offer. Kleit points out that during hectic and volatile times on the trading floor, traders may be more interested in liquidity than getting the best price. Consequently, the CFTC failed to consider alternative explanations and also whether there was motive to manipulate. I would not put much weight on motive—regulation is hard enough without requiring psychiatry—but this lends even more weight to Kleit's argument for the importance of standards of evidence in distinguishing manipulation from benign trading and careful investigation of whether those standards were met.

A third example involves the existence and role of market manipulation in the implosion of California's electricity sector in 2000–2001. After the state opened retail electricity markets in 1998, they worked fine for about two and a half years, until a combination of dry weather reducing supply of hydroelectric power and increased demand from Las Vegas raised wholesale electricity prices in 2000. This led to retail price increases that proved politically unpalatable, leading regulators to cap retail prices while letting wholesale prices rise—a recipe for utility bankruptcy and market collapse.

Most alleged manipulations stand a good chance of being either benign hedging and speculation, expensive mistakes, or exploitation of regulation.

Since opening California's electricity markets passed the legislature unanimously and was supported by virtually every stakeholder, demand for a scapegoat may have exceeded demand for reliable electricity. Enron, surely a bad actor in other respects, perfectly fit the bill for the needed villain. However, Kleit finds that Enron's alleged manipulations—through acquiring rights to transmission without intent to actually use it, or short-selling electricity—either were done by many others or took advantage of peculiar market designs. Kleit suggests that if anyone manipulated electricity markets during the California electricity crisis, it was the major utilities, which attempted to drive down wholesale prices by bidding below their expected demand.

Kleit discusses a number of other putative manipulation cases involving transmission congestion, natural gas futures, gas and electricity price indexes, baselines for calculating compensation for reducing use, and others. In these cases and others, his explanations are sardonically entertaining. If you find yourself at dinner with him—as I have many times—and he starts to say he's got a story about market manipulation to tell you, do not feign a call from the babysitter as an excuse to leave. Stick around and you'll have a good time. Short of that, you'll have to read this book.

Lessons / Unlike most dinner parties, however, this book lacks a conclusion. The reader is left to extract the lessons from Kleit's case studies. I took away a few.

One is that, as he repeatedly admits, stories of energy market manipulation are usually confusing. When the underlying theory remains unclear, that's to be expected. A second lesson is that most alleged manipulations stand a good chance of being either benign hedging and speculation, expensive mistakes, or exploitation of dubious regulatory market designs. Third, in the one or two instances where Kleit thinks manipulation may have taken place, the regulatory proceedings were dubious at best and abusive at worst. If there's a clear and clean case of manipulation in energy markets, it is not in this book.

So, how to explain the existence of successful manipulation? While manipulating an index and other forms of lying are inconsistent with the Nash equilibrium method for understanding strategic outcomes, it may not be if listeners believe they are being told the truth most of the time. If, say, investors believe indexes are truthful 90% of the time, then they may choose to always believe what they hear—perhaps with some hedging—and one observes manipulation 10% of the time.

Why might investors have such optimistic explanations? One possibility is simple trust. For those with a more cynical view of commercial human nature, the belief has to come from something else. The most apparent "something" is enforcement policy to maintain the veracity of an index. Perhaps paradoxically, the justification for going after market manipulation may be that investors simply expect regulators to do so. R

IN REVIEW

Virtuous Entrepreneurship

BY PHIL R. MURRAY

Felix Livingston teaches economics and directs the Honorable Entrepreneurship Program at Flagler College in St. Augustine, FL. He also is the author of *On the Private and Public Virtues of an Honorable Entrepreneur*, which celebrates entrepreneurs and condemns crony capitalists.

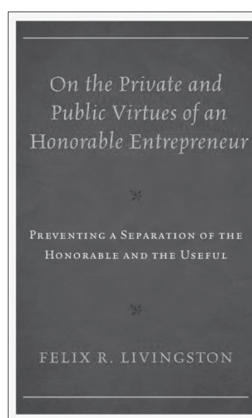
In the book, he describes capitalist society as the "extended order of peaceful social cooperation," drawing on the thought of Friedrich Hayek. The key institutions of a capitalist society are, according to Livingston, private property and the Rule of Law. "It is hoped," he tells us, "that this book will improve understanding of the extended order of peaceful social cooperation and its prerequisites."

Livingston's exaltation of the entrepreneur taps intellectual history beginning with Alexis de Tocqueville. In a fanciful prologue, Livingston imagines Tocqueville expressly warning the 21st century of "activities now taking place that are dishonorable even though they are considered to be perfectly legal." Tocqueville characterizes honor as acting based on the virtues of "courage," "honesty," and "hard work." These virtues need exercising. Livingston's Tocqueville warns, "Today, dishonorable business executives commit acts of plunder when they seek and obtain preferential treatment from compliant politicians whose legislative actions weaken private property rights and undermine the Rule of Law."

Rule of law / Livingston reviews the history of private property rights and the Rule of Law. The ancient Greeks, Romans, English, and Americans contributed to these key institutions. Livingston shares this wisdom of Aristotle: "Property should be in a certain sense common, but, as a general rule, private; for when everyone has a distinct interest, men will not complain of one another and they will make more progress because everyone will be attending to his own business."

The Greeks called their Rule of Law "isonomy." Livingston cites Hayek's *The Constitution of Liberty* to explain isonomy as meaning "that equal laws were created for the noble and the base—all Athenian citizens were governed by known and general rules rather than by the caprice of tyrants." Under the Roman version of the Rule of Law, the Law of the Twelve Tables, all citizens (rulers and the ruled) had comprehensive private property rights.

Fast forward several centuries. The English produced the Magna Carta. Landed barons, with the support of commoners, demanded that the king respect property rights and civil rights. Move ahead another five centuries to the American contribution. "From their study of history," Livingston tells us, "the Founders concluded that human beings are tragically flawed and vulnerable to the corrosive effects of excessive power." The U.S. Constitution enshrined private property rights and the Rule of Law. The Founders' idea of separating powers among legislative, executive, and judicial branches of government, and between national and state governments, bolstered the Rule of Law and mitigated the tyranny of the majority. Alas, the document was imperfect because it institutionalized slavery, ultimately resulting in immense civil disorder to rectify.



On the Private and Public Virtues of an Honorable Entrepreneur: Preventing a Separation of the Honorable and the Useful

By Felix R. Livingston

119 pp.; Lexington Books, 2018

Bad capitalists / Property rights and the Rule of Law enable entrepreneurs to act. An author intent on celebrating entrepreneurs might first illustrate the material benefits of entrepreneurial activity, but Livingston tacks in another direction. He first considers nonmaterial benefits by reviewing Samuel Johnson's 1759 novel *The History of Rasselas: Prince of Abissinia.* Rasselas, the main character, flees the "happy valley" where he had everything he could want except happiness. He and his comrades observe people in different walks of life, many of whom are unhappy. The only happy people are those doing business. Rasselas' adviser, however, suggests that just because people doing business in Cairo appear to be happy, doing business itself is not necessarily the key to happiness. Livingston's point in telling the story is that just as entrepreneurs take risks to become wealthy, they take risks to become happy.

Writer Willi Schramm observed: "The trouble with socialism is socialism. The trouble with capitalism is capitalists." Livingston sees three types of bad capitalists. One type lobbies government officials for favorable tax treatment or subsidies without understanding that this rent-seeking behavior undermines capitalist society. A second type understands that rent-seeking is antisocial, but does it anyway because it is legal. The third type is just plain dishonest, a clever knave eager to circumvent legislation or laws for gain.

The author does not profess mind-reading ability to determine whether business executives understand that their rent-seeking behavior weakens capitalism. He does document such behavior, however. Take the bailouts during the Great Recession: "General Motors received $50 billion, while $182 billion was spent to save the giant insurance company AIG." Subsidies distort the agricultural

sector: "From 1995 to 2012 farmers received $292.2 billion in subsidies from the Federal government, and 'aid' was given even when profits were high." Crony capitalists convince politicians to exempt them from taxes. For instance, "At the beginning of 2013, Democrats and Republicans agreed on a fiscal cliff deal that saw taxes go up for all 'millionaires and billionaires' unless they were fortunate enough to own a NASCAR track in Michigan, a wind energy company, a rum distillery, a business located on an Indian reservation, or a tuna company operating in American Samoa."

Livingston likens the law-breaking type of bad capitalist to Narcissus of Greek mythology. "The impatient business Narcissus values success above everything else, and he pursues fame and fortune using unsavory means such as accounting sleights of hand that hide losses or that make his company's profits seem more robust than they actually are." Livingston is even more fanciful in describing Enron and its accounting firm Arthur Anderson:

> In the end, the self-admiring business Narcissus stared into a pool of debt while trying to preserve an image of success, and when the inevitable failure came, Enron Narcissus and Arthur Andersen Echo pointed fingers at each other. Narcissus exclaimed, "We did nothing wrong," and Echo repeated, "We did nothing wrong," and when Narcissus said, "It is their fault," Echo repeated, "It is their fault."

Entrepreneurs / The extended order, in which entrepreneurs thrive to benefit themselves and in doing so benefit others, has philosophical underpinnings. Livingston sets the stage with this philosophical foundation and profiles actual entrepreneurs. "Entrepreneurs are honorable, in the sense of Tocqueville, when they adhere to general rules of property and just conduct and avoid actions that are personally advantageous but detrimental to the extended social order." Virtue is closely related to honor. Working with Aristotle's concept of virtue, Livingston reasons:

> The virtue of just conduct in the practice of entrepreneurship entails achieving excellence using economic means to acquire external goods of material success, while knowing and exercising those internal qualities that strengthen and preserve the institutions upon which the extended social order depends.

A virtuous entrepreneur aims to satisfy consumers and outcompete other entrepreneurs. The "economic means" of earning a living, originally defined by Franz Oppenheimer, are production and trade. Add innovation to that list. In contrast to economic means, Oppenheimer equated the "political means" to stealing. Virtuous entrepreneurs embrace economic means and reject political means. They are upstanding citizens who respect property rights and Rule of Law.

Livingston profiles the 19th century entrepreneur Cyrus McCormick to exemplify the economic means of doing business. McCormick built a better machine to reap wheat. He located a factory near Midwestern wheat farmers, mass produced the machine at low cost, and enabled farmers to finance the purchase of his machines. The author likewise describes innovations in the communications and health care industries, though he doesn't sketch biographies of the innovators.

He does name individuals who acted heroically in court. John and Florence Dolan, owners of a business in Tigard, OR, sought permission from the city to upgrade their property. The city wanted a quid pro quo: "10 percent of their property for a bicycle path and water drainage." The Dolans argued that the city's decision was an unconstitutional taking and they ultimately prevailed in the U.S. Supreme Court. "The Dolans' actions were honorable," Livingston declares, "because they curbed the ability of cities and other governmental entities to use regulation to require property owners to make public improvements that are unrelated to business licensing requests."

The reader may wonder who is Livingston's idea of an ideal entrepreneur. Perhaps it is John Allison, previous head of BB&T and previous president and CEO of the Cato Institute. The author tells the story of *Kelo v. City of New London:* City officials wrested Susette Kelo's property from her, as well as her neighbors', to pave the way for a corporate headquarters, shopping mall, and other businesses. To the dismay of defenders of liberty, when Kelo challenged this, the U.S. Supreme Court ruled against her. In Livingston's interpretation, "The Supreme Court sanctioned the authority of governmental bodies to take private property for 'public benefit' in addition to the traditional 'public use' criterion." Allison opposed such theft and, Livingston explains, "because of John Allison's leadership, BB&T refused to make loans to any contractor involved with property that had been forcefully acquired through a political authority's power of eminent domain." After the *Kelo* decision, most state legislatures passed laws ostensibly protecting property owners from a government taking their property and transferring it to others for "public benefit."

Social justice? / Entrepreneurs have a stake in calls for "social justice," whose advocates argue for income redistribution. Livingston outlines three problems with this concept. The first is that no omniscient individual exists who is able to weigh manifold factors (ability, merit, etc.) and produce the idea of a fair distribution of income, let alone sell it to the public.

The second problem is that politicians who recognize the first problem could offer their ideas of fair distributions of income and citizens could vote for what they think is best. Livingston introduces an insight of theologian Reinhold Niebuhr to uncover the problem with that. Niebuhr explained that humans behave better in individual settings than in group settings. For example, my "reason" and my "conscience" tell me not to steal from my neighbor. But I drop those guiding faculties when a politician proposes to tax high-income earners and transfer the tax revenue my way through a government program. Politicians' proposals to redistribute income

might lead to a tyranny of the majority.

The third problem is that an authoritarian government, in an effort to overcome the first two problems, could dictate that each individual receives an identical income. But incentives to create income would then fade. Livingston puts it this way: "Everyone can be made equal, but everyone will be equally poor." The author reiterates Hayek's point that by denying an individual the autonomy to earn a higher income, a government also denies that individual the ability to develop morally.

The entrepreneur's role in resisting social justice is the same as in business: embrace economic means and shun political means. Other actors have roles to play as well. Livingston describes American society as a "triune social order": business, government, and "a moral–cultural system that embraces the ethic of pluralism." For example, government officials could refrain from demonizing high-income earners and stirring envy among the public. Our culture could honor wealth creation and spurn redistribution of wealth by government; we could agree to disagree and tolerate differences.

Conclusion / This book is heavier on political philosophy than real-world stories of business ethics. The reader will encounter more intellectual figures than business executives. One such figure is Marcus Tullius Cicero, who pondered the choice between economic means and political means. Livingston quotes the Roman orator, "The rule of what is beneficial and of what is honorable is one and the same."

