Political

The previous chapter dealt with issues that have become linked in many people's eyes with their political identity. This deals with issues that, while perhaps equally important, are less familiar.

Stockholders vs Stakeholders

In theory, private corporations are run for the benefit of their stockholders; insofar as the theory is enforced in practice, it is through two different mechanisms. One is the fiduciary obligation of corporate directors, the fact that under U.S. corporate law they are obliged to run the firm in the interest of its stockholders.[1] How much effect that obligation has is not clear, given the obvious difficulties with having a court second guess the decisions of the firm. The second and more important mechanism is election of the board of directors by a vote of the stockholders. If holders of a majority of the shares are unhappy with how the corporation is being run they can replace the existing board and so the existing management.

The holder of one share of stock, like an individual voter, knows that his vote is unlikely to change the outcome and so has little incentive to spend time and energy judging how well the firm is being run in order to exercise his voting power. But votes in the corporate context, unlike votes in the political context, are transferable; each is attached to a share of stock and shares can be bought and sold. If a corporation is doing a sufficiently bad job of maximizing stockholder value, someone with the necessary assets and expertise can buy up lots of shares. Since owning lots of shares gives you lots of votes, he can then, perhaps in alliance with other large shareholders, vote out the board, replace management and, when it becomes clear to others that the firm is now doing better for its stockholders, sell his shares at a higher price and go looking for another badly run firm to buy stock in. Takeover bids often get a bad press, possibly due to the efforts of incumbent managers who would prefer not to be replaced. They have been made more difficult both by legal rules and by defensive tactics developed by corporate managers, but they provide people running corporations with a reason not to deviate too far from doing what, in theory, they are supposed to do.

Some people, including a past colleague of mine whose work first got me interested in the issue, argue that the theory itself is wrong. Decisions made by a corporation affect not only the stockholders but other people as well, most obviously customers and employees. Why not alter the legal rules to give all stakeholders, all people affected by the corporation's decisions, a voice, either

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[1] UK law now contains a broader statement of a director's obligations:

Duty to promote the success of the company

(1)A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

(a)the likely consequences of any decision in the long term,
(b)the interests of the company's employees,
(c)the need to foster the company's business relationships with suppliers, customers and others,
(d)the impact of the company's operations on the community and the environment,
(e)the desirability of the company maintaining a reputation for high standards of business conduct, and
(f)the need to act fairly as between members of the company
(Companies Act 2006). S172.

by broadening the fiduciary obligation of directors or by expanding the electorate, giving votes to customers, employees, perhaps others, as well as to stockholders.

The reason that is neither necessary nor desirable is that those stakeholders already have protection. A corporation is constrained not only by the legal obligations of the directors and the mechanisms for electing them but by the market on which it sells its outputs and buys its inputs. A customer who finds that its products are more expensive or less desirable than those offered by competitors does not have to intervene in the internal affairs of the corporation to solve the problem, he can simply stop buying what the corporation is selling. An employee who finds that the corporation is offering worse terms than alternative employers can quit. Since the corporation requires customers to provide the money with which it pays dividends to its stockholders and salaries and bonuses to its management and employees to produce the goods and services that it sells to those customers, it has a direct and immediate incentive to produce what customers want to buy and provide employment terms that employees are willing to accept.

Like most mechanisms, this one is imperfect. Customers are not perfectly informed about what they are getting or the alternatives and customers for some goods and services are partly locked in by previous choices. Having spent time and effort learning to use the hardware and software on which I am writing this, I would be willing to switch only if the quality went down quite a lot or the price up quite a lot, so the firms providing the hardware and software have some ability to benefit themselves at my expense without losing my business. Having accepted one job, there would be significant costs to shifting to another, costs of learning my way around a different university, perhaps moving to a different location. Hence my employer as well had some ability to benefit itself at my expense.

But my situation as customer and employee is very much better in this respect than my situation as a stockholder. As a stockholder I have the option of selling my shares of stock, which at first glance looks equivalent to my option as a consumer of not buying a product or as a worker of quitting a job, but the similarity is an illusion. If I choose not to spend twenty thousand dollars buying a car from Ford, Ford has one more unsold car and twenty thousand dollars less money. If I choose to sell twenty thousand dollars of Ford stock, the money I get is not coming from Ford; another investor now owns the stock, leaving Ford itself unaffected. From the standpoint of the firm's incentives it is as if, every time a customer wished to stop buying from a store, he was required to first find a new customer willing to take his place, or as if an employee could only quit if he provided a replacement willing to do the same job at the same pay.

