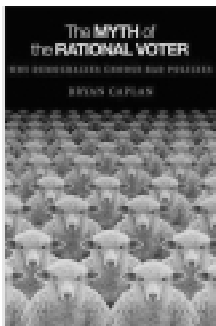
Book Reviews

The Myth of the Rational Voter: Why Democracies Choose Bad Policies

by Bryan Caplan

Princeton University Press • 2007 • 276 pages • $29.95

Reviewed by Dwight R. Lee



In one sense, *The Myth of the Rational Voter* makes a strong case for democracy. Bryan Caplan, professor of economics at George Mason University, argues that 1) citizens accurately communicate their preferences to politicians through voting; 2) politicians are responsive to those preferences, except that 3) when voter preferences are particularly misguided, politicians will often exert leadership and enact policies that deviate somewhat from the citizens' preferences in socially beneficial ways. But if this is correct, why does Caplan subtitle his book *Why Democracies Choose Bad Policies*? He quickly dispels any confusion by letting us know that he believes that while democracy gives citizens most of what they want, most of what they want is nonsense.

Caplan discusses four systematic biases in most citizens that lead to harmful policies. These are 1) an antimarket bias, 2) an antiforeign bias, 3) a make-work bias, and 4) a pessimistic bias. In order, people underestimate how much we benefit from what they see as the uncoordinated pursuit of self-interest and profit; are suspicious of foreigners and skeptical of claims that we benefit from dealing with them; applaud the creation of jobs and lament the loss of jobs regardless of the value being produced; and concentrate on economic problems while underestimating economic successes.

But couldn't the typical voter be correct in his biases and economists wrong in overwhelmingly seeing them as errors? Caplan devotes his longest chapter to addressing this question with creative use of data from the Survey of Americans and Economists on the Economy. I won't attempt to explain Caplan's analysis, but he convincingly challenges the argument that the biases of economists render their views on economic issues no more credible than those of the general public.

He next considers Public Choice explanations for why mistaken views inform the typical voter's decisions. Because of the extremely low probability that the outcome of an election will turn on one vote, voters have little motivation to become well informed. This has become known as rational ignorance—voters are rational to remain ignorant on most, if not all, issues they're voting on. But Caplan doesn't think the concept of rational ignorance adequately explains voting behavior. He argues that rationality requires updating one's beliefs in response to new evidence or arguments. Even by this minimum standard, however, most voters are irrational because they have emotional attachments to their political views that make them resistant to opposing evidence. This is "rational irrationality" because, Caplan explains, it's subject to the law of demand. The higher the personal cost of irrationality, the less irrational people will be. Unfortunately, the arithmetic of voting eliminates the personal cost of holding and expressing silly beliefs at the polls. So they persist.

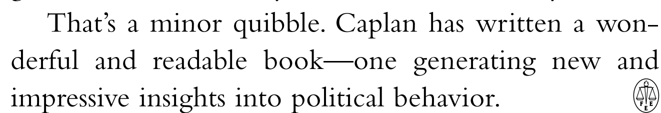
If most people don't take the time to become informed and their views were random, then informed voters would determine the outcomes of elections. But most voters are misinformed in the same way—according to the four biases. And with no cost to expressing those biases at the polls, rational irrationality results in voters consistently choosing bad policies.

My brief review cannot do justice to all the insights Caplan pulls from the notion of rational irrationality. I particularly appreciated his answer to the question, why aren't policies even worse than they are? Caplan puts forth a compelling reason for believing that politicians often ignore the expressed wishes of their constituents for the constituents' own benefit. He also does a nice job responding to the criticism that economists are a bunch of "market fundamentalists."