Livingston is persuasive that entrepreneurship is a noble endeavor. When entrepreneurs choose to produce, trade, and innovate, and refrain from legal plunder, citizens receive goods and services as well as the intangible benefits of an extended order. R

Eudaimonic Business

REVIEW BY ART CARDEN

Done right, business is not just tolerable, it is honorable—and that is the message of Wake Forest University philosopher James Otteson's new book. Otteson, whose previous efforts include *Adam Smith's Marketplace of Life* (2002), *Actual Ethics* (2007), and *The End of Socialism* (2014), has, in *Honorable Business*, explained what makes business morally acceptable, even praiseworthy—when it is conducted honorably. Over the course of about 200 pages, he explains how and when buying low, selling high, and innovating are positively virtuous. As Tyler Cowen argues in his recent book *Big Business*, "American business … at its best, represents many of humankind's highest values." (See "A Love Letter to Tyler Cowen," Summer 2019.) Otteson explains how.

This thesis might be a surprise to many who think that business is ipso facto dishonorable and who, frankly, have never given it much thought. Otteson draws a clear distinction between business conducted honorably and business conducted dishonorably. Honorable business respects others as free and dignified moral agents. Honorable business does not defraud or coerce, and Otteson does deal with Karl Marx's objection that exchange is simply "mutual plundering." The person going about honorable business creates value *as the customer defines it*.

Otteson's "early operational definition" says that "honorable business is business that contributes to growing, generalized prosperity in a properly functioning market economy." The honorable businessperson "embrac(es) and internaliz(es) … a professional identity as a businessperson who sees her purpose as the creation of value for others."

Business and society / Business, Otteson argues, is an element of a eudaimonic life of contributing to a just and humane society. Eudaimonia is the central concept of Aristotle's ethics and is often translated (poorly) as "happiness" or (much better) "flourishing." Wealth, Otteson argues, "is a necessary prerequisite of a eudaimonic life," which "implies that we need institutional structures—political institutions and economic policies—that enable wealth production."

Business, therefore, has an important place in a hierarchy of moral value. Otteson conceptualizes this as follows (Otteson's emphases):

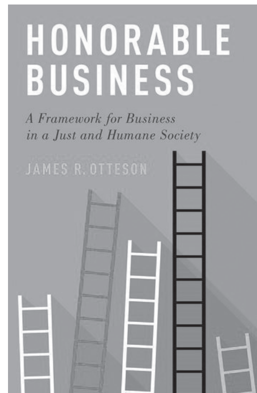
- We want a *just and humane society*.
- A just and humane society depends on a variety of *social institutions,* including political, economic, moral, cultural, and civic institutions.
- Included in those required social institutions is a *properly functioning market economy*.
- A properly functioning market economy requires *honorable business.*
- Honorable business includes industries, firms, and individual businesspeople *creating value.*

How, then, does one go about doing honorable business and, therefore, contributing to a just and humane society? Otteson offers a five-point code of ethics:

- You are always morally responsible for your actions.
- You should refrain from using coercion and the threat of injury.
- You should refrain from fraud, deception, and unjust exploitation.
- You should treat all parties with equal respect for their autonomy and dignity.
- You should honor all terms of your promises and contracts, including your fiduciary responsibilities.

I'm especially interested in—and con-

victed by—his discussion of honoring all terms of promises and contracts. How often have I promised an email or article or follow-up or whatever, only to find that my failings in managing my time, energy, and attention have pulled me off track and led me to go back on my word? I don't make promises intending to break them; indeed, I fully intend to deliver and can, as humans are wont to do, cook up a good (to me) story for why my missing a deadline isn't my fault. But here I'll borrow from Thomas Sowell: sincerity—or simply meaning well—is overrated. Likewise, honorable business requires fidelity. It's something we in the academy would do well to heed if we want our teaching and academic scribbling to be honorable business rather than the "moral mess" described by Jason Brennan and Phil Magness in their recent book *Cracks in the Ivory Tower*. (See "Incentives in the University," Summer 2019.)



Honorable Business: A Framework for Business in a Just and Humane Society

By James R. Otteson

248 pp.; Oxford University Press, 2019

Otteson is a renowned Smith scholar, so readers shouldn't be surprised to see that he takes much of his inspiration from Smith and from what Otteson has elsewhere called Smith's "economizer," "local knowledge," and "invisible hand" arguments. People want to find the "most advantageous" way to do something (the economizer argument). They are better situated than outside observers to understand and act on what F.A. Hayek called "the particular circumstances of time and place" (the local knowledge argument). In pursuing their own good in a commercial society, they are led to pursue others' good—and unintentionally to create a harmonious social order (the invisible hand argument). In a world with honorable business that follows the five principles discussed above, we expand our capacity to flourish.

Honorable Business is, like other volumes in Otteson's oeuvre, a spirited defense of liberal individualism against criticisms from scholars concerned about things like the tyranny of choice, the limits to markets, alienation, commodification, and other ills that supposedly emerge from the liberal order. He addresses these criticisms head-on and, by the time he is finished, he has produced a robust case for a commercial society.

Against calls for paternalistic control of things like salt intake, for example, he points out that the case for paternalism crashes against the rocks of the local knowledge argument. He writes in a footnote, "I do have a heart condition that means I need to ingest more salt daily than most people require." I didn't know such a thing was possible. I suspect that a lot of people who think it wise for government to control people's choices are in a similar situation. What else, I wonder, don't we know about the others we presume ourselves fit to control or at least nudge?

Many critics distrust commercial society because it doesn't have a purpose of its own—the glory of the nation, for example, or universal brotherhood, or any of a number of other lofty notions that have inspired people to die at barricades and on battlefields since time immemorial. Otteson shows us that while social institutions and organizations are properly agnostic as to our ultimate purpose, we can nonetheless live whole, flourishing, satisfying, ethical, virtuous, eudaimonic lives by conducting *Honorable Business.*

With surging interest today in nationalism, racism, socialism, and so many other ideas that should have been dispensed with long ago, this book is a timely and important contribution. I hope it will be read by businesspeople and business students around the world for many years to come.

Not the Average Economist

BY PIERRE LEMIEUX

This year marks the 40th anniversary of James Buchanan's *What Should Economists Do?* The collection of 15 essays, written in the 1960s and 1970s, offers an overview of his rich thought. Given its relevance to today's problems—and Nancy MacLean's recent misrepresentation of Buchanan's life and thought (see "Buchanan the Evil Genius," Fall 2017)—now is a good time to revisit this book.

Buchanan quipped that he was tempted to paraphrase Friedrich Hayek's essay title "Why I Am Mot a Conservative" by titling this book's postscript "Why I Am Not an Economist." He objected to many orientations of contemporary economics, including a standard characterization of the discipline as the study of the allocation of scarce means among competing ends. Instead, he saw economics as a logic of subjective choice, which brought him close to the Austrian school of economics.

His thinking was, however, too big to fit in that school. He often invoked Adam Smith, the founder of classical economics. In many ways, Buchanan was a neoclassical economist, even if his criticisms were mainly directed at this reigning school itself.

Human nature / Economics, Buchanan notes, is based on a model of human behavior, as required for any science that tries to understand social phenomena. At the most abstract level, the individual is modeled as trying to improve his situa-

tion—this is the pure logic of choice. He wants to have more rather than less of whatever he desires. One means of getting more "is choosing to engage in trade." Just as Adam Smith viewed human nature as characterized by a "propensity to truck, barter, and exchange," trade is central to Buchanan's thought; it is "the pervasive means through which man has expanded his command of goods."

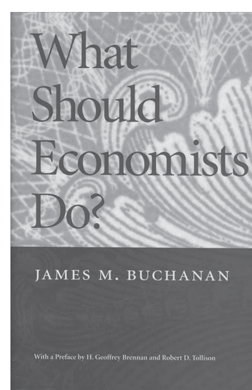
Buchanan emphasizes that individual motivations are not reducible to those of *homo economicus*, the self-interested pursuer of purely economic goods. Man has many different motivations. How does economic theory recognize that? One way is to apply utility functions to other human desires besides standard economic goods and services. Buchanan, however, believes that a theory based on such very general utility functions cannot be tested because, we may say, they reduce to the truism that individuals maximize what they maximize (though Gary Becker, a most standard neoclassical economist, appears to refute this objection). Buchanan follows another path and restricts economic theory to voluntary cooperation in markets (and, as we shall see below, in the quasi-market of politics). *This* is the realm of *homo economicus*.

Buchanan insists that economics must avoid what Hayek identified as "scientism," which is the improper and naive use of "hard" science methods. Buchanan criticizes the sort of analytical economic theory that turns economics into a branch of mathematics. On the other hand, he considers theoretical statistics and the underlying probability theory as a useful reminder of "the relevance of randomness, or chance in determining outcomes" in social phenomena.

Institutions—rules that organize and dictate how things are accomplished in society—are crucial to Buchanan's thought, as they are to much of contemporary economics. Institutions create the constraints and incentives within which economic and political activities proceed. Analyzing these activities requires an understanding of institutions.

Buchanan's approach is grounded in methodological individualism, as is most if not all of economic theory, but he takes this grounding more seriously than many economists. Only individuals make choices. "'Society,' as such," he writes, "must always be conceived in terms of its individual members." There is no such thing as "the public interest" or a social welfare function, a sort of utility function for the whole society that welfare economists liked to imagine. Only the interests and welfare of the several different individuals exist.

He reminds us that a central discovery in economics has been the principle of spontaneous order—that is, the possibility of an auto-coordinated order where government direction is not constantly required. This principle "is in no way 'natural' to the human mind which, in innocence, is biased toward simplistic collectivism," he writes. Economists must thus teach "a vision of economic process that is not natural to man's ordinary ways of thinking."



What Should Economists Do?

By James M. Buchanan

292 pp.; Liberty Press, 1979

A remarkable chapter of the book, titled "Natural and Artifactual Man," explains that people are not simply animals with preprogrammed behavior. Because individuals have free will and make genuine choices, "our predictions about man must always be less accurate than our predictions about animals." Forecasting the behavior of a single individual is unreliable; forecasts can only be good for large numbers.

A person is also an "artifactual man." The individual is not just a predictable short-term utility maximizer. In essence, he creates himself as he moves through time. He develops his utility function. Buchanan quotes his University of Chicago professor Frank Knight: "Insofar as man is wise or good, his 'character' is acquired chiefly by posing as better than he is, until a part of his pretense becomes a habit." Buchanan concludes, emphasizing the sentence, "*Man wants liberty to become the man he wants to become.*" Who said that Buchanan was a pessimist? (But wait!)

Public choice analysis / Buchanan was a pioneer of the "public choice" school of economics, which models politicians, government bureaucrats, and special-interest groups the same way as standard economics models ordinary individuals: as self-interested. Between the private sector and the public sector, the individual's self-interest does not change, although it will be expressed differently given the different institutional constraints. Public choice economics, which is the economic analysis of politics, goes on to show that "government failures" exist just like "market failures" do. Just because the latter exist does not mean that government solutions will be better than the problems they try to solve.

Buchanan opposes the traditional idea of welfare economics (and, implicitly, the idea held by many students of politics) that government officials are selfless decision makers. Either the individual is *homo economicus* and he must remain self-interested when he participates in politics, just as he is in other activities, or else he entertains other motivations, including altruism, in which case market failures would seemingly not be a problem. Either market failure is a problem and so is government failure, or else government failure is not a problem and market failure is not either.

Thus, if *homo economicus* is postulated, politics is not necessarily more efficient than the market and may be much less so. "What is the orthodox economists' response when pure public goods are postulated?" Buchanan asks rhetorically. "It is relatively easy to define the formal conditions that are necessary for allocative efficiency, but it is not possible to define the governmental process that might generate these results."

Yet, for him, public goods do exist and there is scope for collective action in the form of state intervention. Recall that public goods are goods that all individuals want and that all can consume simultaneously. Consequently, only government can finance them to a roughly efficient level, overcoming the free-rider problem. National defense and police protection are standard examples of public goods. But—and this is crucial to understanding Buchanan—the only basis for such government action is *unanimous* consent among individuals. "There is nothing even remotely sacrosanct about the will of a simple majority of voters in an election," he writes. The equivalent of exchange and trade in politics is unanimous consent.

A related structural element of Buchanan's thought is that it is easier to agree on general rules than to politick on ad hoc transfers or tax shares. Agreeing on general rules is the same as agreeing on a constitution. The test of any constitutional rule is whether *all* individuals could conceivably have agreed to it.

Buchanan noted that "the Leviathan that we observe today simply cannot be ignored." A sort of constitutional reform was thus needed to chain Leviathan and restore constitutional government.

Science or ideology? / Is all this really social science? This is a complex question to which Buchanan gives a complex answer. Economics, he believed, is first and foremost a positive science, which must guard against normative judgments inserted at the start of the analysis. Value judgements must come *after* positive analysis. Any policy evaluation must bring in value judgments regarding the alternative of no policy versus the expected results of the proposed policy.

In normative judgements, the economist has no more authority than the ordinary citizen. The best the economist can do is to offer "suggestions for widening the range for potential choice" and thus the range of potential trades. The economist should be the counselor of the people, not the adviser of the state. He should recommend realistic institutional changes. Heeding his own advice, Buchanan would not say which form the necessary constitutional reform should take.

He admits that his policy orientation still hides value judgments. For instance, for a human being with free will, more choice is better than less. The ultimate goal is the welfare and flourishing of all individuals. The individual is a better judge of his own welfare than is any external observer, a value judgement "upon which Western liberal society has been founded." Consent of all and every individual is required, as opposed to the rule of some elite.

Some "faith" (Buchanan's word) is required. On the positive side, we must have faith that it is possible to do value-neutral economics, that truth "can be discerned independently of value judgments." On the normative side, we must believe in the value of liberty and progress.