The stockholder's view of the value of the stock directly affects the firm only if it wishes to raise capital by selling a new issue of stock. So far as existing stock is concerned, the shareholder is locked in; if the firm is being run in a way that fails to maximize stockholder value he cannot escape that cost by selling his share, since the price he can sell it for will reflect the expected reduction in future profits.

As a customer of Apple I am to some limited degree locked in; I can switch to hardware and software from another firm but only at a significant cost. The same was true of my situation as an employee of Santa Clara University. In both cases I had born what became sunk costs as a result of my initial decision to buy a product or accept a job. But as a stockholder in Apple I am entirely locked in; all of my cost is sunk. If Tim Cook announces tomorrow that he plans to run Apple entirely for the benefit of its employees and customers, never paying another dividend, the fact that I can respond by selling my stock provides me no protection.

The stockholder is dependent, much more than the other stakeholders, on other ways of getting the firm to act in his interest. That is an argument in favor of the current mechanism for corporate control and the legal rules defining the fiduciary obligation of the directors. More than that, it is an argument for strengthening stockholder control by removing current barriers that make takeover bids more difficult and so make it easier for managers and directors to serve their own interests at the expense of the stockholders. One example of such a barrier is the rule requiring anyone accumulating stock in order to take over a company to make the fact public as soon as he acquires more than five percent of the outstanding shares of any class.

And while on the subject of corporate control …

When a Pecuniary Externality Isn't

The CEO of a corporation releases an optimistic report on its future prospects; the stock goes up. Six months later the future arrives and the optimism turns out to have been misplaced. The stock goes back down. An enterprising lawyer sues the corporation in a class action on behalf of everyone who bought stock between the two events, claiming that their loss when the price fell was due to their being fraudulently induced to buy at too high a price by the CEO's report and that since the CEO was an agent of the corporation the corporation is liable for their losses.

The buyers' losses are the sellers' gains, hence the announcement did no net damage. It produced what economists call a pecuniary externality, an action by A that causes a transfer from B to C. That was the argument against fraud on the market suits that I offered in my *Law's Order*.

A more obvious example of a pecuniary externality would be someone becoming a physician, thus driving down the prices other physicians can charge for their services. That is an external cost to the other physicians but a matching benefit to their customers, so no net negative externality. That is the economic argument in support of the well-established common law rule that competition is not a tort. A firm can't collect damages from a competitor just because competition caused it to lose money.

The previous two paragraphs represent my view prior to reading a paper that offered a persuasive rebuttal. The CEO is supposed to act as an agent for the existing stockholders; that, after all, is the theory of how a joint stock company works, even if imperfectly realized in practice. Everyone who gains from the temporary price rise by selling stock is someone who owned stock when the report was made and the price went up. If we view the CEO as acting for the existing stockholders the externality is no longer pecuniary; it is instead a case of A taking an action that benefits him but injures B, a negative externality. The standard economic argument is that he will take such an action even if the gain to him is less than the loss to B, hence the existence of externalities can result in actions that on net make us worse off. In the context I started with, a CEO who was a loyal servant of the existing stockholders might take costly actions to make the future value of the company appear larger than it really was.

Generalizing the point, whether we classify an externality as normal or pecuniary depends critically on what we assume about the relation between the actor and those affected. If A takes an action that benefits B at the cost of C that is a pecuniary externality — unless A is actually working for B.

It does not follow that fraud on the market suits are a good thing. Other objections can be made to the legal theory, most obviously that the money to pay damages is coming from the company,

hence at the expense not of the stockholders who benefitted by selling at the temporarily high price but those who didn't. In order for a damage payment to make sense, it should come from the stockholders who sold — or the CEO.

But the objection I offered in *Law's Order* implicitly assumed that the CEO should not be viewed as a faithful agent of the current stockholders, an assumption it never occurred to me that I was making.