The only nit I would pick with Caplan is that I think he tries to draw too much of a distinction between rational irrationality and "expressive voting" as developed by Loren Lomasky and Geoffrey Brennan in their 1993 book *Democracy and Decision*. Brennan and Lomasky use the arithmetic of voting to explain why

people express support for feel-good proposals at the polls even when aware that they'll be worse off if those proposals pass. Caplan praises *Democracy and Decision,* acknowledging that expressive voting and rational irrationality aren't mutually exclusive, but he distinguishes between the two by claiming that expressive voters "know that feel-good policies are ineffective." Most expressive voters as envisioned by Brennan and Lomasky, however, surely believe the proposals they favor are worth feeling good about. How common is it to feel good about voting for a proposal you believe is socially harmful? It no doubt happens. A woman voter, for example, might feel good voting for a woman candidate even if convinced she favors bad policies, but this is surely an exceptional situation. To the extent that it's true, it makes the theory of expressive voting more general than the theory of rational irrationality.

That's a minor quibble. Caplan has written a wonderful and readable book—one generating new and impressive insights into political behavior.



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The Science of Success: How Market-Based Management Built the World's Largest Private Company

by Charles G. Koch
Wiley • 2007 • 201 pages • $22.95

Reviewed by William H. Peterson

The Science of Success and its remarkable author bring to mind a sonnet strategy of Shakespeare: "Let me not to the marriage of true minds
Admit impediments."

Meet then corporate thinker, entrepreneur, investor, hard-headed visionary, and impediment overcomer, Charles G. Koch. Koch, CEO of Koch Industries, Inc., with his rule of highly principled direction, has built the world's largest private firm, a mainly energy enterprise of 80,000 employees and $90 billion in annual sales, one that invested $21 billion in 2005 to purchase the publicly traded paper and wood giant Georgia Pacific.

Koch thinks and usually creates successful long-run company outcomes. His vision includes running an entrepreneurial meritocracy, a fused individual and team effort, and shrewd reinvesting of earnings for growth. He has been phenomenally good at that, and this book is all about his philosophy that has made it possible.

He calls his system Market-Based Management (MBM), a unique scientific approach to business management rooted in what our author describes as "the Science of Human Action." The system has five dimensions:

• *Vision:* Determining where and how the business can create the greatest long-term value.

• *Virtue and Talents:* Helping ensure that people with the right values, skills, and capabilities are hired, retained, and developed.

• *Knowledge Processes:* Creating, acquiring, sharing, and applying relevant knowledge, and measuring and tracking profitability.

• *Decision Rights:* Ensuring the right people are in the right roles with the right authority to make decisions and holding them accountable.

• *Incentives:* Rewarding people according to the value they create for the business. (He turns Marx around by proposing the maxim "From each according to his ability, to each according to his contribution.")

What Koch has done is to take key insights about what works for an economy and apply them to his business ventures. The MBM prowess of our author on the firing line is in outthinking and so staying ahead of competition, thanks in part to a team of profound manager-thinkers bent on creating "the greatest long-term value." By establishing a corporate climate that rewards efficiency and innovation—as the larger economy should do—Koch has seen his enterprises grow and prosper.

His ideas did not emerge out of a vacuum. Koch cites as particularly important two great books whose authors were both closely associated with FEE. One was F. A. Harper's *Why Wages Rise;* the other, Ludwig von Mises's *Human Action.*

Harper's book is hailed for spotting the causes of real, sustainable wage gains. The main cause, said Harper, lies in ongoing capital creation, which raises marginal productivity and enables producers

to bid more for labor and talent. That's been the history of markets and rising living standards over the last 300 years.

In *Human Action* Mises showed how a market society, based on private property rights and tightly limited government, yields civility, peace, and prosperity. Koch quotes Mises, whose writings helped inspire the MBM methodology: "The market determines who shall [have what property and who shall do what work]. None of these decisions is made once and for all; they are revocable every day. The selective process never stops." That fact challenges our author constantly.

