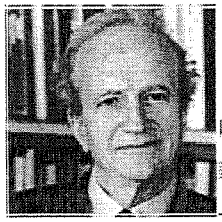

THE BECKER-POSNER BLOG

A BLOG BY GARY BECKER AND RICHARD POSNER

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June 14, 2009

The Fatal Conceit: A Pay "Czar"-Becker

This week the Obama administration, acting through Secretary of the Treasury Geithner, appointed a pay czar to review, reject, and possibly set the pay of companies that received large amounts of federal assistance during the financial crisis. No appeals will be allowed from his decisions. The Czar, Kenneth Feinberg, will have broad authority over compensation for the top executives and 100 top employees at Bank of America, Citigroup, American International Group (AIG), General Motors, and a few other companies that received large federal bailout monies. This is surely one of the more preposterous ideas to come out of Washington.

The title of my post, "The Fatal Conceit", is taken from the title of a book published in 1988 by Friedrich Hayek. In this book Hayek attacks socialists for "the fatal conceit" that government officials can effectively determine prices and production through various forms of central planning without having the incentives and information available to firms in competitive markets. A closely related conceit is behind the belief that someone sitting in Washington can determine the pay to hundreds of executives and other employees.

The social purpose of competition and private enterprise is to provide quick responses to constantly changing market conditions. These responses include determining and changing the salaries, bonuses, and stock options of employees and top executives. Companies get into trouble and even fail when their decisions, including decisions on the quality of employees and their compensation, are less effective than decisions of their competitors.

All the companies that will have the pay of top employees under the control of the Czar compete against companies, both domestic and foreign, that will be free to set the pay of their employees. If these companies offer higher pay than the Czar allows for companies under his jurisdiction-whether this higher pay takes the form of bonuses or other forms, or whether fully justified or not-the controlled companies will lose their best employees to competitors, and they will have trouble attracting employees who are highly capable. The Czar could even be making serious mistakes if he just allowed the pay of companies under his control to match the pay offered by competitors. For it is plausible that companies in hock to the government may have to pay more than competitors to entice capable persons to take on the task of resurrecting

these companies. This is especially likely since Congress and the Treasury will be calling them to testify and second-guessing their decisions.

The background of the Czar, Kenneth Feinberg, is not reassuring in these respects. A lawyer, he first worked for the federal government, and then during the past several decades headed a law firm based in Washington. Since he apparently has never been an employee of any company other than the government and Washington law firms, how can this background prepare him to set the pay of large companies, such as AIG or GM, that are in highly competitive industries?

In recent interviews Mr. Feinberg claimed that excessive risk-taking fuelled the crisis, and that this risk-taking also led to excessive compensation. Surely, risk-taking has essentially nothing to do with the problems of GM and Chrysler, two of the companies under his wing. Growing leverage by banks of their limited capital base did contribute to the crisis, and perhaps that also greatly increased the pay of bank executives. However, even if this claim is entirely correct, I do not see how that can help him efficiently determine the pay of the (fortunately) few companies under his jurisdiction when their competitors can set the pay of their employees much more freely.

Defenders of the selection of Mr. Feinberg point to his almost three years spent as a pro bono Special Master of the fund that compensated victims of the 9/11 terrorist attacks. I do not know how well he carried out these duties, but determining compensation of victims is entirely different from what is required to set compensation of executives. As Special Master he had to assess the value of losses due to wrongful deaths and injuries. Although that assessment is not easy- it depends on lost earnings and other aspects of the so-called statistical value of life- it really has little to do with determining employee pay in a few companies engaged in highly competitive and changing industries.

The same fatal conceit behind the setting up of a pay Czar is also responsible for the belief that members of Congress and Washington officials are capable of steering GM and Chrysler toward profitable directions. This is behind the government pressure on these companies to shift toward small fuel-efficient cars, even though GM and Chrysler have been best at producing trucks and larger cars. Perhaps they will be able to make this shift, but it is far more likely that Honda, Kia, Toyota, and other foreign auto manufacturers that have been making small cars for decades will eat their lunch.

Posted by Gary Becker at 11:14 AM | Comments (15) | TrackBack (0)

The Pay Czar and Compensation Issues--Posner's Comment

I agree with Professor Bebchuk of Harvard, and others, that there is a problem with the compensation of top executives at publicly held corporations (that is, corporations in which ownership is widely dispersed), so that control resides in the board of directors. The problem is that the individual directors do not have strong incentives to limit the

pay of the CEO and other top executives. By limiting his and their pay, the board would narrow the field of selection, and if the company got into trouble they would be criticized for having been penny wise and pound foolish in resisting their "compensation consultant's" advice to pay top dollar. In addition, the directors often owe their lucrative directorships, and their continuation in them, to the CEO. The movement toward "independent" directors (as distinct from directors who are officers of the corporation) does not cure the incentive problems, but rather compounds them by making the board less knowledgeable about the corporation.

So there is a basis for concern with the compensation of top management in publicly held corporations, but it is not a momentous concern and costly measures to ally it would not be justifiable. Modest measures, such as making it easier for shareholders to replace directors than under the existing, Soviet-style system in which shareholders vote for or against the slate proposed by management, and requiring full disclosure and monetization of all forms of compensation paid CEOs and other top executives, may be sensible; but nothing more should be attempted.

The solving of the overcompensation problem would have little if any effect on risk taking by bankers and other financiers, so probably any efforts to solve it should be postponed until the economy recovers from its present sickness.