Buchanan argued that economics as such has nothing to say on "the proper private-sector–public-sector mix." As much as he rejected the bad dream of socialist planning, he considered "the libertarian anarchists who dream of markets without states" as "romantic fools, who have read neither Hobbes nor history." Perhaps he mellowed on this indictment of libertarian anarchists after the 1985 publication of Anthony de Jasay's *The State*, which he reviewed favorably in the journal *Pubic Choice.*

Morals / As opposed to a mathematized science aiming at the maximization of some objective function, Buchanan sees economics as more of a "moral science," as it was classified at the time of Adam Smith. Its positive contributions should ultimately facilitate how people can better live in society. To convey this more general scope of economics, Buchanan often uses the older term "political economy."

The interface between morals and economics is an area of inquiry in which Buchanan was always interested. Social order, he writes, "requires general acceptance of a minimal set of moral standards"; otherwise, naked power must replace independent individual actions. Among important institutions that represent moral constraints, he mentions family, religion, property rights, schools, and agreed-upon law. He even mentions patriotism and respect (presumably guarded) for government among moral values.

Unlike Hayek, Buchanan does not fear a somewhat constructivist approach to social reform. Which of them is correct is an important question to ponder as one reads *What Should Economists Do?*

Buchanan echoed fears "that modern man has lost the faith in progress that was pervasive in the post-Enlightenment period, the eighteenth and nineteenth centuries, and most of this century." He was worried about "the excesses of the 1960s," when moral standards were attacked and the ordered intellectual anarchy of academia was challenged. He found incongruent that, in universities financed by taxpayers, "academic freedom" would protect professors more interested in transforming their classrooms into revolutionary cauldrons against liberty itself than in pursing truth in their disciplines.

Buchanan is on record as favoring public schools, inheritance taxes, and equality of opportunity. Perhaps one might say that he was a classical liberal, stock-and-barrel. The danger of equalizing opportunities may seem innocuous by the condition of unanimous consent, but it is not that clear. Consent needs to be given behind some veil of ignorance *à la* John Rawls. And since unanimous consent is virtual, how do you determine that it has been given? It is clear in Buchanan's mind, however, that once generally accepted institutions are in place, individuals should be free to spend their incomes and live their lives as they want.

Current evolution / What happened in the five decades or so since Buchanan wrote these essays? Here are some observations that seem uncontroversial. Economics has continued to accumulate "the excess baggage of modern mathematics" that we do not need "to grasp and to convey the basic wisdom that Adam Smith discov-

ered and that his successors emphasized." The subsequent development of the field of behavioral economics has brought some important psychological insights to economics, but it is disappointingly unmindful of the motivation of government actors and benevolent despots. Economists continue to be mainly interested in advising Leviathan on how it can manipulate people rather than how it can help people better achieve their desires, as Buchanan thought economists should do.

In America, both major political parties now seem to embrace government power as the only means of "running society," as opposed to spontaneous coordination through markets and individual liberty. There is some evidence that American public opinion is veering toward socialist causes, from redistribution to protectionism and business-bashing.

In a 2005 article in *Public Choice*, Buchanan himself predicted a revival of socialism as people ask the state to fill the role for them that parents fill for their children, what he calls "parental socialism" or "parentalism." The article includes this troubling remark: "The thirst or desire for freedom, and responsibility, is perhaps not nearly so universal as so many post-Enlightenment philosophers have assumed." Buchanan seems to have grown more pessimistic that his artifactual man "wants liberty to become the man he wants to become." Or perhaps he believed this varies between individuals?

On the bright side, he contributed to a revival of subjectivism in economics. Public choice economics has desacralized the state. As a result, more students are now introduced to the basic idea that social coordination without constant coercion is possible.

Buchanan was certainly not the "average" economist. He was an inquisitive economist and a brilliant political philosopher. In both fields, he was one of the very best of the 20th century. Whether one agrees or not with him on all points, his thought presents challenges that we, interested in economics, politics, and the artifactual man, must meet. R

Run the Economy Hot?

REVIEW BY RYAN BOURNE

Labor economist David Blanchflower joined the Bank of England's Monetary Policy Committee in July 2006. In the run-up to the financial crisis, his analysis of leading indicators and other observations led him to believe a major recession was coming.

Beginning in October 2007, he voted consistently for interest rate cuts to get monetary policy "ahead of the curve," but found himself in the minority. His new book, *Not Working*, drips with disdain for his colleagues' apparent poor judgment and blames central banks for unnecessarily exacerbating the unemployment spike in the United States and the United Kingdom during the recession.

At the time, Blanchflower was portrayed as a crank in the UK press for his constant calls for monetary loosening. Yet he turned out to be right when most of the world and economic establishment were wrong. Buoyed by that vindication and scarred by the experience, his book presents a new warning, confidently asserting that policymakers are again taking their eye off the ball.

Central bankers and government finance departments are still causing unnecessary suffering, he believes, because they are wedded to conventional labor market indicators that signify full employment is close and inflation is just around the corner. Fiscal and monetary authorities are therefore setting inappropriate policy, holding back the economy from its potential and preventing the delivery of good jobs at high pay. The results of this policy, he thinks, are catastrophic. On top of existing structural economic and social problems, the subsequent weak recovery has contributed to the political dysfunction that has yielded Brexit and the Trump presidency.

Conservative thesis / *Not Working* contains a wealth of information, statistics, and literature summaries. One cannot help learning a lot from it. However, the book sometimes meanders, making it difficult to discern a clear mechanistic thesis for its central assertion.

My attempt at summarizing the book would conclude this: Blanchflower believes there is still substantial slack in the labor market, evidenced by measures of "underemployment," some of which he helped to pioneer. Though he never convincingly explains why, he implies the financial crisis resulted in a structural break that made this additional margin of unemployment more important for countries such as the United States and UK.

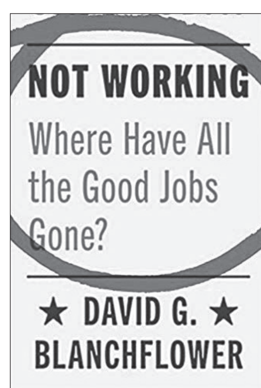
Taking a traditional demand-side interpretation of the wage Phillips curve (the negative relationship between unemployment and nominal wage growth), this remaining slack helps explain why low official unemployment rates in the United States and UK did not coincide with rising nominal wage inflation over many years. This is the primary answer to the mystery of the perceived "flattening" of the wage Phillips curve that has occupied central bankers.

Blanchflower further believes the "natural rate" of unemployment has fallen since the crisis for structural reasons. A decline in homeownership rates and improvements to internet job-matching sites mean a greater potential capacity for workers to move and connect to opportunities. Increases in aggregate demand through stimulatory monetary or (non-offset) fiscal policy could therefore still go a long way to boosting output and total hours employed without creating substantial wage inflation.

In many ways then, this thesis could

be considered conservative. Whereas other economists, such as Roger Farmer, have demanded ditching the concept of a natural rate of unemployment or the Phillips curve entirely, Blanchflower believes those concepts still work; we simply aren't measuring unemployment appropriately. If people want to work more hours at their prevailing wage rates, he considers this untapped potential for employment and growth in gross domestic product. If the "natural rate" of unemployment has fallen post-crash too, then we could continue to see falling unemployment without experiencing wage inflation.

He's no doubt right that, to the extent it's a meaningful concept, the "natural rate" of unemployment is an imperfect, changing, and difficult-to-quantify measure, as central bank pronouncements since 2008 have shown. With demographic change, migration, and constant industrial flux, assessing it is near-impossible, hence contemporary monetarists urge us not to use labor market indicators alone as a guide for policy. Perhaps Blanchflower's underemployment measures are a better proxy for slack; perhaps not.



Not Working: Where Have All the Good Jobs Gone?

By David G. Blanchflower

456 pp.; Princeton University Press, 2019

Sadly for him, wage growth evidence since the book was printed undermines his claim that labor market slack remains substantial. What's more, the contention that more expansionary policy could cure underemployment, deliver higher pay, and help quell a range of social and economic challenges in western economies looks even more speculative, particularly given there is little evidence from the crash that lack of stimulus leads to permanently scarring effects on the labor market.

It's difficult not to conclude that he is still fighting the last recession, with too much focus on the demand side of the economy and not enough consideration of the supply side and productivity.

U.S. underemployment / Take Blanchflower's thesis in relation to the U.S. economy. His main evidence for underemployment, in the absence of survey data to devise his more comprehensive measure, is the percentage of workers who are part-time for economic reasons (PTFER). This measure spiked post-crash before falling. Since the book went to print, it has dropped further to 2.8%. That stands above the July 2000 trough of 2.3%, but is about the same level as immediately pre-crisis. Given structural changes to the economy—not least the introduction of the Affordable Care Act and demographic change—Blanchflower himself presents San Francisco Fed evidence that we might have expected this underemployment measure to be structurally higher now than before the crash.

This also suggests the underlying cyclical trend in this measure of underemployment is now below its pre-crisis level. This is supported by the fact that the U-6 unemployment rate —an unemployment rate that includes all marginally attached workers plus total employed part-time for economic reasons —is now pretty much as low as its trough in 2000. Combined with the low unemployment rate and an employment rate that looks strong once one accounts for population aging, the labor market appears to have largely recovered. The tight labor market should therefore be delivering nominal wage growth akin to that seen pre-crash.

Yet Blanchflower believes that "underemployment" and labor market slack are still significant. Further, he thinks the PTFER could fall further, to its 2000 levels, and that today's natural unemployment rate could be as low as 2.5%. If he's right, we'd expect to see at least one of these indicators improve alongside stable wage inflation. Yet in the past two years, nominal wage growth appears to have increased. The Federal Reserve Bank of Atlanta says that the 12-month moving average growth rate for nominal wages ticked up to 3.6% in May 2019, a level last seen in 2009. The three-month weighted rolling average suggests this wage growth is higher still, at 4.2% right now. Wage growth has sped up in other countries, too, including the UK, as the un- and underemployment rates continue to fall.

In other words, wage growth does appear to be rising as the unemployment and underemployment levels fall to pre-crash rates. Though there might be a bit more labor market slack (the unemployment rate is at a 50-year low already), claims that unemployment could drop sustainably to 2.5% and PTFER fall to 2000 levels seem unlikely. The uptick in wage growth suggests the United States is already approaching full employment, all without the discretionary stimulus that Blanchflower believes is necessary to achieve it.

Confusion about long-term unemployment / In some ways, Blanchflower should feel vindicated. Plenty of economists believed that the elevated unemployment level immediately post-crash indicated structural challenges, such as skills mismatches, that would permanently worsen employment prospects. Many said the structural rate of unemployment across countries had risen, not fallen. Back in 2012, the Fed thought the medium-term natural rate of unemployment was 5–6%. When the Bank of England issued its "forward guidance," it considered the UK's natural rate to be 6.5%.

In other words, many economists thought the structural effect of the crisis would mean we'd have run up against supply-side constraints at unemployment levels far higher than seen today. Though we cannot say for sure whether they were wrong at the time (perhaps an impaired financial sector did impair potential growth, but that problem has since dissipated), the subsequent strength of the labor market rebound does imply that unemployment or weak participation

was largely cyclical and not structural. As Blanchflower himself writes, "The gloomy predictions of some that the long-term unemployment numbers wouldn't come down as the economy recovered have turned out to be short of the mark."

This is true, but it highlights an inconsistency in Blanchflower's arguments over the years. In advocating for more stimulus in the past, he warned that tight monetary policy and/or public spending cuts could result in a "lost generation" of workers. Much of his case for greater monetary and fiscal stimulus now rests on the idea that failure to eliminate labor market slack will result in the unemployed or underemployed suffering substantial skills atrophy, making it difficult for them to find gainful, productive employment in the future. Yet this labor market "hysteresis" effect does not appear to have occurred so far to any great extent in the United States or at all in the UK, despite Blanchflower's previous warnings. So why should we fear it now?

This tension between wanting to damn the effects of policy mistakes while using the labor market improvement as vindication for stimulus, appears throughout the book. Just two pages before explaining that gloomy predictions about long-term unemployment had proven false, Blanchflower writes, "Long-term unemployment used to be mostly a European but not an American phenomenon, but that has changed also." He uses this as evidence that monetary and fiscal mistakes have severely worsened social problems, creating the urgency for new action.

But where long-term unemployment is concerned, his claim is just false. The percentage of unemployed people who've been out of work for more than a year in the United States was indeed higher in 2017 at 15% than in 1985 (9%). But the unemployment rate fell from 7.2% to 4.3% over that same period. That means 0.65% (15% of 7.2%) of the labor pool found themselves "long-term unemployed" in 1985. In 2017, that proportion was still 0.65%. Across the major European Union economies (France, Germany, Italy, and the UK), a crude cross-country average shows 43% of unemployed people have been out of work for nearly a year, or 3.4% of the labor pool. Whatever the long-term consequences of the recession or incorrect policy in the United States, a shift to European levels of long-term unemployment is not one of them.

In fact, Keynesian economists have now largely switched their stance, arguing not that absence of more stimulus resulted in hysteresis through longer-term unemployment, but that failure to fulfill economic potential has resulted in a form of "productivity hysteresis." There is much less micro evidence from previous recessions for this kind of effect, and it's unclear even what the causal mechanism would be.

It's far more likely, as mainstream macro models that feature a "natural rate" indicate, that demand shocks only have temporary effects on employment until wages and prices adjust, at which point output and unemployment return to their natural rates. Even if the Great Recession simply was a demand-side shock, its effects may have largely fallen away by now.

What can macroeconomic policy achieve? / Even if Blanchflower's thesis were correct that underemployment represented a key margin of slack, evidence suggests that slack has almost entirely been eliminated. Nominal wage growth appears to be accelerating because the level of wages has been too low (wage stickiness) relative to market conditions. If that is correct, then Blanchflower is overly optimistic about what looser monetary policy or government infrastructure spending could achieve.