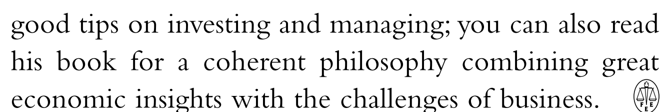
No one picks winners all the time, though. In an appendix, Koch lists over 40 businesses exited by his firm. Included are tankers, drilling rigs, Canadian pipelines, service stations, and telecommunications. That is much exiting, and in most cases from *profitable* operations. But why quit a profitable business? Because profitability is not enough. Profitable investments can tie up precious capital otherwise available for better returns elsewhere, precluding creating "the greatest long-term value."

Koch here reminds us that opportunity cost is the value of the best alternative that must be forgone to undertake any investment. So he counsels that "we must look forward rather than backward" when calculating that cost in the face of ever-new dynamic conditions to beat.

Our author also says that individuals, nations, and organizations such as Koch Industries should seek their "comparative advantage" in a world of changing technology and markets, and so concentrate on producing goods and services in which each "has the greatest *relative* superiority" (my italics). This is the stuff of Econ 101, but it's amazing how many high-ranking people in the business world seem to forget basic economic principles.

Relativity, teamwork, benchmarking, capital creation, capital maximization, improving talent or human capital, insighting-outlooking macro-micro profit centers, and, above all, ever achieving that rising value creation—all mark Koch's MBM road to success.

Charles G. Koch defines "the science of liberty" as: "How societies can best achieve long-term peace, civility, and prosperity." You can read his book for a lot of



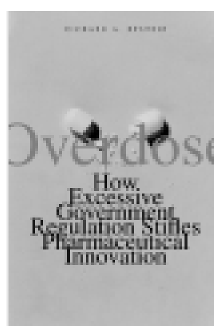
good tips on investing and managing; you can also read his book for a coherent philosophy combining great economic insights with the challenges of business.

Contributing editor William Peterson (WHPeterson@aol.com) is the 2005 winner of the Schlarbaum Award for Lifetime Achievement in the Study of Liberty given by the Ludwig von Mises Institute.

Overdose: How Excessive Government Regulation Stifles Pharmaceutical Innovation

by Richard A. Epstein
Yale University Press • 2006 • 271 pages • $30.00

Reviewed by George C. Leef



Over the course of his distinguished career in the law, Professor Richard Epstein has done as much as anyone to show how bad laws and regulations are harmful, both to individuals and to the fabric of society. He has tackled a wide array of subjects, from the misinterpretation of the Constitution to the attack on property rights, and with his current book, *Overdose,* Epstein applies his talents to the extremely important topic of pharmaceuticals. He gives the reader a comprehensive look into the process of bringing a new drug to market, carefully detailing the numerous obstacles the federal government puts in the way at each stage.

Epstein concludes that, far from protecting consumers, current regulation of the drug industry unnecessarily drives up costs and impedes development. What we need, he argues, is a consistent policy of liberalization. But he ominously suggests that instead we are apt to venture even further into the morass of political meddling with this vital industry.

Americans today live longer, healthier lives due in large measure to the wonderful advances in drugs over the past century. Most people assume that such progress just happens automatically, but Epstein shows that pharmaceutical progress cannot be taken for granted. It depends on property rights, incentives, and freedom. Unfortunately, drug companies are tempting political targets and a large number of people seem to think that

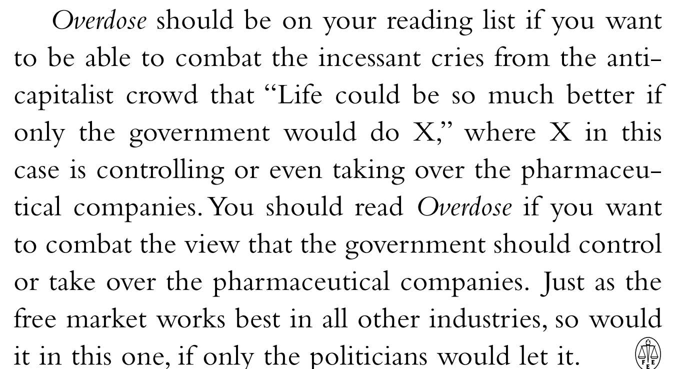
these golden geese will continue laying eggs no matter how they're treated. Epstein takes us through intellectual-property issues, R&D issues, pricing, marketing, safety, and liability issues, always detailing the ways government policy works against the interests of people who benefit from (or could benefit from) drugs.