A distinct problem is that of compensation of executives of firms that are owned or controlled by the federal government, such as General Motors, American International Group, Fannie Mae, and Freddie Mac, and (or) that are recipients of federal bailouts. These are troubled firms, and the concern is that management may try to funnel the federal moneys that the firms have received into dividends and bonuses so that shareholders and executives will be protected should the company fail completely. The danger in other words is that when a firm is teetering on the edge of bankruptcy, management may stiff the firms' creditors by funneling some of the firm's remaining assets to managers and shareholders. The time to deal with this problem, however, is when the bailout is made; suitable conditions can be attached to it. To instead appoint a "pay czar" to deal with executive salaries of bailout recipients on an ad hoc basis creates all the problems that Becker discusses.

These problems are especially grave with regard to General Motors and Chrysler, as these are fast-failing firms that need to be able to offer high salaries to attract able executives. Between efforts by the "pay czar" to limit these companies' flexibility in compensation, and the efforts by Congress to limit the companies' ability to import vehicles and close plants and dealerships, the government is doing to best to minimize its chances of ever recovering its $60 billion investment in the two firms. This is called shooting oneself in the foot, or, alternatively, politics as usual.

Still another distinct problem is that of compensation practices of banks and other financial intermediaries. Here the problem is not the compensation of top management, but the compensation of traders and other investment officers at the operational level. The concern is that compensating them on the basis of the profitability of the individual deals that they make motivates them to take excessive risks. Suppose a deal has a positive expected value, but there is a 1 percent chance that it will fail in a way that imposes heavy costs on the corporation, and perhaps, because of the chain-reaction effect of the failure of a major bank (as we saw last September, when Lehman Brothers went broke), on the financial system as a whole. The trader who makes the deal may not worry much about that risk, because a 1 percent annual risk of disaster is very unlikely to materialize in the short run; the probability that an annual risk of 1 percent will materialize in 10 years is only 10 percent (actually a shade less).

Financial firms that worry as they should about such a catastrophic risk (since the firm makes many deals, which multiplies the risk of disaster), typically try to reduce it by employing "risk managers" who review proposed deals. Because this method of limiting risk failed to avert the financial collapse of last September, there are suggestions that it be supplemented or replaced by rules limiting the cash bonuses paid to traders, instead compensating them in restricted stock of the corporation, which they cannot sell for a number of years, or authorizing the corporation to "claw back" any bonus they receive should the risk involved in one or more of their deals later materialize and reduce or eliminate the profit that the corporation made on the deals.

It might seem that top management would have all the incentive it needed to prevent its subordinates from taking risks that would jeopardize the solvency of the company. But that is not true, because the private cost of bankruptcy is truncated by limited liability (the shareholders cannot be forced to pay the corporation's debts), but the social cost, as we have learned, can include a devastating global economic shock.

An external cost is a conventional justification for regulatory intervention--in principle. But the specific suggestions for curbing risk taking by traders are problematic. There are many influences on the value of a corporation's stock besides the outcome of a particular deal, and a claw-back possibility can greatly reduce the present value of a bonus, as well as complicating the recipient's tax and other financial planning. I conclude that it is premature to start regulating compensation practices in the banking industry; there are other ways of reducing financial risk that are less problematic.

Notice that this problem has nothing to do with boards of directors' inability under existing rules to control the compensation of top executives, because traders are not top executives. Management has no

incentive to overpay its subordinates! Nor has this problem anything to do with government ownership or control, or a risk of insolvency that might induce top management to try to appropriate a firm's remaining assets.

Any monkeying by government with compensation practices, especially below the top level of management and especially in financial firms, will impair the ability of American firms to compete with foreign firms. The banking business is thoroughly international, and unless all countries act in lock step with the United States in regulating compensation practices, many of our ablest financiers will be lured to foreign banks.

One can only hope that the appointment of a "pay czar" is merely a sop to ignorant public and congressional opinion, and that Mr. Feinberg will be suitably restrained in the exercise of his powers. Secretary of the Treasury Geithner seems unenthusiastic about the government's imposing more than cosmetic changes on corporate compensation. practices. More power to him.

Posted by Richard Posner at 10:42 AM | Comments (5) | TrackBack (0)

June 7, 2009

The Administration's Health Care Plan--Posner

It is understandable why there is widespread concern with the American system of health care. The nation spends about 15 percent of its very large Gross Domestic Product on health care, which is almost twice as much per capita as the nations that we consider our peers spend, yet outcomes, at least as measured by longevity, are no better in the United States than in those other nations, or for that matter in many much less wealthy nations. We provide much greater health care to elderly people at the end of their life than other nations do, though without much to show for it in increased longevity. Some 45 million people--15 percent of the population--have no health insurance, either private or public. They are either charity patients, or pay the full price of any medical treatment they receive--or at least are charged the full price, for a common sequel to an expensive medical procedure for an uninsured patient is the patient's declaring bankruptcy in order to wipe out his medical debt.

The Administration wants every American to have medical insurance. The details are unclear, but the thrust of the Administration's plan is those who can afford to buy medical insurance, either directly or through their employer, would be required to do so and that those who cannot would have their insurance subsidized. The cost to the government alone of the Administration's program is estimated by the Administration itself to be $120 billion a year. How it will be financed remains up in the air, along with many other crucial details. Probably part of the cost will be defrayed by limiting the tax deductibiliy of employer-provided health insurance. But most of it, at least in the short run, will simply be added to the

government's huge budget deficit--so huge that amounts like $120 billion are beginning to seem like small change.