In his final chapter, he calls for "Put[ting] the Pedal to the Metal." He claims that running the economy hot would "boost wages, which is [the policy's] main point, and hence boost living standards." But in a near-full-employment economy, the only way that stimulatory activity could enhance employment would be via removing labor market frictions and helping reallocate workers to more productive activities (i.e., boosting real GDP rather than nominal GDP). The only way that real wages grow in the long run is through faster productivity growth.

Can stimulus achieve this? It might be the case that slightly looser monetary policy might draw some newly discouraged or disabled workers into the labor force or that an even tighter labor market might lead to more options for workers in a way that leads to better allocation of workers and increased productivity. In theory, some productive government-led infrastructure investments might improve the productive capacity of the economy too, although these effects are often overstated given the types of investments government makes.

But surely Blanchflower is asking too much of macroeconomic policy here. He certainly doesn't present sufficient evidence that subdued business investment and weak productivity are driven by weak demand. At times, he seems to discount entirely that there is a supply side of the economy. This is all the more surprising given productivity measures themselves have started to rise somewhat in both the United States and UK in recent years. With consumer price inflation anchored, this improving productivity has meant rising real wages and living standards, as Blanchflower desires.

Strong economic growth, lower un- and underemployment, and rising wages would indeed alleviate some of the strains that lead to a host of social and economic problems. But some of the challenges documented in meticulous detail in the book—"deaths of despair," the opioid problem, the decline of the UK's coastal towns, Rust Belt economic woes, etc.—are too often alluded to as symptoms of recent policy mistakes rather than as deep-seated, multifaceted problems that slightly looser monetary policy or more infrastructure spending would fail to solve.

That, again, sets up Blanchflower's thesis for failure through overpromising. If nominal wages continue to rise strongly as underemployment falls, then according to Blanchflower we should expect these problems to dissipate. They might improve on the margins, but one suspects most will remain. The risk, as ever, is that trying to use monetary policy to push the economy

beyond its productive limits could destabilize it entirely.

Sloppy / Blanchflower is clearly an extraordinarily talented labor economist. His chapters drip with interesting tidbits and references to studies on the labor market, disabilities, the perils of forecasting, and the rise of economic populism. His book goes far beyond the unconvincing macro thesis. One can learn a lot about labor economics as a discipline and about key contemporary debates over labor market performance across a range of countries by reading this work.

Yet so vast are his references and insights that at times the writing is extraordinarily sloppy. We have already seen this in relation to discussion of long-term unemployment. A similar contradiction occurs in the final chapter where he uses Japan's recent history as both a model and a cautionary tale. Perhaps there's a way that Blanchflower can reconcile contradictory evidence to support his overall contentions, but often it is difficult to see it clearly. Other times the writing is just careless and badly edited. One section on UK life expectancy, omitting key qualifiers in a sentence, gives a completely misleading picture of life in a poor part of the richest borough in the country. I noted several other errors or misinterpretations.

For all its insight and punchy reading, this book disappointed on two levels. First, its main thesis seemed dated and exaggerated. Second, attention to detail, at certain points, seemed lacking.

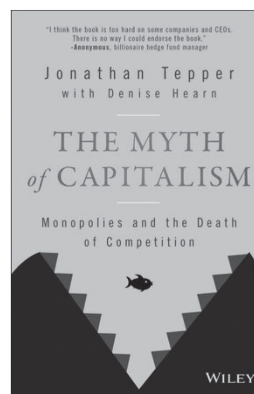
Plenty of economists have been left with egg on their faces by economic trends since the crash. Blanchflower proved to be on the right side of some key debates, from forecasting the recession through to claiming unemployment was a cyclical problem. Yet, given that sluggish productivity and economic inclusiveness are the concerns of today, a policy platform headlined by more monetary and fiscal stimulus risks makes him look like a one-club golfer. The United States and UK face major economic and social challenges. Running the economy hot will solve relatively few of them. R

A Call for Government-Induced Competition

REVIEW BY THOMAS A. HEMPHILL

"Capitalism" is the hot topic of political discussion—and criticism—in the global media. Much of this criticism involves claims that modern capitalism has resulted in reduced economic growth and increased economic inequality in Western societies in recent decades. This, in turn, has fueled a resurgence in populist and socialist ideologies that are challenging the primacy of capitalism in Western democracies—including in the supposed bastion of "free market" capitalism, the United States.

Jonathan Tepper and Denise Hearn, in *The Myth of Capitalism*, take a contrarian approach to evaluating and criticizing U.S. capitalism. Tepper, the founder of Variant Perception, a macroeconomic research group catering to hedge funds, banks, and family offices, is the co-author of two previous books on financial topics, *Endgame* and *Code Red*, while Hearn is head of business development at Variant Perception. As the authors state: "The unbridled, competitive free markets that the Right cherishes don't exist today. They are a myth." Furthermore, "The Left attacks the grotesque capitalism we see today, as if that were the true manifestation of the essence of capitalism rather than the distorted version it has become."



The Myth of Capitalism: Monopolies and the Death of Competition

By Jonathan Tepper with Denise Hearn

300 pp.; John Wiley & Sons, 2019

If the solution to capitalism's problems is not in the platforms of the political right or left, then what can address the underperformance and inequality in the U.S. economy? Tepper and Hearn argue that what is needed is a boost in competition in many key U.S. industries.

Sustainable advantage / The lack of competition in some markets is something that many people agree on, but they do not necessarily see it as a bad thing. Business-world chieftains ranging from Democrat Warren Buffett, the "embodiment of American capitalism," to billionaire libertarian Peter Thiel, "Silicon Valley's godfather," deliberately seek out investment in uncompetitive sectors. For nearly four decades, Harvard Business School professor Michael Porter's Five Forces of Competitive Strategy framework has taught future executives, hedge fund managers, and venture capitalists to analyze and evaluate competitiveness in different industries and avoid those industries with high levels of competition. For example, two of these five forces are "threat of established rivals" and "threat of new entrants." The worst-case scenario is for managers to find themselves in an industry where competitors are strong and any potential rival can easily enter the industry and compete.

Strategically, CEOs will develop actionable strategies to keep rivals out of their respective industries. As Tepper and Hearn note, this is why mergers are embraced: to eliminate established rivals. Moreover, it is why companies will employ rent-seeking

strategies in the public policy arena to erect regulatory and legal barriers to entry into their industries. Thus, they write, when an oligopolistic industry is created, all the players cooperate and erect barriers to entry, and these cooperative companies (often only three or four) divide the market and collude through price signaling. Ostensibly, any real "competition" is the result of product or service differentiation strategies instead of price strategies, which set off ruinous "price wars" that only depress company profit margins. This market environment is what these oligopoly industry members view as "sustainable competitive advantage."

Call for antitrust / Tepper and Hearn point to the predominance of the "ultra" free-market University of Chicago view of competition, which focuses exclusively on consumer welfare ("efficiency and the price of goods and services") as the criterion of antitrust policy enforcement, to the exclusion of all other considerations. The Chicago school has significantly influenced the U.S. Department of Justice's Antitrust Division, the Federal Trade Commission, and the federal judiciary's views on the nation's antitrust policy. According to the Chicago school, "Cartels and collusion were almost impossible because it is difficult to coordinate competitors" because "competitors would be prone to cheat, and new entrants would come in to compete with the cartel."

However, Tepper and Hearn write, this idea "flies in the face of decades of evidence and billions of dollars in fines." They note that price-fixing cartels that reduce supply often persist for years and do not necessarily break down as a result of difficulty in coordinating price-fixing agreements. They cite numerous economic research studies that indicate that two-thirds of cartels exist in industries in which the top four firms possess 75% or greater of market share, with the median duration of cartels being five years and some operating for decades. They further note that antitrust expenditures for enforcement actions by the DOJ and the FTC (in constant dollars) have been at all-time historic lows since the 1980s. Finally, they point out that merger waves have occurred in every decade since the Reagan era of antitrust "non-enforcement" began.

The authors refer to modern American capitalism as reminiscent of the Gilded Age of "robber barons" charging exploitative prices because of their market power. Among their modern-day examples:

- Three companies control 65% of the nation's cable market but, at the local level, companies face no real competition. (A lack of competition and choice in the broadband market is due to regulation from federal, state, and local governments.)
- Microsoft controls over 90% of computer operating systems and has similar control over office productivity programs through Microsoft Office.
- Facebook has over 75% of the market share in all global social media advertising spending.
- Intel has close to 90% of microprocessor market share.

Tepper and Hearn cite similar industry examples of duopolies:

- Visa and Mastercard control over 80% of the payment system market, with American Express in a distant third position.
- Molson Coors and AB InBev control over 90% of the U.S. beer market.
- Apple and Google effectively control 99% of the phone operating system market.
- In 2016, Google held 76% of the search ad market, while Facebook accounted for 78% of U.S. social advertising.

When it comes to oligopolies, Tepper and Hearn pull no punches. They begin with credit reporting bureaus. Today, after multiple mergers, only three companies control the credit reporting market: Experian, Equifax, and Transunion. The U.S. airline industry consists of four major airlines—American, Delta, United, and Southwest—with each smart enough to stay out of the others' hubs. Four firms dominate the mobile phone industry: Verizon, Sprint, AT&T, and T-Mobile. In the banking industry, four banks—JPMorgan Chase, Bank of America, Citigroup, and USB—control 44% of the $15.3 trillion in assets held by U.S. banks. In the health care services industry, three pharmaceutical benefit managers—Express Scripts, CVS Caremark, and Optum Rx—manage pharmacy benefits for 266 million Americans and control between 75% and 89% of this market. Among drug wholesalers, three—AmerisourceBergen, McKesson, and Cardinal Health—handle more than 90% of all drugs in the United States. When it comes to media and news outlets, six corporations—Walt Disney, Time Warner, CBS, Viacom, NBCUniversal, and News Corp—own 90% of the market. Moreover, with the assistance of government regulators, four major underwriters control 87% of the title insurance market: Fidelity, First American, Stewart, and Old Republic.

Government and competition / Tepper and Hearn do criticize old-style "government-regulated monopoly" intervention. "Capitalism," they write, "is at its core dynamic, fluid, and daring." Yet, government, by making a monopoly permanent, can prevent the sort of innovation and competition that challenges the dominant position of established companies. In the case of patents—an exclusive monopoly authorized by the U.S. government—nearly half of the increase in the number of patents granted since the 1980s are tied to low-quality patents and software that are not likely even enforceable under current law; these patents nevertheless stifle innovation and impose enormous costs on society. Government regulation is also an impediment to encouraging competition. For example, when it comes to approving generic pharmaceuticals, as of 2016 the Food and Drug Administration can take three to four years to approve a manufacturer for production of a generic. It is no wonder that pharmaceutical manufacturers can charge what the market will bear,

as competition is missing. It is also not surprising that excessive regulation can reduce economic growth, create barriers to entry, and discourage new competitors.

Also not surprising is that rent-seeking activities—i.e., lobbying legislators and regulators—pay off. Companies that successfully lobby can distort "the rules of the game" in their favor. For example, in 2017 pharmaceutical manufacturers paid for 882 lobbyists and spent $171.5 million in their efforts to oppose lower prescription drug prices and to slow the approval of generic drugs. In a study, James Bessen of Boston University's School of Law found a significant correlation among lobbying, regulation, and profits in a small number of influential industries: pharmaceuticals, chemicals, petroleum refining, transportation, equipment/defense, utilities, and communications. Tepper and Hearn believe that until lobbying reform takes place, there is little hope for reducing barriers to entry for smaller firms to compete in the marketplace. In conclusion, they write, the consequences of industry concentration lead to higher prices, fewer start-ups, lower industrial productivity, lower wages, higher income inequality, less investment, and the decline of "small town" America.

Policy suggestions / Yet Tepper and Hearn are not without optimism. They offer principles for reform and solutions/remedies for regenerating American capitalism. Their ideas revolve around several principles, one of which is that capitalism without competition is not the essence of capitalism, but when operating correctly the market results in the diffusion of economic power and political freedom. Further, they claim, the role of capitalism is not maximizing efficiency but creating value for firms, consumers, and employees. Monopolies and not "Big Business" are generally the enemy of markets, competitors, employees, consumers, and society. Moreover, markets must remain competitive and open to new entrants, but capitalism must be in favor of equal opportunity ("a level playing field") and not equal outcomes. Lastly, competition does not exist independently of government and society because markets operate within the rules established by society and government. For those who espouse a view of robust capitalism and recognizing established rule of law, these principles for reform will serve well.

Under their solutions and remedies section, Tepper and Hearn offer solutions for several policy areas: monopoly and merger, regulation, intellectual property, and shareholders. I will focus on a few of their suggestions that I believe are most significant.

The authors argue that mergers and acquisitions that materially reduce the number of competitors, and thus artificially increase the market share of a dominant firm, should be prohibited and previous mergers that have reduced competition should be reversed. Moreover, a standard for rejecting mergers, say the authors, must be based on a clear, simple rule, namely that industries with fewer than six competitors should not be allowed to merge.

They propose moving away from a rule-of-reason to a *per se* approach to antitrust enforcement. Considering that today 90% of mergers are successfully completed after antitrust review and antitrust decisions are almost never challenged, the consumer welfare criteria have proven over time to be less than adequate. While I personally prefer a rule-of-reason approach to antitrust enforcement, until antitrust enforcers broaden their consideration of factors beyond efficiency, a blunter rubric may be what is necessary, at least in the short-term. Undoing some previous mergers and acquisitions may be what the economy needs, but this policy will definitely fuel intense rent-seeking behavior by firms potentially affected. A wiser policy approach would be to focus on the future and not the past.

One should be suspicious of the development of complex rules as this is often the result of successful rent-seeking by entrenched oligopolists.