The Cost of Eyeglasses

I buy my glasses online from Zenni.com. The total price for two pair, shipping included, is about $40. Buying two pair at one of the less expensive local sources, such as Costco, would have cost at least five times as much, perhaps more.[2] This raises an obvious puzzle; if Zenni can sell them online for under $20/pair, why doesn't someone sell them for $40/pair in the mall and make a fortune on volume?

Three possibilities are:

1. The online glasses are of inferior quality. So far as I can tell — I have been wearing them for years — that is not the case.

2. Consumers are so badly informed that they would not notice if one seller cost less than half as much as another. This does not strike me as plausible.

3. Competition among realspace sellers is constrained by regulatory rules, probably at the state level.

According to a summary of regulation across the U.S., some states, such as Alabama, do not require a license to sell eyeglasses, only to prescribe them. In California, where I live, "Individuals, corporations, and firms engaged in the business of filling prescriptions of physicians or optometrists licensed in California for prescription lenses are considered dispensing opticians and cannot engage in that business unless registered with the Division of Licensing of the Medical Board of California." An extensive list of the relevant regulations in California can be found online. It shows, among other things, that to be a "Registered Spectacle Lens Dispenser" who may fit and adjust spectacle lenses one must have passed the exam of the American Board of Opticianry.

It would be interesting to compare prices in states that do or do not have such restrictions.

Regulation: Too Much or Too Little

The 2008 financial mess is frequently blamed on deregulation. It might more accurately be blamed on interventions in the housing market designed to make it possible for more people to borrow money in order to buy houses. On the other hand ...

The ideal arrangement would be an entirely free market with the government playing no role, but once the government does intervene, less regulation is not necessarily better than more. If, as in 2008 and the earlier Savings and Loan case, government intervention makes the government ultimately liable for losses by regulated firms, less regulation may mean more opportunities for firms to gamble on the basis of "heads we win, tails you lose," with "you" being the taxpayers.

[2] Checking online, the least expensive Zenni glasses are about $12/pair, the least expensive from Costco $126, so ten times the price.

When over a thousand S&L's failed, $132 billion of the $160 billion cost was paid by the taxpayers.

Once the government is liable for losses it may be prudent for the government to make rules designed to limit risk.

Eggs: An English Lesson

> Faced with a crisis more than a decade ago in which thousands of people were sickened from salmonella in infected eggs, farmers in Britain began vaccinating their hens against the bacteria. That simple but decisive step virtually wiped out the health threat.
>
> But when American regulators created new egg safety rules that went into effect last month, they declared that there was not enough evidence to conclude that vaccinating hens against salmonella would prevent people from getting sick. The Food and Drug Administration decided not to mandate vaccination of hens — a precaution that would cost less than a penny per a dozen eggs. (The New York Times)

The obvious implication was that the U.S. ought to imitate a wise British decision and require vaccination. Further down in the article, however, we discover that:

> There are no laws mandating vaccination in Britain. But it is required, along with other safety measures, if farmers want to place an industry-sponsored red lion stamp on their eggs, which shows they have met basic standards. The country's major supermarkets buy only eggs with the lion seal, so vaccination is practiced by 90 percent of egg producers, ...

Or in other words, Britain's success in drastically reducing the number of salmonella case was due not to regulation but to voluntary private action driven by market pressure.

Following up a comment on my blog, I found an interesting parallel in the U.S. — the attempt by the USDA to prevent Creekstone Farms Premium Beef from testing its slaughtered cows for Mad Cow Disease in response to public fears of the disease.

> In order to address those fears, Creekstone decided to conduct its own testing of all of its cattle. It built a laboratory for BSE testing at its Arkansas City, Kansas, beef processing facility and sent employees to France for training on BSE testing procedures by Bio-Rad, Inc., which produces a BSE rapid screening test used by USDA, Japan, and other countries.
>
> Creekstone also discussed purchasing test kits from Bio-Rad. In the course of those discussions, Bio-Rad informed Creekstone that USDA would only permit BSE testing as part of USDA's official surveillance program and would not permit the sale of test kits to Creekstone.
>
> …
>
> In an April 8, 2004 meeting with Creekstone officials, USDA rejected Creekstone's request to perform BSE testing. …

Creekstone sued and, in 2007, the district court ruled that Creekstone could perform the tests.

The government not only did not insist on the company testing, it tried, unsuccessfully, to prevent it.