The Administration claims that in the long run the aggregate cost of health care will actually fall. Indeed, the hope is that the $120 billion annual cost will not have to be funded at all, but instead will be offset by various reforms that the Administration proposes, including digitization of health records, allocation of greater resources to preventive care, and evaluating the performance of hospitals and other medical providers more carefully, to determine which medical procedures are really useful, and limiting reimbursement to providers accordingly.

I don't think the program makes fiscal sense. If enacted in anything like the form that the Administration is urging on Congress, it would be immensely costly and would thus add significantly to our national debt, which is already growing at a fast clip because of the decline of tax revenues as a result of the current depression and the immense government expenditures on trying to speed economic recovery.

Ignored in estimates of the cost of the health care program is the effect of insurance on the demand for medical services. When people, because they lack health insurance, have to pay for medical services or encounter long queues in hospital emergency rooms, they have an incentive to economize on medical treatment. If they have health insurance, the marginal cost of treatment in excellent medical facilities falls to the cost of a deductible or copayment; and it is the marginal cost that the insured consumer of medical services confronts--the cost of the health insurance premium itself is a fixed cost, which is not affected by how much treatment the insured receives. Because the supply of medical services is not highly elastic, an increase in the demand for those services will increase average as well as total cost.

I would not object if a program of universal health insurance could be financed by reducing or eliminating the tax deductibility of health insurance. But only a modest reduction, if that, in its deductibility is politically feasible. The reforms that the Administration contends will not only pay for the program but also reduce the aggregate costs of health care in the United States are probably pie in the sky. Digitization of medical records does increase efficiency: it makes it easier to change doctors, track health histories, and coordinate medical services. But the net savings are likely to be modest or even negative, because anything that lowers the average cost of a given quality of health care increases demand, just as broadening insurance coverage does.

Preventive care--another efficiency measure touted by health-care reformers--is potentially very costly, because by definition it provides health services to people who are not yet ill. Advances in preventive care are not limited to telling people to exercise and eat healthful foods, but increasingly are dominated by massive and costly programs of screening and follow-up. Such programs, and the treatments that ensue for

persons found to have a treatable condition, may extend life, but often this means keeping alive very sick people who will require expensive care for the remainder of their prolonged life.

An effort to create a form of benchmark competition between hospitals and between doctors, by careful evaluation of outcomes and by using the results of the evaluation to calibrate reimbursement by insurers so that the best-performing health-care providers will be rewarded and the worst punished, is likely to founder on the difficulty of adjusting for differences in outcomes that are not attributable to the efficiency of the health-care provider.

In addition, efforts to limit treatment by limiting reimbursement, especially efforts by government to do so, are deeply unpalatable both to patients and to doctors and hospitals. A patient convinced by his doctor that a particular treatment is his only hope for continued life will not be reassured to be told that in the opinion of the government's experts, the treatment would not be cost-justified because it is very costly and is unlikely to be successful. Insurers, and employer health-benefits plans, try to do this kind of financial triage now, but their lack of success is reflected in the enormous annual cost of American health care.

A deep problem is the replacement, in the medical profession as in the legal profession, of a professional model of service with a business model. In the professional model, the service provider is assured a good but not extravagant income by limitations on competition, and in exchange he is expected to avoid exploiting the ignorance of patients as he could do by performing unnecessary or low-value procedures. In the business model, the service provider endeavors to maximize his net revenues. In the case of medicine, the disparity of knowledge between provider and patient, coupled with the fear and desperation that serious illness (or just the possibility of it) engenders, enables the profit-maximizing provider often to convince the patient to undergo costly low-value treatments. Certainly the profit-maximizing health-care provider will be very relucant to refuse to provide a treatment that the patient insists upon, his insistence being made convincing by the fact that insurance will pay all or most of the cost. Insurers do try to limit their costs by refusing to approve low-value procedures--but in the face of combined pressure by provider and patient, the insurer is often forced to back down.

To return to the initial puzzle of why our peer nations are able to provide what seems, judging by outcomes, a level of health equal or superior to that of Americans at far lower cost, the only convincing answer is that the health-care providers in those nations limit treatment. I am not sure of the explanation, but the possibilities include: the professional model is more tenacious in societies less committed to free markets and a commercial culture than the United States; more of their hospitals are public and more of their doctors are public employees, who are therefore salaried rather than entrepreneurial; and Americans, being less fatalistic

than most other peoples, have a more intense demand for life-extending procedures. These are reasons why a national health plan modeled, as the Administration's appears to be, on the health plans of peer nations with much lower aggregate health costs is unlikely to work well, or at least to generate net cost savings.

Of course if people value extension of life very highly--and there is evidence that, in the United States at least, most people do--a very costly health care system may be cost-justified, in the sense that the benefits exceed the costs. Yet the benefits seem rather illusory, since the extra money we spend on health care does not seem to produce better outcomes. But international comparisons of health that are limited as they largely are to differences in longevity are crude. They ignore health benefits unrelated to longevity, such as the benefits conferred by cosmetic surgery and the possibility that the additional costs of health care in the United States enable people to live more dangerous, strenuous, or self-indulgent lives and by doing so confer utility.

Posted by Richard Posner at 4:27 PM | Comments (47) | TrackBack (0)

Health Care-Becker

The best way to evaluate America's expensive health care system would be to estimate the effects of different kinds of healthcare on the quality and quantity of health for individuals of various ages, incomes, races, and other categories. To my knowledge, no researchers have come close to doing this. Instead, the American system has sometimes been found wanting simply because life expectancies in the United States are at best no better than those in France, Sweden, Japan, Germany, and other countries that spend considerably less on health care, both absolutely and relative to their GDPs.