When it comes to regulatory solutions and remedies, Tepper and Hearn argue that regulations must serve society and not erect barriers to entry to small businesses. Given that regulations can play an important role in society, where they protect citizens from safety, health, and environmental harms, administrative rules should nevertheless be calibrated to avoid harming new companies. Such regulations should be based on principles and not complex rules, say the authors. Complex rules impose substantial costs on new entrants and prevent competition. I agree that simple rules encourage following the spirit of the law. One should be naturally suspicious of the development of complex rules as this is often a result of successful rent-seeking activities funded by entrenched oligopolists attempting to quash new entrants promoting competition.

The authors are spot-on when discussing solutions and remedies addressing patents and copyrights. They argue that to promote competition, patents and copyrights must only be granted for a limited time, without extension. For example, a narrower interpretation by the U.S. Patent and Trademark Office of what characterizes a novel invention eliminates de facto extensions of previously patented inventions. Moreover, continually extending the "life" of a copyright beyond a realistic return on investment only extends the benefits to the copyright holder and not to society. Competition must be encouraged once patents expire. The example of generic drugs is telling; the Food and Drug Administration under the Trump administration is undertaking a series of policy initiatives to reduce the regulatory delay on bringing generics to market. Congress should remove patent protection for areas that are rife with abuse. While they cite software and business method patents as prime targets of abuse by "patent trolls," those areas have received significant relief in recent years. The new

target for patent trolls is now the biopharmaceutical industry.

Tepper and Hearn believe that workers must be granted shares in their firms so that labor can become owners of capital. While employee stock ownership plans and 401(k) plans are available to most workers, the authors want employee share programs to be encouraged through legislation and regulation. Because Tepper and Hearn do not define this "employee share program," I can only assume it would be in the form of stock granted as a benefit of employment, similar to stock options granted to executives as part of their benefits package. I am unsure whether they want this to be imposed by legislation or regulation, or they simply want to encourage employers to provide the option of a share program. Furthermore, the authors argue that managers should be forced to own shares they purchase via stock options for a minimum of a year. This relatively easy fix will incentivize managers to think about longer-term investments (versus a shorter-term perspective) in their companies.

One quibble I have is with the authors' use of the term "antitrust regulation." Antitrust law and policy do not coerce a company to do anything; it simply advises executives of what anticompetitive behaviors to avoid. I also disagree with their arguments to change antitrust laws. The authors make a strong case that the problem with the antitrust laws is found in the policy interpretation by antitrust enforcement authorities and the courts. Rather than a weakness, this is a strength of the antitrust laws. The antitrust statutes are interpreted in policy based on the empirical evidence of anticompetitive behavior found in the economy. If the economic results are reflective of a noncompetitive environment, then, for example, a new interpretation of pre-merger antitrust agency evaluation of factors to effectively address evidence of anticompetitive behavior may be warranted.

Tepper and Hearn offer a well-researched and provocative book for policy analysts and executives to consider and debate. There is too much disturbing narrative here to ignore. R

Quiggin's Missing Lesson

REVIEW BY DAVID R. HENDERSON

In 1946, Henry Hazlitt published *Economics in One Lesson*, a book that, through various printings, sold over one million copies. Hazlitt was a self-taught economic journalist who thought he could cover the basics of economics in one book—thus, the title. His slim volume has been a great starting point for people who want to understand some basic economics; it was one of the first economics books I read, at age 17.

I don't know if Hazlitt ever would have said that all the economics you need to know is in his book. But in *Economics in Two Lessons*, University of Queensland economist John Quiggin writes as if he thinks that was Hazlitt's thinking. Because Quiggin sees it that way, he decides to give two lessons. The first, echoing Hazlitt, is that markets work well a lot of the time. The second, which Quiggin says Hazlitt overlooked, is that markets also work badly a lot of the time. The first 38% of the book is dedicated to the first lesson while the remaining 62% is dedicated to the second.

Quiggin is a good writer who lays out much of the economics well. His analysis of rent control and price controls in general is a thing of beauty. Along the way, though, he makes small and big mistakes. He also shows by omission that the book, to be complete, badly needs a third lesson, on why government works so badly even when it intervenes in cases where markets work badly.

One Lesson thinking / Throughout the book, Quiggin talks about "One Lesson thinking" and "One Lesson economists." Although he mentions Hazlitt numerous times, Quiggin rarely names other economists to whom he attributes what he says are mistakes in One Lesson thinking. For instance, he writes:

> GDP was not intended as a measure of society's total productive activity or of economic well-being. Unfortunately, it is often (mis)used in this way, particularly by One Lesson economists.

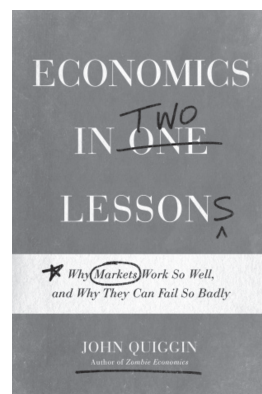
He also writes that One Lesson economics "produced the Great Depression." Is Quiggin unfamiliar with the pathbreaking work by Milton Friedman and Anna Schwartz on how the Federal Reserve's monetary policy helped cause the Great Depression?

By not naming the people he criticizes, Quiggin makes it impossible to know whether he has characterized their views accurately. It's true that, at the end of each chapter, he gives a list of references for statements made in the chapter, but it is far too brief and often fails to list sources of some of the ideas he criticizes. When he does cite sources, some of his citations are misleading or incorrect. That makes me, as a reader, wonder what else he gets wrong.

Indeed, I can pick out a number of important facts and ideas that he gets wrong. Consider, for example, his claim, referencing anthropologist David Graeber, that money arose from debt, contra the standard economist's claim that money arose because barter was inconvenient. He credits Alison Hingston Quiggin for making the same point about money and debt. I consulted monetary economist Jeffrey Hummel of San Jose State University for his take. Hummel, who has read both the Graeber book and the book by Alison Quiggin, answered that the view of many anthropologists, archaeologists, and historians—particularly those who specialize in money—is that the standard economist's account of money's origin is correct. Moreover, he said, John Quiggin "most definitely

misrepresents" Alison Quiggin's book.

Property and income inequality / Everyone is allowed a few mistakes, but John Quiggin makes many. In his introduction, for example, he writes, "The other crucial issue of the day is the distribution of income and wealth, which is becoming steadily more unequal." If he is referring to only the United States, his point would be correct (though, as economic historian Phil Magness has pointed out in various technical articles, some of the most prominent economists who have worked on the issue lately have overstated the increase in U.S. wealth inequality). But if Quiggin is referring to income inequality worldwide, he's wrong. As India and China, which together have 36% of the world's population, have become wealthier, wealth worldwide has become more equal. In a 2015 study, Tomas Hellebrandt and Paolo Mauro found that the Gini coefficient of global income inequality fell from 69 in 2003 to 63 in 2013. (The lower the coefficient, the more equal are incomes.)



Economics in Two Lessons

By John Quiggin

390 pp.; Princeton University Press, 2019

Related to Quiggin's discussion of income inequality is his discussion of what determines income. He writes, "Incomes in turn are determined by the allocation of property rights, including financial wealth, access to education, obligations to pay debts including taxation, and rights to receive income from others, or from government programs like Social Security and Medicare." Those are all relevant factors. But where in his system is the role of effort or smarts or inspiration? Such a narrow view has to be wrong.

An important part of Quiggin's case is that governments are needed to enforce property rights. There's a reasonable chance that he's right, but he might be wrong. Consider economist Edward Stringham's 2016 book *Private Governance*. Stringham shows how contracts were enforced by arbitration on the Amsterdam Bourse in the early 17th century—a private arrangement. To that, defenders of the view that government is necessary for property rights often respond that government is the ultimate backstop behind private arbitration. But Stringham points to contracts that obligate the contractees to engage in transactions that the government has made illegal and notes that arbitration works even then. In those cases, the government cannot be a backstop.

Even if Quiggin is right about the necessity of government, his illustration of the point gets some important history wrong. For instance, he notes that when radio first began in the United States, there was a lot of interference between stations' signals. So far, so good. But, he writes, that led the U.S. government to establish, in 1927, the Federal Radio Commission, which later became the Federal Communications Commission. Wrong. As telecom economist Thomas Hazlett explained in his 2017 book *The Political Spectrum*, in the early 1920s the U.S. Department of Commerce had figured out how to minimize interference: by granting rights to those stations that had been there the longest. But in 1926, Commerce Secretary Herbert Hoover abandoned this arrangement and that caused chaos. Hoover then championed the creation of the Federal Radio Commission, thereby creating "a problem in order to solve it," in Hazlett's words. So, Quiggin is right about the role of government but badly wrong that chaos made the FCC necessary.

Broken window redux / In *Economics in One Lesson*, Hazlitt retells the story, first told by 19th century economist Frederic Bastiat, of the broken window fallacy. A boy breaks a window and many people think that's bad. But one of the observers says it's good because it makes work for the glazier. The problem, notes Bastiat and echoes Quiggin, is that, whereas the glazier has a new demand for his services, there is also the opportunity cost of what the shopkeeper would have done with the money that he now must pay the glazier. Quiggin claims that one of Hazlitt's implicit assumptions is that there is full employment, but if there is high unemployment, the loss is less clear. The shopkeeper is worse off, but the opportunity cost is not quite as clear-cut as Hazlitt and Bastiat had thought.

That's a good point, although it can be overstated. What if, for example, there is no unemployment among glaziers? Quiggin overstates it even more. He writes:

> The critical assumption in Hazlitt's version is … "Everyone faces the same market-determined prices for all goods and services, including labor of any given quality, and everyone can buy or sell as much as they want to at the prevailing prices."

But that's not critical for the argument at all. For the broken window lesson to be correct, not everyone has to face the same prices for all goods and services. Quiggin's passage is reminiscent of modern critics of Adam Smith who claim that Smith assumed perfect competition, a situation in which no buyer or seller is important enough to affect the price. Smith assumed no such thing.

Fortunately, Quiggin grants that Bastiat's broken window point—destruction does not increase wealth—is apropos even if he thinks the conditions under which it applies are narrow. It was especially heartening to see him recognize, in that context, the huge costs of the Afghan and Iraq wars, which total trillions of dollars. Never forgetting opportunity cost, Quiggin has a great anecdote about the cost of World War I: He tells of the 1915 death at Gallipoli of Harry Moseley, "widely regarded as the greatest experimental physicist of the twentieth century." Fellow physicist Niels Bohr is supposed to have said that Moseley's death alone made the war an unbearable tragedy. (According to *Wikipedia*, Isaac Asimov said something similar.)

Gains through trade? / In explaining gains through trade, economists often use the fictional case of Robinson Crusoe bartering with Friday. Quiggin writes, "In the typical One Lesson textbook version of the story, Crusoe and Friday bargain on equal terms and share the gains from trade more or less equally." I can't speak for other economists or for textbook writers, but when I've taught similar stories, I've never made that assumption. Maybe I'm alone, but I doubt it.

My favorite story, which I made up, is of Rita's Friendly Oasis offering two quarts of water to a dehydrating person who has no other options, charging him $50,000. Both sides gain. The otherwise dehydrating person gains the value of his life minus $50,000 and Rita gains $50,000 minus the marginal cost of the water. But Quiggin, in discussing the outcome of a similar trade, laments that "the Nash bargaining solution gives Crusoe most of the additional goods and services generated by the bargain, while Friday [whose life, Quiggin admits, Crusoe has saved] gets his life and not much else." His life and not much else? It seems as if Friday got a pretty big benefit from that particular trade.

Quiggin argues that labor unions, by bargaining for higher wages, increase income equality. I was initially skeptical of this claim because one of the subtle effects of successful unions' increases in wages is to cause employers to reduce the number of union workers hired, which causes many of those workers to shift to non-union jobs, thus driving down non-union wages. But with a quick check of recent studies, including one co-authored by Princeton University's Henry Farber, I learned that Quiggin is right. (I assume they accounted for the effects on non-union workers, although it's hard to tell from a quick reading.)

Unfortunately, in describing how the Wagner Act of 1935 guaranteed the right to join unions and go on strike, Quiggin leaves out a crucial fact: the legislation made unions the sole bargaining agent for workers when the workers voted, by a simple majority, to form a union. Dissenting employees who want those jobs have to be represented by the union. Even pro-union economists Richard Freeman and James Medoff have admitted that unions are a government-enforced monopoly. In many parts of the book, Quiggin criticizes monopoly, but he somehow didn't mention unions as an important source of monopoly.

On the monopoly issue, he gives a distorted treatment of the effects of trusts that became prominent in late 19th century America. Because he advocates strong antitrust action against what he regards as current monopolists, this history matters a lot. Quiggin claims that the trusts used monopoly power to raise prices for consumers but he gives no evidence for this claim, which is unfortunate because the evidence goes the other way. In a 1985 article in the *International Journal of Law and Economics*, Loyola University Maryland economist Thomas DiLorenzo found that between 1880 and 1890, when real GDP rose by 24%, real output in the seven trusts for which data were available rose on average by 175%. In six of the seven trusts for which he had data, inflation-adjusted prices fell dramatically. Because monopolists tend to restrict output and charge high prices, both the output and the price data are strong evidence against the idea that the trusts were monopolistic. Quiggin reports none of these data.

He criticizes high executive pay, asserting there "is ample evidence that the increased pay of senior executives over recent decades has not produced a commensurate increase in their economic contribution." In his recent book *Big Business*, George Mason University economist Tyler Cowen gives strong evidence that the pay of senior executives is in fact commensurate with, but somewhat lower than, their economic contribution to their firms' bottom lines. (See "A Love Letter to Tyler Cowen," Summer 2019.)

To his credit, Quiggin points out that increasing the already high marginal tax rates of high-income earners will cause them to engage in more tax avoidance. He can't resist, though, casting aspersions on the ethics of someone who would avoid taxes. Such people, he says, are "not concerned with the ethics of tax avoidance." Possible Quiggin has in mind tax *evasion*, which is illegal and is a subset of tax *avoidance*, which also includes legal ways to lower own's taxes. But if he's saying all ways to avoid taxes are bad, does he really think that it's ethically suspect to buy tax-free municipal bonds, claim the mortgage interest deduction, or write off charitable donations? All of these are tried and true methods of tax avoidance.