Some of his analysis will probably be familiar to *Freeman* readers. We learn, for example, that the Food and Drug Administration's testing regime does more harm than good by screening out many potentially beneficial drugs from legal use in America because they haven't been proven safe and effective to the satisfaction of agency officials. Those officials tend to err on the side of caution since, from their point of view, the visible harm that occurs when someone is hurt by taking an approved drug is far worse than the invisible harm that occurs when people can't obtain a drug that could save them. While this line of analysis has been made many times, Epstein elucidates it with particular clarity. Noting that some drugs the FDA blocks could be lifesavers, he writes, "If there were ever a life-and-death situation where collective choice is inappropriate, this one is it."

Other aspects of Epstein's case against the regulatory status quo will probably be less familiar. His lawyerly analysis of the swamp of tort liability faced by drug companies gets at the heart of the matter. The United States has trashed the law of contracts in this area, leaving firms entirely at the mercy of tort lawyers and their well-honed expertise in jury selection and manipulation. "The one conclusion that clearly stands out," Epstein writes, "is that no legal system can afford to try complex matters before a jury even one time, let alone ten thousand times." He suggests several ways of improving on the current situation, which greatly resembles a game of Russian roulette for the drug companies.

One way would be to establish specialized courts and expert juries as the venue for trials over pharmaceutical liability, thus minimizing the chances for plaintiff attorneys to sway juries of common people with junk science and emotional appeals. Another would be to bypass tort litigation and have all cases of alleged consumer harm due to a drug be handled by a special federal prosecutor, with a cap on total damages that would be shared among all injured claimants if the case were proved. Epstein cautions that there is no perfect solution here, but we need to find the best alternative to our badly flawed tort system.

Epstein concludes with a devastating critique of the faddish demands that the federal government socialize the entire market for drugs. "Relentless populism has led to recriminations and sanctions that have already crippled the industry," he writes. The best course for us to follow, Epstein shows, is to remove the many legal obstacles to drug safety and innovation.



Overdose should be on your reading list if you want to be able to combat the incessant cries from the anti-capitalist crowd that "Life could be so much better if only the government would do X," where X in this case is controlling or even taking over the pharmaceutical companies. You should read *Overdose* if you want to combat the view that the government should control or take over the pharmaceutical companies. Just as the free market works best in all other industries, so would it in this one, if only the politicians would let it.

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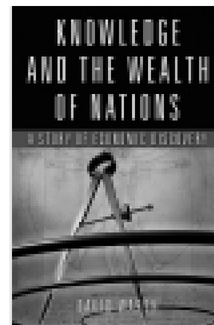
Knowledge and the Wealth of Nations: A Story of Economic Discovery
by David Warsh
Norton • 2006 • 426 pages • $27.95 hardcover; $16.95 paperback

Reviewed by Donald Boudreaux



The work that launched economics as a distinct discipline is Adam Smith's *An Inquiry Into the Nature and Causes of the Wealth of Nations*. Note well the title, especially the first eight words that typically are left off when people mention this book.

That great Scottish scholar inquired into the nature and *causes* of prosperity. Worded only slightly differently, Smith asked, "What causes economic growth?" His inquiry brilliantly identified as the chief proximate cause of prosperity the division of labor. The jack of all trades becomes a master of none. So a world full of jacks is poor. But let each

of those jacks specialize at performing a distinct task, and the same number of workers can produce a much greater quantity of output than they could produce when each was a jack.