Life expectancy is surely one supremely important measure of health since individuals in rich countries are willing to pay a lot even for small increases in their probabilities of surviving different ages (see the studies in the book "Measuring the Gains from Medical Research", ed. By Kevin M. Murphy and Robert Topel, 2003). Studies show that an additional year of life is worth over $120,000 to the typical American adult, apparently also including older adults, where "worth" is measured by willingness to pay for a one-year improvement in length of life. One can easily see without a lot of fancy calculations that the large sums Americans are willing to pay for improvements in health imply that they would pay a considerable fraction of their incomes in order to achieve significant improvements in their life expectancy, and also in their quality of life. Similar conclusions apply to other countries since the willingness to pay in different countries for an additional year of life varies approximately proportionately to their per capita incomes.

Although such calculations show that improvements in life expectancy

are worth a lot to most people, national differences in life expectancies are a highly imperfect indicator of the effectiveness of health delivery systems.for example, life styles are important contributors to health, and the US fares poorly on many life style indicators, such as incidence of overweight and obese men, women, and teenagers. To get around such problems, some analysts compare not life expectancies but survival rates from different diseases. The US health system tends to look pretty good on these comparisons.

A study published in Lancet Oncology in 2007 calculates cancer survival rates for both men and women in the United States, the United Kingdom, and the European Union as a whole. The study claims that the most important determinants of cancer survival are early diagnosis, early treatment, and access to the best drugs, and that the United States does very well on all three criteria. Early diagnosis helps survival, but it may also distort the comparisons of five or even ten-year survival rates. In any case, the calculated five-year survival rates are much better in the US: they are about 65% for both men and women, while they are much lower in the other countries, especially for men. These apparent advantages in cancer survival rates are large enough to be worth a lot to persons having access to the American health system.

Several measures of the quality of life also favor the US. For example, hip and knee replacements, and cataract surgery, are far more readily available in the US than in Europe. The cancer survival and quality of life advantages enjoyed by US residents indicates that Americans get something for the large amount they spend on health care, but they do not indicate that the bang for the health buck is greater in the US, or even that the US health delivery system is reasonably efficient. Indeed, the American health system has several characteristics that may considerably lower its efficiency.

The American system ties medical insurance to employment by allowing company spending on medical premiums to be fully tax-deductible. Companies introduced health benefits during World War II in order to get around wage controls to be competitive in attracting employees. It was maintained as income tax rates increased during subsequent decades. This employer-based system is partly responsible for the high number of Americans who have no insurance coverage, since many small companies do not provide insurance to their employees. In addition, the system favors persons with high earnings since tax deductions for insurance premiums are worth more to them. A much better approach, so far opposed by President Obama, would provide a certain number of dollars each year to every person-perhaps $2500- as tax credits to be used only to buy health insurance and pay for medical care. Unused amounts in any year would be folded into health savings accounts (see my discussion of these accounts and other health care issues in posts for April 15, 2007 and January 13, 2008), and unused balances in any year would be carried over to spend in later years. This approach gives the same tax incentives to everyone, and it would encourage individuals to economize on their health care spending since unused balances would be

available to spend in the future. It would also induce many persons without health insurance to get some since otherwise they lose access to this tax credit.

Health insurance is expensive in the US partly because most states mandate coverage of various health expenditures that have little to do with insurable risks. For example, the majority of states require insurance companies to cover the medical costs of all birth deliveries, even though these deliveries are mainly planned, and the expenses are known beforehand. The proper insurance approach would cover only unusual birth expenses caused by complications in the delivery and post delivery stages. By getting rid of unnecessary mandates, health insurance would become much cheaper, especially in states with the more onerous mandates.

The President wants to establish government-run health insurance companies to compete with private companies. This is a bad idea because experience from government-owned enterprises in other sectors conclusively shows that that they are run inefficiently, in good part because of political interference. Moreover, government enterprises do not compete fairly since they generally are subsidized, often generously and in hidden ways. Private health insurance companies in the US compete very strongly, although they are hampered by mandates and other regulations that frequently have nothing to do with effective and honest coverage of health needs.

Posted by Gary Becker at 4:06 PM | Comments (35) | TrackBack (0)

May 31, 2009

Is the World Economic Center of Gravity Moving to Asia? Becker

The short answer is "yes", although not immediately, and not inevitably. My reasons for an affirmative answer are partly demographic and partly economic. Asia has a large fraction of the world's population, and their biggest economies are generally experiencing rapid growth as they narrow the gap in living standards with the West.

To start with the demographics, about 4 billion persons, or almost 60% of the world's population, live in Asia. India and China alone have about 2 ½ billion individuals. Other Asian countries with populations in excess of 100 million are Japan, Indonesia, Pakistan and Bangladesh, while Vietnam and the Philippines each have almost 100 million persons. In addition, Asia's population is growing much faster than that of either Europe or North America, so that 20 years into the future, Asians will constitute more than 2/3 of the total world population.

By contrast, the whole European Union has only about 500 million people, and the very low birth rates in almost all countries within this Union imply that its population will be falling over time, unless offset by steep levels of immigration. The United States is still growing- partly fueled by considerable immigration- but more slowly than Asia's. As a

result, the populations of Europe and North America will decline over time, perhaps absolutely but surely relative to the growing numbers in the rest of the world.

Large populations alone do not have much impact on the world economy, as seen from the rather minor economic influence of both China and India prior to 1980, or the unimportance to the world economy of Sub-Sahara Africa's 800 million persons. Asia must have rapid economic growth during the coming several decades for it to become the major player in the economic world. Fortunately for them, China, India, Indonesia, Vietnam, and some of the other larger Asian countries discovered during the past 20 years many of the vital ingredients required to produce economic progress.