Labor / One of the big controversies in labor economics in the last 25 years has been about the extent to which increases in the minimum wage puts low-skilled workers out of work. The big challenge to the traditional economist's view that minimum wage laws hurt employment came from economists David Card and Alan Krueger, who found that after the minimum wage rose in New Jersey but not in Pennsylvania, employment in the fast-food industry in New Jersey did not fall relative to employment in the same industry in Pennsylvania. In discussing their findings, Quiggin writes, "These estimates were subject to lots of reanalysis, the majority of which tended to confirm the original Card and Krueger analysis." I asked Jonathan Meer, an economist at Texas A&M University who studies the employment effects of minimum wages, if he thought that statement was accurate. He emailed in reply:

> The only actual attempt at replication that I know of is by [David] Neumark and [William] Wascher, and it (famously) did not replicate Card & Krueger. To the best of my knowledge, no one has "reanalyzed" Card & Krueger's data. The most charitable interpretation of that statement is "Lots of other people have done minimum wage studies and the majority of them tend to confirm Card & Krueger," but that is *also* wrong.

Quiggin is a strong believer in Keynesian economic policy. For that reason, he thinks unemployment insurance (UI) is a

good automatic stabilizer: UI payments rise when the economy goes into recession and fall when the economy recovers. He notes that during the last decade's financial crisis, Congress extended eligibility for UI benefits from the typical length of 26 weeks to 99 weeks. He writes, "However, the extension was wound back well before the labor market recovered from the crisis." His unstated implication seems to be that the labor market would have recovered more quickly had the extension remained in place longer. In fact, ending the extension of UI brought the unemployment rate down substantially. A 2015 study published by the National Bureau of Economic Research found that "1.8 million jobs were created in 2014 due to the benefit cut." This should not be surprising: pay people to stay out of work while seeking a better job, and some people will stay out of work longer, not because they're lazy but because they're rational.

Conclusion/ One of the weakest parts of the book is Quiggin's treatment of macroeconomic policy. As noted above, he completely misses Federal Reserve monetary policy as a cause of the Great Depression. Related to that, he claims that expansionary monetary policy at the start of last decade's financial crisis "proved unable to stimulate a return to normal economic conditions." But he completely misses the fact that the Fed sterilized, by selling assets, much of its monetary injection and, in October 2008, chose to pay interest on bank reserves, thus giving banks an incentive not to lend to the public. In short, monetary policy was not expansionary.

I noted earlier that Quiggin has a beautiful analysis of rent control and price controls in general. He writes:

> The problem with price controls is simple when we think in terms of opportunity cost. If prices are fixed by law, they cannot tell us anything about the true opportunity cost of goods and services. Nevertheless, the logic of opportunity costs still applies to producers, including landlords, and consumers, including tenants.

He then goes on to show that price controls, by reducing the amount supplied, often raise the implicit price consumers pay to a level above the price they would pay in a market without price controls.

Also to his credit, Quiggin critiques the extreme form that patent and copyright laws have taken and argues that the costs of the extreme forms outweigh the benefits. I'm inclined to agree but he doesn't make enough of a case.

One of the areas in which he sees a big market failure and, thus, the need for "Two Lesson" thinking, is pollution. I agree. It's difficult to conceive of a plausible free-market solution for air pollution or pollution of the oceans.

While Quiggin is quick to notice the imperfections of free markets, he says very little about the imperfections of government. He relegates the discussion of government failure to one page, on which he does admit that government fails. He says that the central lesson of Two Lesson economics is to examine both sides—market failures and government failures. But he doesn't follow through on this. He claims that markets have not done well in providing education or health care but he doesn't discuss the various government interventions that have hobbled those two sectors. He refers, for example, to the "near-total failure of for-profit school companies," but doesn't point out that because they are embedded in a system where the competition—the government sector—charges a zero price, they start at a huge disadvantage. If, for example, a for-profit school or a nonprofit school wishes to charge a modest tuition of $8,000, it must provide a service not worth $8,000 but worth $8,000 *more* than the zero-price government option.

Perhaps Quiggin needs to write another book, called *The Missing Third Lesson in Economics.* R

Cereals and the State

REVIEW BY ART CARDEN

Sometime between when *homo sapiens* appeared on the scene and today, people went from being nomadic roamers to being "sedentary, cereal-growing, livestock-rearing subjects governed by the novel institution we now call the state." In *Against the Grain*, Yale political scientist and anthropologist James Scott explores how and why.

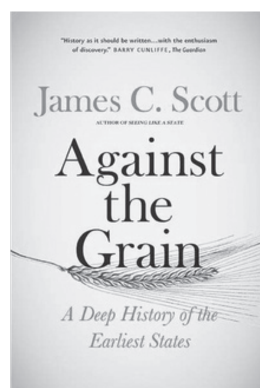
He points to the long gap—some four millennia, at least—between the development of sedentarism and fixed-field agriculture on one hand and the rise of the modern state on the other. He notes that one of the driving forces of early societies was the insistence—at the point of a sword—on the cultivation of cereal grains. In contrast to origin stories about the state emphasizing social contracts and collective action problems, Scott explains that the state had its origins in good, old-fashioned domination and exploitation of farmers.

Grain and civilization/ All early states, Scott notes, were fundamentally grain states. There were no cassava states or potato states or lentil states. Why? Building on his earlier work in *Seeing Like a State* (1998) and *The Art of Not Being Governed* (2009), he points to the importance of "legibility" to the project of state-building and state governance. From the state's perspective, cereal grains have the "virtue" of being easy to see, easy to measure, easy to divide, easy to store, and easy to transport—which is what he means by "legibility." Cereal grains grow above ground, making them difficult to hide. They are easy to harvest and their harvests happen on regular timetables. They are homogeneous and divisible.

In spite of the drawbacks of grain cultivation that Scott discusses, it nonetheless emerged as the major economic and agriculture activity of the earliest states because grains were easy to tax. His hypothesis reminds me of the discussion of geography and the lateral orientation of Eurasia compared to the vertical orientation of Africa and the Americas in Jared Diamond's 1997 book *Guns, Germs, and Steel.* According to Diamond, the enormous size of the Eurasian landmass meant diversity with respect to potentially domesticable plants and animals. Its horizonal orientation meant these plants and animals could be moved over long distances without radically altering the climate and conditions to which they were acclimated. It's a condition that lent itself to Eurasian (as opposed to African or American) development.

Scott argues that in many ways, fixed-field agriculture was a curse as well as a blessing. It did increase fertility and led (slowly) to population growth, but evidence suggests that it quite literally stunted our growth—agricultural peoples were not as tall or as robust as hunter-gatherers—and introduced more toil and drudgery into our lives. Eventually, very slow population growth and the development of "urban" centers made organized states attractive. To think about it in a manner reminiscent of Douglass North's discussion in his 1981 *Structure and Change in Economic History*, the minimum efficient scale of political organization increased as larger populations reduced the per-subject cost of organized violence. Hence the gap between the development of settled agriculture and the emergence of the first modern states.

This suggests there is more than a grain of truth in North's definition of the state as "an organization with a comparative advantage in violence, extending over a geographic area whose boundaries are determined by its power to tax constituents." Taxation, not the provision of public goods, is the state's *raison d'etre.* I'm reminded of Randall Holcombe's remark in his presidential address to the Public Choice Society in 2008, which I paraphrase: Governments provide public goods so they can tax; they do not tax so they can provide public goods. Scott's archaeological excavation of the early history of grain states underscores this notion of taxation, government, and public finance.



Against the Grain: A Deep History of the Earliest States

By James C. Scott

312 pp.; Yale University Press, 2017

Legibility, according to Scott, is central to the power to tax and, therefore, central to state-building. That which is going to be taxed must be organized and measured. Merchant wealth, meanwhile, in (for example) China, was "illegible, concealable, and fugitive," and thus "taxing merchants was a tax collector's nightmare." Moved by the need to cultivate and husband other people, states forced their subjects to cultivate and husband grains and livestock. Subsistence farming of cereal grains, Scott notes, was essentially invented and imposed by early states.

Throughout, he gives us a new understanding of the relationships between civilizations and barbarians, and it's one that smacks of Jean-Jacques Rousseau's "noble savage." Agriculture, it would seem, was humanity's original sin. Alas, Scott's depiction of higher standards of living for hunter-gatherers would do well to better grapple with Steven Pinker's 2011 book *The Better Angels of Our Nature*, which describes the long-run decline in human violence as societies have civilized. Pinker's work suggests that the apparently healthy, leisurely lifestyles of our hunter-gatherer ancestors came at a great price in blood and treasure.

Nonetheless, Scott has a point about states being technologies for exploitation. He notes that the walls surrounding early cities and states—the Great Wall of China, for example—were as likely to have been built to keep people in as to keep barbarians out.

At various points in reading the book, I thought about possible new frontiers in research. The "immaculate conception" theory of the state as implicit in early social contract theories withers, apparently, in the face of archaeological evidence. Why, then, do people actually *love* the state—not merely tolerate it, but *love* it—as Daniel Klein discussed in his 2005 *Independent Review* article "The People's Romance"? How, I wonder, does Scott's analysis contribute to a theory of ideology and especially testable hypotheses about ideologies as they have developed?

Further, it is clear from Scott's discussions of resource management in state- and non-state societies, sedentary and otherwise, that there is a lot of important work to be done on the deep institutional history of resource management in these contexts. That research should draw on the insights of 2009 Nobel laureate Elinor Ostrom, among others. Why, for example, do states tend to crowd out non-states, and what does Ostrom's work suggest about this tendency?

Conclusion / This is an exceptionally ambitious book, one suitable to a scholar of Scott's stature. He describes himself in this endeavor as "an amateur" stepping out of the narrow confines of his specialization and into fields with which he is at best poorly acquainted. He sees his "naivete" as an advantage, not in the sense that he is a plucky outsider overturning the consensus of moribund and sclerotic fields, but because his "ignorance and wide-eyed surprise at how much of what I thought I knew was wrong might be an advantage in writing for an audience that starts out with the same misconceptions."

And so here he is, a learned observer journalistically reporting that things we commonly believe just ain't so. What emerges is a valuable synthesis that "'connect(s) the dots' of existing knowledge in ways that might be illuminating or suggestive." And indeed, *Against the Grain* is both. R

Geopolitics and Finance

REVIEW BY GREG KAZA

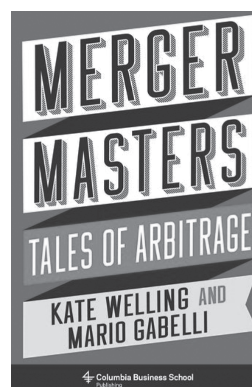
In late 2015, U.S.-based Pfizer and Ireland-based Allergan announced a merger that would create "a new global biopharmaceutical leader with best-in-class innovative and established businesses." The combined firm would broaden an "innovative pipeline with more than 100 combined mid-to-late stage programs in development." It would maintain executive offices in Dublin.

In late 2017, Singapore-based chipmaker Broadcom bid for U.S chip supplier Qualcomm, the largest tech merger ever proposed. "This complementary transaction will position the combined company as a global communications leader with an impressive portfolio of technologies and products," said Broadcom CEO Hock Tan. The combined firm would keep Broadcom's Singapore headquarters.

Both mergers were ultimately halted by U.S. political maneuvers. Pfizer–Allergan would have benefited from domiciling in low-tax Ireland, but the $160 billion deal was terminated in April 2016 because of new rules from President Barack Obama's Treasury Department that sought to reduce "inversion" mergers in which firms move abroad to reduce taxes. In March 2018, President Donald Trump followed the recommendation of the inter-agency Committee on Foreign Investment in the United States (CFIUS) and blocked Broadcom's $117 billion deal, citing "national security."

Welcome to the world of risk arbitrage, which involves trading market price differentials. The practice is fraught with political risk and oftentimes sensationalized in media accounts. In the mid-1980s, *Time* magazine and others elevated Ivan Boesky as the quintessential arbitrageur. The Securities and Exchange Commission later charged Boesky with insider trading and he received a 3½-year sentence and $100 million fine. But the practice has a long history.

Scholar Meyer H. Weinstein, in his classic 1931 treatise *Arbitrage in Securities*, observed, "There was a time when the word 'arbitrage' brought to mind a picture of a mysterious realm in finance which few people seemed to be inclined or at least to have the knowledge to discuss." That soon changed. Benjamin Graham presented a simple formula in *Security Analysis*, first published in 1934 and now in its sixth edition (with co-author David Dodd). Graham's best-known student, Berkshire Hathaway's Warren Buffett, has also written about merger arbitrage. In Berkshire's 1988 report, he explains, "To evaluate arbitrage situations you must answer four questions: (1) How likely is it that the promised event will indeed occur? (2) How long will your money be tied up? (3) What chance is there that something still better will transpire — a competing takeover bid, for example? and (4) What will happen if the event does not take place because of anti-trust action, financing glitches, etc.?" Analyzing the risk of an antitrust authority nixing a proposed deal is also crucial to the practice. Political decisions in the past decade have made it an even more challenging field for investors.



Merger Masters: Tales of Arbitrage

By Kate Welling and Mario Gabelli

408 pp.; Columbia Business School Publishing, 2018

Kate Welling and Mario Gabelli's recent book *Merger Masters* is not a treatise on antitrust policy or political risk. Rather, it raises the curtain on arbitrage strategy by profiling leading practitioners in line with money manager Gabelli's vision to explain "the underappreciated criticality of risk [arbitrage]…, the proper understanding of values and valuation on which the entire edifice of finance rests." The practice is multidisciplinary. Arbitrageurs have backgrounds in finance, marketing, economics, and law. The book also presents the "other side," i.e., executives who faced "arbs" in hostile takeovers.