A fuller account of this wealth-creation process, of course, must be told. Smith himself told much of it, as did David Ricardo and lots of—well, some—economists over the past 230 years.

The sorry fact is that, for all its contributions to our understanding of economy and society, economics has only recently returned in a serious way to the Smithian question of economic growth. For most of its history, economics has revealed the logic of allocating a given stock of resources to satisfy a given set of consumer demands with a given stock of knowledge. The economics of growth—or what came to be called development economics—suffered. All too true was a remark I heard the late Fritz Machlup make in 1981 at New York University: "[D]evelopment economics attracts the least developed economists."

Unknown to Machlup and his students (and to most economists at the time), a turnaround was underway. Its leader was a young economist named Paul Romer from the University of Chicago. Romer (now at Stanford) is no typical Chicagoan. And what makes him least typical of that school is his recognition that externalities exist and often matter.

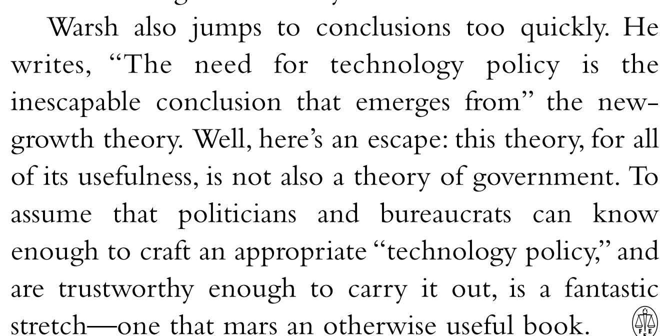
Externalities are effects of voluntary activities that spill over onto persons who are not party to the agreements that give rise to the activities. These effects can be negative (as when a factory dumps soot on the homes of nearby residents) or positive (as when a lighthouse guides whatever ships pass by). So-called "new-growth theory" builds on the latter by explaining how capital goods and human capital not only increase workers' productivity, but also that this increase in productivity often occurs at a faster rate as more capital goods and human capital come into existence. That is, the productivity of existing assets often increases as these are combined with additional assets. Such assets, then, are said to produce "increasing returns"—which means that their rate of output (say, per worker) increases when they are combined with other assets.

The story of the development of new-growth theory is not straightforward. But in *Knowledge and the Wealth of Nations,* economics reporter David Warsh does a fine job of telling it. Although Romer is the central character in the book, Warsh's summary of the economic theory of growth from Adam Smith's day to our own is wonderfully clear. Indeed, in my opinion this is the best part.

And while I heartily recommend this book to those who are curious about what economists now say about the causes of the wealth of nations, I must register a few complaints.

My biggest complaint is of Warsh's portrayal of the economics profession. He portrays economists as being more unified in our interest in pioneering ideas than we really are. I remember well the attention Romer's important papers of 20-odd years ago received from the profession, but no more than a tiny handful of economists eagerly awaited the next conference or paper discussing new-growth theory. Economics, for better or worse, is now a highly specialized discipline. It's the too-rare expert in urban tax policy who has interest enough to follow exciting developments in labor economics or even the economics of growth.

Relatedly, Warsh makes the development of new-growth theory appear to be much more self-conscious than it really was. For example, some work of my George Mason University colleague Tyler Cowen—work critical of one of Romer's papers—is mentioned in the book as playing a noteworthy role in fashioning the emerging theory of development. When I asked Cowen his thoughts on Warsh's description of this work, he replied that he wasn't really aware at the time (contrary to Warsh's suggestion) that he was helping to advance new-growth theory.



Warsh also jumps to conclusions too quickly. He writes, "The need for technology policy is the inescapable conclusion that emerges from" the new-growth theory. Well, here's an escape: this theory, for all of its usefulness, is not also a theory of government. To assume that politicians and bureaucrats can know enough to craft an appropriate "technology policy," and are trustworthy enough to carry it out, is a fantastic stretch—one that mars an otherwise useful book.

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