These ingredients include first of all a reliance on private companies and competition, and a much smaller role for government direction of the economy. China started along this path in the late 1970s, while India began to throw off its socialist traditions in the late 1980s and early 1990s. Second in importance is the utilization of the world economy to find markets for Asian exports, and to attract foreign capital to finance its rapid industrialization, although India has lagged far behind China in using both world capital and world markets. Most Asian countries also have recognized that human capital is the foundation of modern knowledge-based economies, and they have begun to emphasize investments in education and training.

As a result of these and related policy shifts, Asia as a whole experienced rapid economic growth during the past 20 years, and has narrowed the gap in per capita incomes with the rich countries of Europe and North America. The major Asian economies are likely to continue to grow rapidly for the next decade, and perhaps well beyond that decade, given how far behind Asian per capita incomes still are, the thirst of most of its population to become rich like the West, and the momentum their economies have built up. I say "perhaps" beyond the next decade because one cannot be sure that leading Asian countries will not shift away from growth-producing policies in the more distant future.

its rapid growth in both per capita income and population implies that Asia's importance in the world economy will increase quite rapidly. As a result, Asia will become a far more important source of consumer demand not only for products made in Asia, but also for exports from America and the EU. In addition, it is likely that researchers and companies in Japan, China, India, and elsewhere in Asia will generate an increasing share of the world's important innovations.

Greater economic dominance of Asia does not necessarily mean that the United States will not continue to be the world's leader in per capita income and innovation. The development of Asia can stimulate the US and the EU economies by providing greater opportunities for trade, including valuable imports and large markets for its exports, and other advantages from having a more developed and larger Asia. The economic threat to the West is not Asia's development, but it is government excessive interference in the performance of markets, like the automobile bailout in the US, that may choke the very competitive system that created Western wealth, and demonstrated how to become

rich to countries elsewhere.
To be sure, as the economic center shifts to Asia, that continent will expect much greater influence over international institutions, like the IMF and the World Bank, ia greater role in determining common international trade policies, more say on climate policies, and on many other world economic issues. The larger Asian countries will also expect to have a more important role in determining world security and anti-terrorist policies. On security issues and possibly on climate and some other international questions, major conflicts might well emerge between countries like China and India, and the United States and the EU.

Posted by Gary Becker at 9:59 PM | Comments (35) | TrackBack (0)

Is Asia Becoming the Center of the World Economy? Posner

I am less bold than Becker, and so I will make no predictions about the future of the wo rld economy. I do have some reservations about treating Asia as a unit, however. Even if one stops at the eastern border of Pakistan, the Asian countries are far from uniform in their economic prospects. For they include such politically and economically challenged nations as Pakistan, Bangladesh, and Burma, along with Australia and New Zealand, which are not culturally or ethnically Asian; and Japan, which has a rapidly declining population and is economically stagnant, albeit at a high level. The fact that there is such heterogeneity in the Asian world suggests that individual country factors predominate over factors that distinguish Asia as a whole from the other continents.

What is a common to a number of the Asian countries is mercantilism, which is to say the policy of accumulating large cash balances (in the old days, it was gold) by devaluing the currency, so that exports are cheap and imports dear. The result is an export surplus; and if a country sells more than it buys, it takes in more foreign currency than it spends in its own currency. China, aggressively mercantilist, has accumulated almost two trillion U.S. dollars.

The mercantilist policy of China and other East Asian countries has been attributed to the financial trouble that a number of these countries got into in the late 1990s when their governments were pursuing the opposite policy--that of encouraging imports and, in particular, foreign investment in their countries. As a result (much like the United States in the 2000s!) these countries accumulated large foreign exchange deficits, which ballooned when the investors shifted many of their investments to other parts of the world. The deficits reached a level at which the countries had to push interest rates up to depression-causing levels in order to prevent the flight of capital from reaching a point at which the countries' credit systems would collapse.

Once burned, twice shy; the East Asian countries switched to an export-first policy, which by enabling them to accumulate large dollar balances have prevented a recurrence of capital flight. I am calling it "mercantilist"

but in part, perhaps major part, it should be viewed as precautionary--to prevent a repetition of the economic crsis of the 1990s. Yet China had already begun to emphasize exporting. The reason may lie in John Maynard Keynes's analysis of mercantilism. He argued that if domestic demand for goods and services is weak, perhaps because of a low propensity to consume, there is likely to be a lot of unemployment, as otherwise supply would exceed demand. By devaluing the currency and thus making exports cheaper and so increasing the demand for exports, government can increase employment, because the higher output is, whether consumed domestically or abroad, the more workers are needed. The Chinese population was (and is) poor, so domestic demand was weak, and overall demand and therefore output could be increased by pushing exports. The success of such a policy would depend on the foreign demand for goods that Chinese industry was able to produce at reasonable cost, but that demand proved to be strong. The large dollar balances accumulated as a consequence of the export-first policy were available for investment. As a result, China is today the world's largest creditor.

Should the United States and other debtor nations reduce their foreign borrowing, China's (and other East Asian countries') mercantilist policies will become less attractive because interest rates will fall. Moreover, as domestic demand in those countries grows, there will be pressure to make imports cheaper and to divert production from satisfying foreign demand to satisfying domestic demand. On both counts, trade balances will become more even.

But how even? Japan, despite its very high standard of living, had, until the current economic downturn, a strongly positive balance of trade. An unusually high propensity to save, coupled with an inefficient system for distributing consumer goods and services, keeps domestic demand down. It remains to be seen whether, as China's economy grows, it will become more like Japan, or more like the United States.