Welfare and Immigration: The Flip Side of the Argument

Voluntary agreements between people now in Mexico and people now in the U.S., my renting an apartment in California to someone currently living in Mexico or hiring him to mow my lawn, benefit both parties. Conventional economic arguments suggest that although there may be negative effects on third parties, someone else who wants the apartment or someone else who wants to cut my lawn, the net effect is positive. The arguments for freedom of association, contract, and trade apply to immigration as well.

Opponents of open immigration have an obvious counterargument: not all interactions are voluntary. A Mexican who comes to mow lawns benefits us as well as himself, one who comes to collect welfare benefits himself at our cost. A common conclusion is that free immigration may be desirable in a completely laissez-faire system, even in the relatively laissez-faire America of a hundred years ago, but not in a modern mixed economy.

The strength of this argument is an empirical question. Immigrants may get things they do not pay for but they also pay for things they do not get, since they tend to be predominantly young adults, a long way from collecting Social Security or Medicare. The question of net effects is a complicated one and I am far from sure that a correct answer would support the argument against immigration.

There is, however, another side to the argument. The existence of a welfare state makes open immigration less attractive. But the existence of open immigration also makes a welfare state less attractive which, for those who would like less of a welfare state, is an additional argument in favor of open immigration.

Consider the analogous argument applied intrastate. Supporters of higher levels of welfare generally want them to be provided at the federal level — for a good reason. If welfare is provided and paid for by the states, high levels of income redistribution pull poor people in and drive taxpayers out, which provides a potent political incentive to hold down redistribution.

This is one example of a more general principle: The more mobile taxpayers are, the more governments, like businesses in a competitive market, have to provide them value for their money and thus are less able to tax A in order to buy the votes of B. The argument applies across national borders as well as state borders.

For those who favor higher levels of redistribution from rich to poor, that is an argument against freer immigration. The problem for their position is that the immigrants who would benefit from coming to the U.S. are, for the most part, much poorer than the American poor who might lose by reduced redistribution.

What's Wrong With Steroids?

From time to time I see a news story about an athlete who has been caught using steroids to improve his performance. Everyone seems to agree that this is a bad thing and should be punished but it is not clear why.

I see three possible answers. The first is that since steroid use is currently banned, the athlete who uses them is breaking the rules, cheating in a competitive game. That leaves unanswered an

obvious question: Why are steroids banned? Absent the ban, using steroids is no more unfair competition than practicing on the weekend. It could be argued that in sports where current players are competing with past players by trying to beat their records using steroids gives them an unfair advantage, but that applies to any new technology that improves performance such as better equipment or improved training or nutrition. As one commenter on my blog put it:

> Alex uses steroids to improve his hitting. Bob videotapes his swing at high speed to analyze and correct it with the help of his coaches and advanced computer models of the physics of hitting the ball. Is it offensive for Alex to break records, but not Bob? Why?

In running, the record for the best time seems to gradually fall over time, possibly for such reasons.[3]

The second answer is paternalistic. Steroids can have undesirable long run effects on their users; if athletes, many of them young and inexperienced with the world outside their profession, are free to use them they may do so even when they should not.[4] That is especially likely in the world of sports. A carpenter who works ninety percent as fast as a competitor can expect to receive about ninety percent of the competitor's income. A professional football player who runs ninety percent as fast as his rivals is no longer a professional football player.

That explanation is inconsistent with how we treat other competitive sports. Taking steroids may reduce your life expectancy but so does driving a car around a racetrack at something over 200 miles an hour. A ten percent reduction in speed means not that your salary as a race car driver goes down ten percent but that you are no longer a race car driver.[5]

The third and most interesting answer is that competitive sports are special because what is being consumed is relative, not absolute, output. We reward a race car driver not for driving faster than 230 miles per hour but for driving faster than any other driver in the race. Arguably our pleasure from watching our favorite baseball team play depends less on how well it plays than on how much better it plays than the opposing team.

If so, a change that makes one driver faster or one team better produces a benefit for that driver or that team but a change that makes all drivers faster or all teams better produces little or no benefit for anyone. A change that makes all athletes faster and cuts three years off their life expectancy makes all athletes worse off. That sounds like a plausible reason for wanting to preventing such changes.