Sussing out arbs / The book offers insights from a colorful cast of financial wizards. Jeffrey Tarr counted Milton Friedman among his clients. George Kellner's parents fled Hungary when he was 3. Karen Finerman is a CNBC *Fast Money* panelist. Guy Wyser-Pratte's 1969 New York University thesis on arbitrage was later published as a book, but by the 1990s he was challenging managements "that were not doing right by their shareholders."

Activist arbs use "their capacity for risk-bearing and expertise in corporate valuation" to recognize "situations where inept corporate managements have created 'value gaps' and where they can employ their capital to catalyze change." Martin Gruss explains that arbs provide "a valuable service to shareholders who may not want to take the risk of a deal successfully closing." They provide liquidity, Michael Price notes, for investors who don't want to wait for a merger to close.

Arbitrage's dimension as insurance is oftentimes overlooked by critics. Arbs assume the risk that a deal will not close. Clint Carlson observes, "The arb spread is my underwriting premium."

Successful arbitrageurs must have a keen understanding of relationships. Will the "marriage"—merger or acquisition—work, or is it really a "divorce," a selling-off of a bad property? John Bader terms this aspect of the trade "constituency analysis."

But it is in the regulatory realm where their skills face perhaps the greatest challenge. Pfizer's 2015 proposal

to buy Allergan in a stock transaction valued at $363.63 per share represented a premium of more than 30%. Yet the deal died because of the Treasury Department's "inversion" action, following Obama's calling global tax avoidance a "huge problem" and tax inversions a "loophole." A proposed 2014 merger between drug companies AbbVie and Shire was also killed by Treasury action, which the U.S.-based AbbVie termed a reinterpretation of "longstanding tax principles in a uniquely selective manner designed specifically to destroy the financial benefit of these types of transactions."

In both cases, politics—not antitrust law—was the deciding factor. The mergers were not anticompetitive for consumers. Kellner says the failed Pfizer–Allergan merger taught arbs "the Obama administration was willing to take things to the edge."

Geopolitics strikes back / Different politics have emerged under President Trump, whose antipathy to trade with China has ended mergers with firms with Chinese ties. The federal enforcer is CFIUS, created by a 1975 executive order to merely *study* foreign investment. The 1988 Exon–Florio Amendment mandated a review of foreign investments that might affect "national security" and gave the president power to block deals. The 2007 Foreign Investment and National Security Act further empowered the government. In 2018, Trump signed another measure, the Foreign Investment Risk Review Modernization Act, which expands CFIUS's authority. Today, CFIUS includes representatives from 16 federal departments.

Firms wishing to merge must jump through this additional regulatory hurdle, which means arbitrageurs must be more astute in their understanding of geopolitics. Recent deals involving Chinese firms illustrate this new political dimension. In 2016, U.S. legislators called for CFIUS to review China National Chemical's bid to purchase Sygenta, a Swiss agricultural company, citing the potential for "risks to our food system." But CFIUS blessed the deal and it occurred in 2017. Later that year, Lattice Semiconductors' sale to a firm with Chinese ties was blocked by Trump, citing CFIUS and national security. In 2018, Trump blocked Broadcom's deal for Qualcomm, again citing CFIUS and national security—Qualcomm supplies chips to the Pentagon. CFIUS found the deal would jeopardize the firm's lead in 5G technology, a focus of Chinese research efforts.

Conclusion / The book profiles big players. Capitalism, though, is dynamic and it also produces successful small arbs. That means there are plenty of opportunities for plenty of arbitrageurs. To tweak an old adage: "Give a man a fish and you feed him for a day. Teach him how to arbitrage and you feed him forever."

Why be optimistic about this corner of capitalism? Because it's open to nearly everyone. James Dinan, profiled in the book, observes: "A kid with Wi-Fi has 99.9% of the information I have. Thirty years ago, there were only 20 firms." Price differentials will always exist in free markets, despite regulatory attempts to impede them. R

Are the 'Big Four' on Their Last Legs?

REVIEW BY VERN MCKINLEY

Deloitte. Price, Waterhouse, and Coopers. Ernst and Young. Klynveld, Peat, Marwick, and Goerdeler. The names of the green-eyeshade financial services firms—some now truncated (i.e., PwC, EY, KPMG)—still honor long-dead accounting partners, even as the so-called Big Four have in recent decades expanded well beyond the narrow field of auditing and accounting services.

The authors of *The Big Four*, Ian Gow and Stuart Kells, offer a great description of how truly dominant these four firms are on the audit side. They write, "Of the 500 companies in the S&P 500 index, 497 used a Big Four auditor in 2017." Gow and Kells both have the credentials to write this book: Gow previously worked at Andersen Consulting while Kells worked at Deloitte and then was a director at KPMG. (He also was a receiver on the Lehman Brothers bankruptcy.) Notwithstanding those connections, the book is a mostly critical look at the industry and the evolution of the firms. The authors were apparently compelled to write the book, at least in part, because "much of the extant history of the Big Four was commissioned by the firms themselves."

Infancy / Gow and Kells begin their tale with the Medici Bank of 14th and 15th century Italy, whose operations would have important parallels to the Big Four. Medici Bank was a network of partnerships operating as a far-flung network of branches and agencies throughout Europe, with each having an assigned geographic territory and defined services. This structure is not unlike the business model that the Big Four firms follow today. Profit-sharing and the "partner track" were also institutions at Medici that have found homes in the Big Four.

Centuries after the fall of Medici, the Big Four got their start in 19th century London. This was a chaotic era of hypergrowth in the accounting industry, which was (not surprisingly) followed by a period of consolidation:

> In 1811 the London trade directories listed twenty-four accounting firms. Seventy years later they would list 840. Many of the men who were attracted

> to accountancy would quickly leave the field.

Among those who remained were Deloitte, Price, and Cooper, who started their practices mid-century. They occupied themselves primarily in sorting out business failures, what Gow and Kells describe as "a boon for accountants" that was more important than even auditing and bookkeeping in those early days.

Maturity / The Big Four reached maturity in the 20th century, becoming the types of operating entities that we are familiar with today. Among their features:

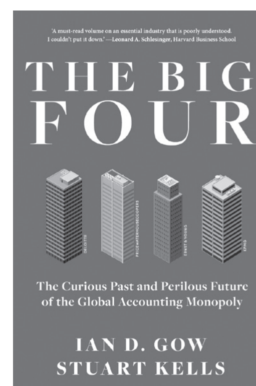
> diversification of the firms' activities, particularly into "management consulting" or "advisory" services; cosying up with governments; benefiting from the "audit explosion" and the rise of the "audit society"; and, like modern Medici, spreading out internationally, with networks of branded franchises in which each national practice was a separate legal entity.

Fueling this massive growth was a new, reliable cash cow resulting from the 1929 stock market crash and the Great Depression: government accounting mandates under the Securities Act of 1933 and the Securities Exchange Act of 1934, especially the requirement for independently audited financial statements.

This was just part of the "complex relationship with government" that benefited the Big Four in the 20th century. Gow and Kells write:

> The firms provided advice and services in support of infrastructure investment, health-care policies, defence procurement, the design of regulations, and nearly every other aspect of public administration.… At the same time, they spent millions lobbying bureaucrats and elected officials in order to shape the legal environment in which they operated. The firms were called upon to help write important pieces of commercial legislation.

Given the incentives to get involved in the legislative and regulatory processes, the lines between the work of the Big Four and "Big Law" became blurred, with thousands of lawyers on staff of the accounting firms. An even more significant trend in the industry began when Arthur Andersen (formerly a "Big" accounting firm; there once was a "Big Eight") entered the consulting business in the 1950s. Price Waterhouse (as it was then known) followed in 1963, applying the moniker "management consultancy services" to its growing army of consultants. One major benefit of this move was the smoothing out of the volatility of seasonal bookkeeping and audit work.



The Big Four: The Curious Past and Perilous Future of the Global Accounting Monopoly

By Ian D. Gow and Stuart Kells

256 pp.; Berrett–Koehler, 2018

Adulthood / The Big Four have had their share of near-death experiences, oftentimes involving questions of quality of performance. The biggest breakdown did destroy a Big firm: Arthur Andersen (AA), which imploded in the wake of the Enron scandal. AA was convicted of obstruction of justice in the investigation of Enron, though that decision was later overturned by the Supreme Court. That reversal was too late for AA; in the interim between the initial verdict and the Supreme Court's ruling the firm suffered an enormous reputational hit and lost its ability to audit, its bread-and-butter business along with tax and consulting. Tens of thousands of Andersen employees had to transition elsewhere. Gow and Kells do not give much detail on the AA collapse, which is a little surprising given that it was such a singular event in the history of the Big accounting firms.

The authors also offer comments on the 2008 financial crisis, noting the Big Four's role in monitoring some of the firms that were at the center of the crisis:

> Deloitte had audited Bear Stearns and Fannie Mae. KPMG had audited Citigroup. PwC had audited American International Group and Goldman Sachs. EY had audited Lehman Brothers.… Lehman, Bear Stearns and Northern Rock all received unqualified audit opinions before their collapse.

They offer some detail on the Lehman Brothers collapse and the use of Repo 105, which they describe as an "aggressive form of financial window-dressing." (See "Is There Value in Revisiting the Lehman Collapse?" Spring 2017.) They also highlight the over $100 million in settlements for EY, which was Lehman's auditor.

Another chapter in this section of the book delves into detail on "the audit expectation gap," the difference between what financial statement users believe the role of auditors is and what auditors themselves believe their role is. Typical of the auditors' view is John McDonnell of PwC, who led the firm's audit of Bank of Ireland, which saw its stock price collapse during the financial crisis: "Matters such as stability, capital adequacy and future prospects are outside the remit of accounting standards." Gow and Kells seem to agree:

> Yet this might be one area in which the auditors' lamentations regarding the expectation gap have some merit. Predicting bankruptcy requires skills and information well beyond those required to audit financial statements.

Although *The Big Four* includes a few high-level references to failing firms, a much more detailed case study of one or more of the problem institutions would have been more illuminating.

Twilight / This final part of the book considers what life will be like for the Big Four

IN REVIEW

going forward. Gow and Kells raise the possibility that many workplace trends may not only disrupt the Big Four's comfortable business model, but destroy it. The authors believe the flexibility of finding consultants in the "gig economy" outside of the Big Four, on websites such as Freelancer.com, is one such threat. Developments in big data, which allow competitors to be more agile in their auditing and consulting analysis, can bypass sampling and the Big Four's labor-intensive business model. Finally, competition from universities, nonprofit think tanks, government bureaus, and offshoring, along with antitrust challenges on the legal front, will likely chip away at the dominant position the Big Four have long held on auditing and advisory work. This final section of the book offers some unique insights.

Overall, the book is a compelling read. However, readers hoping for a deep dive into many of the questions about failings of the Big Four over the past 20 years will be disappointed by the limited discussion given to those major events. R

In Praise of Capitalism

REVIEW BY PIERRE LEMIEUX

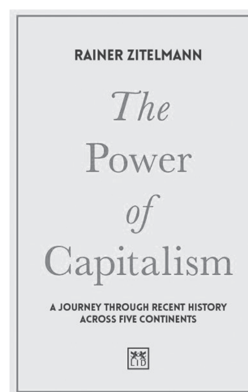
Rainier Zitelmann's latest book, *The Power of Capitalism*, offers a chronicle of capitalism and socialism in recent times. The author, a German historian and political scientist turned journalist and then businessman, emphasizes that his book is a work of history as opposed to economic theory. His first goal is to show that economic freedom leads to "economic prosperity for the majority of citizens." This is a modest and realistic goal.

What is capitalism? He uses the term as a synonym for free markets. It's only a matter of definition, and I will follow him here. Socialism, as traditionally defined, is the public (that is, government) ownership of the means of production. But as Zitelmann notes, the government does not have to own the means of production to control them; regulation suffices. Widespread regulation—presumably along with a large measure of redistribution—would thus be a form of socialism. Capitalism is, on many dimensions, the opposite of socialism.

Natural experiments / How have the two systems fared against each other? The first and major claim of the book is that capitalism benefits most individuals while socialism impoverishes them. This should be obvious from the recent historical record, at least as far as the extremes are concerned. History has offered us natural experiments that Zitelmann reviews.

North and South Korea provide one of these natural experiments. One may object that North Korea is not ideal socialism and South Korea is not perfect capitalism. The first part of this observation is true, but that's part of the point: ideal socialism always ends up in practical poverty and tyranny. The second part of the observation is also true, but there is certainly much more capitalism in the South than in the North. After starting at a similar level of poverty seven decades ago, North Korea followed a socialist path and is now one of the most destitute places on earth, while South Korea's residents enjoy a per-capita gross domestic product higher than Spain's.

Zitelmann notes that migration flows tell us something about how most people prefer one type of system to the other. On the Korean peninsula, people flee the North for the South, not the other way around. (In economics, we call this "revealed preference.") A similar pattern is observable in all cases of advanced socialism, from East Germany to Venezuela. The government of North Korea forbids emigration, as the government of East Germany did ostentatiously with the Berlin Wall. (East Germany's official justification for the barrier was to prevent the infiltration of agents from the West.)



The Power of Capitalism: A Journey through Recent History across Five Continents

By Rainer Zitelmann

256 pp.; LID Publishing, 2019

East Germany's socialism was imposed by the Soviet Army after World War II, while West Germany was allowed to evolve toward capitalism. The West German economy rapidly surpassed the East German one. As the Berlin Wall was falling in 1989, Zitelmann reports, "only just over half of all East German households owned a car, and more than half of these were Trabants. … Private citizens had to wait between 12.5 and 17 years for a new car." The socialist man not being less self-interested than the capitalist man, many East Germans who could not afford a car nonetheless applied for a spot on the queue and sold their spot on the black market. Used cars cost two or three times the price of new cars.