Posted by Richard Posner at 9:33 PM | Comments (28) | TrackBack (0)

May 24, 2009

A Soda or Calorie Tax to Reduce Obesity--Posner

Articles in the *New England Journal of Medicine* on April 30, and in the *New York Times* on May 19, discuss a proposal now before Congress to impose a tax on sugar-sweetened sodas in order to reduce obesity. Taxes are ordinarily intended to raise revenue, but some taxes, such as taxes on alcohol and tobacco--and on carbon emissions, should such a tax ever be passed--are designed not to raise revenue but to alter behavior, and the more they succeed in altering behavior the less revenue they generate.

Sugar-sweetened sodas are high in calories, are drunk in great quantity,

and because they have little nutritional value don't substitute for other foods; they are a net addition to caloric intake. The *NEJM* article estimates that consumption of such sodas adds an average of 125 to 150 calories per day to the average American's diet, and cites studies that estimate that the elasticity of demand for such products is about -1, so that a 10 percent soda tax tax could be expected to reduce consumption by about 10 percent, with the result, according to the author of reducing the average person's weight by about 2 pounds a year.

I am skeptical, because the author ignores the possibility of substituting untaxed sugar-sweetened foods or beverages. People who crave sugar will find no dearth of substitutes for sugar-sweetened sodas. Moreover, most consumers of these sodas are not and never will be obese. They may well be overweight, but all that that means is that they are heavier than the "ideal" weight calculated by physicians; if they are only slightly or even moderately heavier, the consequences for health or social or professional success are apparently slight.

To the extent that a soda tax would cause substitution of equally sugared foods, it would not only have no effect on obesity; it would yield no revenue--a material consideration because supporters of the tax hope, albeit inconsistently, that it will both reduce obesity significantly and contribute significantly to financing the Administration's ambitious and very costly program of health-care reform.

There are many obese Americans, in the sense of ones who are grossly overweight (with some being morbidly obese), and we should consider whether society should be concerned with obesity if not with mere overweight. Obesity impairs health, and, in most segments of the population it diminishes social and professional success as well, and so it can be regarded as self-destructive behavior. Some of it is involuntary--there are people whose genes make it virtually impossible for them to avoid becoming obese--but most obesity could be avoided by careful diet and exercise. The obese are people who by dietary choice and preference for a sedentary style of life have traded off the costs of obesity against the costs of being thin and have decided (at least in a "revealed preference" sense--they may not have consciously chosen a style of life that predisposes them to obesity) that the costs of thinness preponderate over the benefits. And in general we do not try to prevent people from making such tradeoffs.

But there are two situations in which preventing people from choosing the style of life that maximizes their utility can be defended (provided certain assumptions are made about cost and efficacy) on economic grounds. One is where consumers are unable to evaluate a product or to act upon their evaluation; another is where a voluntary transaction imposes costs on other people which the transactors do not take into account.

The first is a significant factor in the soda market. The sellers advertise

very heavily to children, who do not have the knowledge or the self-control that they would need to be able to resist such advertising. In well-ordered households, the parents regulate children's access to television and the Internet and know they should limit the children's consumption of sugar-flavored drinks and do limit it. But in many modern American households, especially but not only those in which there is only one parent, children's access to soda and soda advertising is not restricted.

The solution, though, is not a tax on sodas, as such a tax would have only a small effect. A ban on advertising would be preferable; it would probably impose only slight costs on adult consumers of such drinks, because the advertising of such drinks contains little information. It is true that such a ban would reduce new entry into the soda market and that this might lead to higher prices, but if so that would reinforce the effect on sales of the ban on advertising.

As to whether by increasing obesity the sale of sugar-flavored sodas imposes costs on other people besides the buyers, the evidence is mixed. Obese people have more health problems than the non-obese and hence higher annual medical costs; they also lose more time at work because of illness. Their poorer health increases the medical costs of other people in their insurance pools and reduces the productivity of their employers, assuming realistically that employers cannot selectively reduce the wages or health benefits of their obese employees. Cutting the other way, obese people have a reduced life expectancy, and the shorter a person's life, the less an above-average annual cost of medical care translates into an above-average total (lifetime) cost. But assuming nevertheless that the net social costs of obesity are positive, this would be a ground for arguing for taxing obesity, but such a tax would be unacceptable as well as cruel. The alternative of a soda tax would be unlikely to have much effect, for the reasons stated earlier.

Are there better ways of fighting obesity, assuming it is worth fighting? Probably not. Education would probably have very little effect, because almost all people know that being fat has bad consequences and that eating foods rich in sugar and butter and not exercising increase the likelihood of becoming obese. Obesity is concentrated in the lower middle class, which contains a high proportion of people who have very high discount rates, which prevents them from giving significant weight to the future consequences of present behavior.

Children may be ignorant about the costs of obesity and the effects on it of sugar, but because of lack of self-control and children's inability to imagine themselves as middle-aged adults, I doubt that trying to educate them in the dangers of drinking sugar-sweetened beverages would be effective.

A tax on calories, or on high-calorie foods or ingredients, would be difficult to design and administer and would impose welfare losses, without significant offsetting wealth gains, on thin people. A further

problem is that fattening foods, including sugar-flavored sodas, have fallen in price over time relative to fruits and vegetables and other healthful foods, so that a tax on calories would be highly regressive.

A modest measure would be to bar the sale or other provision of sugar-flavored sodas and other fattening foods in schools, and the substitution of nutritious low-calorie school lunches for the present fare. In addition, more school time could be allotted to physical education, which in recent years has diminished in most schools. The cost of these measures would be modest and they would have some effect in reducing obesity.