One test of this conjecture would be to look at sports that have separate competitions with and without steroids or other drugs and see which version is more popular. One mentioned by a commenter on my blog is power lifting but I do not think that is primarily a spectator sport. The

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[3] Looking at the top 25 records for the hundred meter dash, the earliest was in 1991, the current record in 2001. For the mile race, the earliest of the top 25 was run in 1981.

All of the top 52 recordholders in the 100 meters are black, either from the U.S., the West Indies, or Africa. So another alternative is that improvements in black opportunities, both in the U.S. and elsewhere, increased the size of the relevant pool of talent, with the result that the best became, on average, better. That does not explain the same pattern for the 1 mile race, where the national and racial origins of the winners are more diverse.

[4] I raised a similar possibility in chapter XXX [Tribal Politics] in other contexts.

[5] Paternalism in sports does exist in the form of required safety equipment, but that is easier to observe than whether someone takes steroids and probably has less, if any, effect on performance.

closest thing I can think of is boxing with weight classes. I gather heavyweight matches are more popular than lighter classes, which can be viewed as some evidence that spectators care about absolute rather than only relative performance..

Ed Schultz vs Daniel Webster

Listening to Ed Schultz, a leftish talk radio host, warning of the perils of U.S. external debt, I was reminded of a paper I wrote in high school about the controversy, almost two hundred years earlier, over the Second Bank of the United States. After reporting how many billions were held by various countries, Schultz suggested that if a few of those countries decided they didn't like our policies on global warming or foreign affairs, we would be in deep trouble. They could call in their loans, U.S. interest rates would shoot up and the average American homeowner would suddenly find he was paying much more for his mortgage or car loan than he expected.[6]

There are two things wrong with this. The first is that the U.S. government borrows on a world capital market and capital is fungible. If South Korea gets mad at us and South Koreans insist on cashing in U.S. treasury securities as they come due, refusing to buy any more and investing in Japan instead, that frees up capital that would otherwise have been invested by someone else in Japan which can then be used to buy the next issue of T-Bills. If the South Koreans decide, for some odd reason, not to invest anywhere at all, that decreases the world supply of capital by a tiny fraction of the total and pushes up world interest rates, not several fold as Schultz seems to imagine but by a minuscule amount.

Much the same mistake is made by those who explain the Iraq War as an attempt by the U.S. to make sure it can get enough oil. Oil, too, is a fungible commodity with a world market. Middle Eastern countries that depend on oil revenue are unlikely to stop pumping and selling it, whoever runs them. If Iraq decides to sell to France instead of to the U.S., that frees up for our use whatever oil France would otherwise have bought.

The second mistake was pointed out, as best I recall from my high school researches, by Daniel Webster c. 1832. Then as now, there were vocal worries about foreigners owning too much of America. Webster pointed out that foreign investment meant not that they had our stuff but that we had their money. If push came to shove, if foreign governments tried to pressure the U.S. by threatening to withdraw their citizens' investments, we could keep it, refuse to pay back the debt. Their capital, after all, was immovably located under our jurisdiction in the form of canals and the early railroads.

A Proposal to Triple Tax Robots

> Certainly there will be taxes that relate to automation. Right now, the human worker who does, say, $50,000 worth of work in a factory, that income is taxed and you get income tax, social security tax, all those things. If a robot comes in to do the same thing, you'd think that we'd tax the robot at a similar level.
>
> (Bill Gates, from a Quartz interview)

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[6] This is from memory, but I believe I am accurately summarizing his basic argument. It was more than fifteen years ago and I have not been able to find a recording of the show online.

A robot that does a job earns income for its owner. If the owner is an individual, that income gets taxed—income tax, social security tax, all those things. If the owner is a corporation, the income pays corporate income tax then is paid to the stockholders as dividends and taxed again, although sometimes at a lower rate than ordinary income.

Gates is proposing that we replace the double tax with a triple tax.

I expect one could, with some effort, construct arguments for special taxes on capital that replaces labor, but there is no particular reason to focus on robots. Capital has been substituting for labor at least since the invention of the plow, probably longer. But this argument is either stupidity, unlikely in the case of Gates, or blatant demagoguery.

Did Greek Protesters Want a Default? Should They Have?