In West Germany, the Christian Democratic party was originally anti-capitalist, but chancellors Konrad Adenauer and especially Ludwig Erhard moved it toward a "market-oriented model." As the director of the Bizone (American and British) economic administration after the war, Erhard had unilaterally abolished the controls of the planned economy. Later, in the first years of the 21st century, Social Democrat chancellor Gerhard Shröder effected another rebalancing toward the free-market economy. "France and Italy, to name just two—have watched Germany's economic performance with envy," Zitelmann writes.

Venezuela has not built the equivalent of the Berlin Wall, but who doubts that

its regime has failed abjectly? Zitelmann compares this failure with the reverse path taken by the Chilean government after 1973. In terms of GDP per capita, Chile is now the richest country in Latin America. The "Chicago Boys" (the free-market advisers of dictator Augusto Pinochet) did a good job. Zitelmann admits that the economic transition was difficult (not to mention the repression of political opposition), but there was no widespread humanitarian catastrophe like what we are seeing in Venezuela.

More complex cases / Along with Erhardt, Margaret Thatcher and Ronald Reagan "were the most significant and most adamant proponents of free-market capitalism among the 20th century's Western political leaders," Zitelmann writes. He notes, however, that Reagan financed his military build-up with government debt. The federal budget deficit increased from 2.6% to 3.7% of GDP during his presidency.

Zitelmann's enthusiasm for Thatcher and Reagan may be overdone. One can argue that they only temporarily slowed the trend toward more interventionist government. According to data compiled by John Dawson of Appalachian State University and John Seater now of Boston College, the *Code of Federal Regulations*, an annual consolidation of all existing federal regulations, roughly stopped growing in 1981 (the first year of Reagan's presidency) and stayed that way through 1985. But it began growing again in 1986, two years before the end of Reagan's second term.

Capitalism is lifting certain African countries out of extreme poverty. Those countries did not need more foreign aid or natural resources (which have always been abundant in Africa), but entrepreneurship and a retreat of the state. This is what is sparking economic growth. However, growth is still limited by poor social institutions and, in many countries, by the continuing repression of economic freedom.

Sweden is another case Zitelmann documents. Contrary to the myth of socialist Scandinavia, he argues that "Sweden stopped being a socialist country several decades ago—if it ever was one in the first place," although he adds that "contemporary Sweden remains a traditional welfare state in some respects (e.g., it has comparatively high tax rates)." He explains that Sweden was a capitalist country between 1870 and the 1930s, then moved to an increasingly socialist model. But it moved back to capitalism in the early 1990s. The economy grew more during the capitalist periods, although Zitelmann notes that favorable "cultural factors" also played a role in Swedish prosperity.

This issue of cultural factors introduces more complications than perhaps Zitelmann is willing to admit. How can we determine if economic improvement comes from a move to capitalism or from other factors? And when does a country cross the invisible line between being socialist and being capitalist?

If we don't know about how capitalism and socialism work in theory, we cannot hope to determine which system predominates in a particular economy.

Consider China. Has it become capitalist in recent decades, as suggested by the title of Ronald Coase and Ning Wang's 2012 book *How China Became Capitalist*? (See "Getting Rich Is Glorious," Winter 2012–2013). Zitelmann believes so. But others claim it is merely becoming capitalist. So, is China now capitalist with socialist elements, or socialist with capitalist elements? Is its incredible growth since its gradual liberalization in the 1980s the product of its socialist or capitalist elements? We cannot answer such questions without some theory about how capitalism and socialism work.

Economic theory strongly supports the idea that Chinese growth was generated by the relaxation of socialist constraints. Liberalization has allowed growth of entrepreneurship and incomes worldwide, lifting a large part of mankind out of poverty, as documented in *The Power of Capitalism*. Unfortunately, Chinese liberalization seems to have slowed recently and the future is rendered more uncertain by the current protectionist push of the U.S. government, which may isolate China in the world economy.

Improving the argument / It is difficult not to agree with Zitelmann that more capitalism stimulates economic growth while more socialism stifles it. But his argument could be improved.

For one thing, we must be more conscious that "capitalist" and "socialist" are matters of degree. The two systems are defined over many dimensions, which makes the measurement of the related components difficult not only in practice but even conceptually. Indexes of economic freedom (Zitelmann uses the Heritage Foundation's Index of Economic Freedom) are only compound indicators that depend on the variables included and the weights assigned to them. In extreme cases such as the two Koreas or the two Germanys or Venezuela, the relative preponderance of socialist and capitalist elements is easy to "guesstimate," but the guesswork is less reliable in many other cases. In this perspective, Zitelmann is probably right to challenge the Heritage index when it indicates that economic freedom has increased around the world in recent years.

Another suggestion to improve Zitelmann's argument is to reject the idea that studying history is sufficient to determine whether capitalism or socialism "works better." Only with an underlying theory can we make sense of the notion of what it is to "work better." Only with an underlying theory, explicit or implicit, can the historian know which facts to look for. If we don't know about how capitalism and socialism work in theory, we cannot hope to determine which system predominates in a particular economy.

According to standard economic theory, "working better" means better satisfying the preferences of individuals. We should consciously start from there. "You don't need to read a lot of economic theory to decide which system is better," Zitelmann writes.

Perhaps not "a lot," but certainly some.

He implicitly agrees with the importance of theory when, toward the end of *The Power of Capitalism*, he addresses the claim that the Great Recession of 2007–2009 showed that capitalism does not work. He rightly points out that the recession did not demonstrate a failure of the market, but instead confirmed the failure of government intervention. He explains how the recession, which started in residential real estate and the market for mortgage-backed securities, followed decades of federal intervention in these markets. More generally, he notes, "it is perfectly possible to demonstrate that many alleged contemporary 'problems of capitalism' are in fact the result of violations of the very principle of capitalism." The nature or operation of the "very principle of capitalism" is a theoretical question.

Intellectualism vs. capitalism / Another issue Zitelmann tackles is one that has worried many classical liberals before: why are intellectuals mostly anti-capitalist on the Left and on the traditional Right? He quotes a recent declaration of Alain de Benoist, a French intellectual who, a few decades ago, was a guru of the New Right: "My principal enemy has always been capitalism in economic terms, liberalism in philosophical terms, and the bourgeoisie in sociological terms."

Intellectuals, defined as "professional thinkers who are more skilled at expressing their thoughts than most other people," don't like capitalism, Zitelmann argues. They feel that their own perceived intellectual and moral superiority is not remunerated enough compared to what (successful) businessmen and entrepreneurs earn. Moreover, intellectuals tend to value formal, academic, explicit knowledge and to underestimate the role and importance of implicit knowledge: the knowledge of the artist, craftsman, and entrepreneur. Interesting hypotheses.

Zitelmann correctly notes that the business elite have no "intellectually adequate response" to attacks on capitalism. They turn the other cheek, not unlike the reaction before an angry customer who is always right. Worse, they often fall in the trap of crony capitalism, which is not the sort of capitalism Zitelmann is defending.

The Power of Capitalism concludes by calling for radical reforms to expand capitalism. The author realizes that such reforms are difficult to accomplish because they generate short-run disruption costs and don't make good election programs. A crisis might spark the necessary reforms, but there's the risk that voters will instead turn to anticapitalist politicians, as the Germans did when they gave the majority of their votes to the National Socialist and Communist parties in the early 1930s.

The Power of Capitalism is a sound and moderate book—perhaps a bit too moderate, if anything. More theory might have enhanced it. A few tables or charts, more primary sources and citations, and an index of subjects would have been welcome.

Nonetheless, Zitelmann's book remains an instructive praise of capitalism. It should be especially appealing and useful to an audience of businessmen and entrepreneurs. *R*

Working Papers BY PETER VAN DOREN

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

Electricity Policy

"Do Renewable Portfolio Standards Deliver?" by Michael Greenstone and Ishan Nath. May 2019. SSRN #3374942.

States have responded to concerns about greenhouse gas emissions from coal and natural gas in electricity generation by enacting laws that mandate the use of renewable generation sources. Those who argue such mandates have low or no net cost emphasize estimates of the total costs of various generation technologies divided by their *potential* output over their operating lifetime, the so-called "levelized" cost of energy estimates (LCOE). By this metric, large-scale centralized solar generation in the deserts of the American southwest and large-scale onshore wind generation both have costs that are competitive with new natural gas generation.

However, even if the lifetime average costs of wind and solar generation are the same as coal or natural gas, the equivalence needs to be qualified. The first problem is that renewable generation sources are intermittent. The sun does not shine at night and the wind blows more at night than in the daytime. According to the authors, utility-scale solar generation plants' annual output averages only 25% of their potential output. Wind plants' output is only 34% of potential. In contrast, the output of natural gas combined-cycle plants that "always" operate is about 85% of potential. Thus, a comparison of LCOEs between intermittent renewable sources and "baseload" conventional technologies is very misleading with respect to total system costs because it does not account for the additional cost necessary to supply electricity when the renewable resources are not operating.

Until cost-competitive green energy that is dispatchable is available, renewable sources of electricity require backup natural gas generation whose output can be varied (sometimes quickly). The fixed and variable costs of the backup must be paid by someone. These hidden costs need to be considered in any calculation of "cost competitiveness."

The second problem is that renewable generation plants are frequently located far from population centers, which increases transmission costs relative to those of fossil fuel plants. According to the authors, a literature review of transmission cost

estimates for wind power by the Lawrence Berkeley National Laboratory finds a median estimate of about $300 per kilowatt, or about 15% of overall wind capital costs. This adds approximately 1.5¢ per kilowatt hour to the levelized cost of generation for wind. An analysis by the Edison Electric Institute in 2011 found that 65% of a representative sample of all planned transmission investments in the United States over a 10-year period ($40 billion) were to link renewable generation with the existing transmission system. These transmission costs are part of the total cost of renewable energy.

This paper attempts to calculate the total costs of renewable mandates on electricity prices by comparing states that did and did not adopt Renewable Portfolio Standard (RPS) policies, using the most comprehensive panel data set ever compiled on program characteristics and key outcomes from 1990 to 2015. Electricity prices increase substantially after RPS adoption. The authors' estimates indicate that in the seventh year after passage, average retail electricity prices are 1.3¢ per kWh (11%) higher, totaling about $30 billion in the RPS states. And 12 years later they are 2.0¢ (17%) higher.

When the emission-reduction estimates are combined with the estimated effect on average retail electricity prices, the cost per metric ton of greenhouse gas abated exceeds $115 in all specifications and can range up to $530. That is several times larger than conventional estimates of the social cost of carbon.

Housing Policy

"The Effect of New Market-Rate Housing Construction on the Low-Income Housing Market," by Evan Mast. July 2019. SSRN #3426103.

What policies increase the availability of affordable housing? One possibility adopted in New Jersey, Massachusetts, and New York City is to mandate that new housing developments have a small percentage of units set aside and priced for low- and moderate-income households. Another is to reduce policy constraints on new construction and allow the effects of the increased new supply to "filter down" to the vacated existing units whose owners have to reduce price to maintain occupancy.

This paper analyzes these policies by using newly available data collected from numerous private and public record sources such as U.S. Postal Service change-of-address forms, county assessor records, magazine subscriptions, and phonebooks. Each address is accompanied by an estimated date of arrival and some limited demographics (age, gender) on each individual. The data consist of 52,432 individuals in 686 market-rate multifamily buildings constructed since 2009. The buildings are relatively evenly distributed across cities, with Seattle, New York City, and Chicago having the most (over 80 each) and Philadelphia and Boston the least (under 20).

The data allow the construction of "migration chains" as people change dwellings. The data strongly suggest that a short series of moves connects new construction and low-income areas, meaning that as new construction expands housing supply, existing housing becomes available for lower-income renters and buyers. One hundred new market-rate units create vacancies in 70.2 units in below-median income tracts, 39.6 in bottom-quintile income areas, and 45.3 in areas that are below median income and in the top quintile of rent burden. Inclusionary set-aside requirements, which are in the range of 5–20% of the new units constructed, are much fewer than the 70% of unit vacancies created by market filtering. Market filtering would appear to be the superior policy for expanded low-income housing.

Health Care Policy

"The Opportunities and Limitations of Monopsony Power in Healthcare: Evidence from the United States and Canada," by Jillian Chown, David Dranove, Craig Garthwaite, and Jordan Keener. July 2019. NBER #26122.

Medicare for All"—opening the Medicare program to people of all ages, either as a competitor to private health coverage or in place of it—has been embraced by some Democratic candidates for president. The economic reasoning supporting the proposal is a claim that a single buyer (a monopsonist) would reduce the prices paid for both health care labor and drugs. Canada has a single-buyer system and is often held up as an example to be emulated by the United States.

Many presume that Medicare for All in the United States would result in Canada-like health care wages and pharmaceutical prices. Highly educated Canadian health care workers earn 26% less than their American counterparts. But *all* skilled Canadians earn 22% less than Americans with similar credentials, so only 4 percentage points of the wage difference between Canadian and U.S. health care workers can be plausibly attributed to the monopsony power of the government. The Canadian government does not use its buying power to lower the wages of health care workers very much relative to other skilled workers because doing so would decrease the supply of health care workers who would turn to other skilled occupations if their wages were suppressed through policy.

Pharmaceutical prices in Canada are 54% less than U.S. prices, whereas overall Canadian prices are only about 4% lower than U.S. prices. So, Canada is exercising monopsony power in the pharmaceutical market. It can do this because it is a small purchaser in the context of the world market and its low prices will not reduce pharmaceutical supply to Canada. The United States is not a small purchaser and could not reduce pharmaceutical reimbursement 54% without having supply consequences.

These findings should temper the expectations of anyone who believes that Medicare for All would reduce U.S. health spending to Canadian levels. *R*