Posted by Richard Posner at 4:06 PM | Comments (23) | TrackBack (1)

A Tax on Sodas? Becker

The number of overweight children and adults has grown sharply since 1980. The explanation is usually partly based on the increased availability of sodas and fast foods that have many calories. Also emphasized is the growing number of leisure hours spent at sedentary activities, such as watching television and using computers and cell phones. To combat obesity, an article in the April 30, 2009 New England Journal of Medicine by Brownell and Frieden argues for a tax on sugared beverages. I agree with Posner that this is a bad idea.

From the data presented by the authors of that article, only a very high excise tax on sugared beverages might reduce calorie intake enough to significantly affect the number of overweight and obese children and adults. According to these authors, sugar-sweetened beverages now account for about 10 to 15% of total calorie intake. They also claim that a review of various studies indicates that a 10% increase in the price of beverages reduces consumption by about 8%. These assumptions imply that a tax on beverages that increases its price by 10%-that means a 10 cent tax on a can of soda that sells for about $1.00- would slightly reduce the intake of calories from sodas by 0.8% to 1.2%. Even this overstates the total effect on calorie consumption, given that consumers who like sugar would substitute toward cakes, candies, and fruit drinks that naturally have lots of sugar. The result of this tax on beverages would be at most a very small reduction in the intake of calories and sugar. Indeed, it is quite possible that since consumers do not only buy products on the basis of their sugar and calorie content, these substitutions away from beverages and toward sweets and other drinks induced by a tax on beverages could actually increase calorie and sugar consumption.

In addition, as Posner indicates, there is little reason to tax the many consumers of sodas and other sweetened beverages who do not become obese, and whose consumption does not cause any social problems. That is why the usual recommendation is not to tax all drinking, but only heavy drinking, or better still only the heavy drinkers who cause auto

accidents and other harm to innocent persons. A similar approach to the problem of overweight individuals would not tax consumption of beverages or fast foods, but would directly tax excess weight. Such a tax would be unusual to say the least, but it could be implemented if desired.

To me, calculations showing the minor effects of moderate taxes on sugared beverages on weight suggest that such taxes would be only the opening salvo in an effort to tax fast foods and other foods with many calories. One justification given by the authors of the New England Journal of Medicine article for caloric taxes is that the growing rate of obesity is partly due to ignorance of consumers, especially children, about the harmful health consequences of consuming many calories. It is also alleged to be partly due to the inability of consumers to act on the information they have because they are alleged to lack self control in their eating habits. These authors also argue that consumers who eat too much and become overweight impose costs on taxpayers since much medical care is financed out of government tax revenues. I do not find these arguments persuasive.

As Posner indicates, children without enough parental guidance and supervision are more likely than adults to be ignorant of the health consequences of high calorie intake, and children are also less able to exercise self-control over their eating. Very much offsetting this, however, is that the negative health consequences of being overweight and even obese will generally be significantly lower for children than for adults. The reason is that aside from very extreme obesity, the really harmful effects to overweight children will not usually kick in for another 25 or more years when they are in their forties or older. However, one can reasonably expect sizable progress during the coming decades in the development of drugs, such as lipitor, that will reduce the health consequences of high cholesterol and excess weight for heart conditions, diabetes, and some cancers. From that perspective, perhaps even ignorant and impulsive children are not acting so stupidly by indulging themselves in their eating since the future will likely see the development of drugs that will alleviate many serious medical conditions.

To be sure, taxpayers will pay for much of the cost of the development and use of these new drugs. This brings us to the argument that excess weight imposes costs on others through the health payment system. Yet such a health payment "externality" argument is hard to use consistently. Consider a person who significantly shortens his life because of heavy smoking, and thereby reduces the amount of public spending on him through social security, and subsidized health care. Would those who advocate taxes on beverages and other foods because obese persons make use of publicly funded health benefits support a subsidy to smoking if smoking cuts the use of health care and social security benefits? Clearly not, and nor should they. The same logic implies skepticism toward arguments to tax sugared beverages because obese persons make greater use of the health care system.

Many doctors and others who advocate taxing sugared beverages and

fast foods at heart do not believe that consumer taste for sugar and fast foods should be taken into account in devising public policy. Perhaps not, but they have to advance better arguments than they have done so far to justify policies that interfere with the exercise of these tastes and desires.

Posted by Gary Becker at 3:39 PM | Comments (1901) | TrackBack (1)

May 17, 2009

The Conflict in Modern Conservatism Once Again-Becker

Posner and I decided to post again this week on the conservative movement because of the great interest in our discussion last week. I will try to respond to some of the thoughtful comments and criticisms, and clarify some of my claims.

I claimed in that post that the current Republican Party is trying to incorporate two inconsistent sets of beliefs: one is the support of competition and generally freer markets, and the other is the advocacy of interventionist policies on various social issues, such as gays in military, stem cell research, or in international affairs. Both these positions are often linked together as "conservative", but they involve contradictory views of government. I argued for a consistent conservative position that supports individual choices, and opposes big government. To be sure, government intervention may be required when individuals make decisions that impose sizable external costs (or benefits) on others that are not incorporated into their decisions. On this approach, however, the harmful (or beneficial) effects on others must be considerable before government actions would be justified because governments are generally so inefficient.