Some years back lots of people in Greece demonstrated, sometimes violently, against the government's "austerity" program, adopted as the price of getting loans to cover Greece's very large national debt. It was not clear what alternative they proposed. One possibility is that they believed the Greek government could continue current policies if it wanted to, that the austerity program was merely a plot by wicked people to make the protesters and people like them worse off. It is hard to see how a government can continue to spend more than it takes in if nobody is willing to lend it money, but that may not be how they were looking at the question.

A second alternative was offered by a commenter on my blog:

> From my perspective I see this as a collective action problem. Each and every group is going to take a hit from the austerity program. Protesting and burning things makes your group's claims on government spending harder to ignore. So each group engages in competitive protesting to make sure they don't get the short end of the stick when cuts do come down. The reason the protest come in the form they do, is because you can't really march with the slogan, "Cuts: Everybody but Us!"

A third, and to my mind most interesting, possibility is that they realized that rejection of the program would result in their government being unable to either borrow more money or turn over its present debts, leading to a sovereign default, and were in favor of it.

The program being proposed, and protested against, was not austere enough to put the Greek budget into surplus; under it the government would still be spending more money than it took in, although not as much more. If defaulting on its present debt makes the Greek government unable to borrow, that would force a balanced budget. At first glance, that would mean lower expenditures or higher taxes than under austerity. But defaulting would eliminate the need to make interest payments; if that was larger than the deficit a balanced budget without interest payments would have resulted in an increase in (non-interest) expenditure.

Further, defaulting might not prevent future borrowing. My friend Jeff Hummel quotes me as saying, when and where I do not know, that sovereign default is the one balanced budget amendment with teeth. I do not know if I really said it, but if so I was wrong. Defaulting once is bad for one's credit rating but defaulting twice is worse, so after a sovereign default a government still has some incentive not to do it again, hence some reason to pay off on further borrowing. And the first default reduces the incentive for the second, since there is now less debt to default on. The

benefit of eliminating a billion dollar debt is much less than the benefit of eliminating a hundred billion dollar debt so evenafter default a government might still have some ability to borrow.

That suggests that a Greek government that had defaulted might be able to spend more money, some of it taxed and some of it borrowed, than currently proposed. Perhaps the protesters were correct in believing that rejection of the proposed program would lead to a better result, from their standpoint, than accepting it.

That argument for default might apply to a lot of other governments, including the U.S., so I find the rarity of such defaults and the willingness of people to lend large amounts of money to borrowers who face no legal penalties if they fail to pay it back mildly puzzling.

One thing that makes default more likely is positive feedback. The greater the perceived risk of default, the higher the risk premium that lenders will require on their loans. The higher the risk premium, the more costly the debt, hence the greater the incentive to default. So a sovereign default could be surprisingly sudden.

What the Tea Party Got Wrong [2011]

Suppose the government wants to subsidize biofuels. There are at least three different ways to do it:

1. For every gallon of biofuel produced, the government will pay the producer a one dollar subsidy.

2. For every gallon of biofuel produced, the government gives the producer a one dollar tax credit.

3. Make a regulatory rule that forces people to use more biofuels, such as a requirement that gasoline can only be sold if combined with at least ten percent biofuel.

The first two differ only in labeling. They have the same effect on the federal budget. They provide the same amount of subsidy. They are both, in fact if not in form, federal expenditures. The only difference is that the second is an expenditure masquerading as a tax cut.

A lot of expenditures pretend to be tax cuts. If you look at the CBO figures for federal income tax in 2007, you discover that, on average, the bottom 40% of the income distribution not only did not pay federal income tax, it was paid federal income tax — a federal welfare program in the form of tax credits. And since these are 2007 figures, it was Bush's federal welfare program, not Obama's.

As best I could tell by news stories dealing with budget controversies a decade or so back, this simple point was somehow missed by the Tea Party Republicans. They insisted on taking such expenditures at face value, as tax cuts rather than expenditures, hence oppose their elimination. They have thus fallen for the very simplest scam operated by their opponents in both parties, and by doing so come out against instead of for cutting federal expenditures.

The third alternative is also an expenditure, also a subsidy, should also be opposed by those who wish to reduce the role of government in the economy. But at least it uses a less obvious device, goes to more trouble to hide what it is, than number 2.