A blog by the excellent development economist William Easterly (http://blogs.nyu.edu/fas/dri/aidwatch/2009/05/confused_american_liberals_and.html) suggests a different definition of conservative beliefs, as do some of those who posted on our blog. Easterly argues that the true definition of a conservative is someone who respects traditions and existing institutions, and who wants to limit change. Although that is a common definition of the essence of conservatism, I do not believe it is a consistent or sensible one. I do agree that considerable respect for what has survived and thrived in the past is warranted, and my anti-big government conservative would certainly respect institutions that have performed well for a long time. However, conditions do change, sometimes in crucial ways, and a sensible conservative philosophy would recognize the necessity of changing one's views when this happens, even when that goes against venerable traditions.

To take one example, until the latter part of 19th century, married women in England were not allowed to own personal property, including

money, in their own name, Even though they had a long history in England and many other countries, such laws were discriminatory and undesirable. Note that some other countries, notably Islamic countries, did not have such laws. Another example: laws against divorce may have made sense in an environment where women did not work and had many children since women would have faced serious financial difficulties if their husbands divorced them (I say "may have" because laws might have protected women's rights to financial support if divorce had been allowed). For these reasons the great philosopher, David Hume, who was a strong supporter of freedom of choice, argued for laws against divorce. However, anti-divorce laws make little sense in the modern world when many married women work to earn a living, and they have few children. Therefore, a true conservative that generally opposes government involvement in private decisions would fully support laws that make divorce quite easy to obtain by both men and women.

Many comments on my discussion centered on the issue of abortion, and that is an especially difficult issue for someone who believes in individual rights. For there is an obvious conflict between the rights of women to control their bodies and their motherhood, and the rights of fetuses that might be far enough along in their development to be considered human beings. This is a very prominent example of the general difficulty of determining where to draw the line when the rights of children conflict with the rights of their parents. I do not claim to have a definitive resolution of this conflict in the case of abortion, or in some other parent-child conflicts. But I come down on the side of women's rights to make decisions about their body, except in very late term abortions where fetuses can survive outside a woman's body, and therefore can be considered real children.

Abortions often allow women to have children at later dates when they are better prepared emotionally and in other ways to have children. In effect, abortions in these cases would allow women to substitute children who would be born later, and would be better taken care of, for the fetuses that are aborted now. That seems to me to be a tradeoff worth making. Moreover, laws banning abortion would be difficult to enforce against wealthy women since they would be able to get abortions illegally under reasonably good conditions, including by going abroad. Poor women who want abortions would suffer the most from enforcement of an anti-abortion law, as they are the ones who mainly suffer from laws against the use of drugs and many other types of laws.

Conservatives are not isolationists on international affairs since they recognize that the interests of a country like the US are affected by what happens in other countries. This is clear in Reagan's successful efforts to wear down the Soviet Union during the Cold War, or in more contemporary efforts to anticipate terrorist attacks planned in other countries. However, just as with the use of government powers on purely domestic issues, conservatives would recognize that governmental foreign actions are usually very inefficient (as in conducting wars), and

are often driven by special interests. A conservative philosophy would limit governmental international interventions to cases where the risks from not taking actions are very large, and the interventions reasonably straightforward.

Posted by Gary Becker at 7:59 PM | Comments (68) | TrackBack (0)

Conservatism II--Posner's Comment

My post last week on the decline of the conservative movement in the United States received more than 200 comments. Many of them were very thoughtful, and many others were very shrill.

It is apparent that global warming, abortion, and guns, in approximately that order, arouse particular emotions among many passionate self-described conservatives. About the first of these three issues, I wish to clarify my position briefly. I do not think there is much doubt that carbon emissions generated by human activities increase the amount of carbon dioxide in the atmosphere and by doing so raise surface temperatures. How much they raise them and with what consequences remain uncertain. I merely think that the risk of catastrophic global warming is sufficiently great to warrant more vigorous remedial efforts than have been attempted thus far by the United States.

About abortion, my personal position is the same as Becker's. I will add only that I think the legality of abortion should be determined by legislatures rather than by courts. I think Roe v. Wade was a mistaken decision, though probably one that we shall have to live with.

Similarly, I think private gun ownership should be a matter for legislative determination, rather than judicial. The Second Amendment is unclear about whether there is a right to own guns for personal self-defense or hunting, and I don't think delving into eighteenth-century documents argued to bear on the meaning of the amendment is a sensible way of doing constitutional law in the twenty-first century.

Some commenters seem to believe that because I am critical of the current conservative movement, I must be a liberal--maybe even a left-wing Democrat. To those commenters, disbelief in global warming, in the regulation of gun ownership, and in the criminalization of early as well as late abortions is a litmus test of "true" conservatism. There are, in fact, multiple conservatisms, as Becker and I have emphasized. Like Becker, I believe in limited government and so do not support government activities that cannot be justified convincingly by reference to considerations of economic prosperity, basic individual liberties, or domestic or national security. I do not favor the curtailment of individual liberties on the basis of religious beliefs, nostalgia for the "good old days," or traditional social beliefs (such as distaste for racial minorities or homosexuals) that cannot be related to economic, libertarian, or security values. One of Reagan's great political achievements was to unite the

diverse conservatisms in a single political movement that managed to gain the support of a majority of the American people.

That unity has now dissolved, and it will require skillful political entrepreneurship plus overreaching by liberal politicians (or the kind of left-wing extremism that marred the late 1960s and early 1970s) to restore it.

The ideological division within the conservative movement has been compounded by a decline in intellectual and managerial competence--a tendency to substitute will for intelligence ("I believe it so it must be so"). Some commenters note the intellectual and ethical failings of liberals, and they are right to do so. But it is only at the Right, at present, that anti-intellectualism is embraced and extolled.

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Posted by Richard Posner at 5:43 PM | Comments (48) | TrackBack (0)

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