REVIEW & OUTLOOK

Eliot's Insurance Policy

Give this much to New York Attorney General Eliot Spitzer: If he weren't prosecuting insurance agents, he could certainly find a useful career selling their products. The way he's promoting his latest campaign against a financial services industry, he could sell anything.

Mr. Spitzer has accused at least five insurance giants —including Marsh & McLennan, AIG and Ace—of participating in fraudulent business practices and has subpoenaed many more. His complaint paints the entire industry as rife with "corruption," a line the media have dutifully picked up. Since we rather doubt that everyone in the business is criminal, let's sort the genuine fraud from Mr. Spitzer's political spin and regulatory preferences.

There's no doubt Mr. Spitzer has discovered bad behavior in so-called bid-rigging by insurance brokers, who serve as middlemen between buyers and sellers of insurance products. Soliciting fake bids to drive up prices is a crime, and Mr. Spitzer has already won two guilty pleas from employees of AIG. At least in this case the New York AG has charged people for breaking the law. This is a prosecutor's main duty, but in his previous financial crusades Mr. Spitzer has used public mau-mauing to scare his targets into a settlement rather than prove something to a jury beyond a reasonable doubt.

But bid-rigging aside, Mr. Spitzer's goal seems to be nothing short of altering the way insurance brokers make their money. And to do so he is portraying as "fraudulent" business practices that are long-standing and well known. State insurance regulators have known about them and declined to act for years—in the case of New York State even after the industry requested regulatory guidance. To have Mr. Spitzer now sweep in and compare the entire industry to organized crime is more troubling than the practices he's seeking to end.

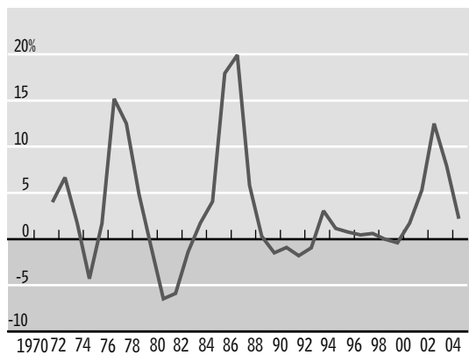
Specifically, Mr. Spitzer is attacking "contingent commissions." A few facts: Historically the insurance-brokerage business has been based on commissions of one sort or another. The most basic are "standard commissions," in which brokers get a percentage of the premium. But brokers can also receive commissions that are "contingent" on other factors, for instance the profitability of the business they drum up. Contingent commissions have been around for decades, are generally confined to insurance sales to businesses (not individuals), and are well understood by corporate customers.

Mr. Spitzer has taken special aim at "placement service agreements," in which brokers tend to be paid based on the volume of premiums they direct to an insurer. PSAs got rolling in the early 1990s, and today insurance buyers can get details about them from their brokers upon request. In the late 1990s, the Risk and Insurance Management Society—which represents corporate risk managers—and leading brokers Marsh and Aon, agreed to disclosure policies that require brokers to identify their contingents and provide estimates of how much revenue they generate.

Mr. Spitzer now describes all of this as a nefarious "steering" of business to certain insurers that hurts corporate buyers and results in "kickbacks" to brokers. But does it really? Consider pricing. If Mr. Spitzer is correct that PSAs were diverting corporate buyers only to those insurers that pay the highest contingent commissions, rather than those with the best deals, we could assume buyers would see real premium hikes.

Premium Competition

Growth in property/casualty insurance premiums, in real $



Note: Written premiums net of reinsurance

Sources: A.M. Best, Insurance Services Offices, Inc.

Not so. The insurance industry is well known for price competition and revenue roller-coasters (see the chart nearby). As recently as 2003, the average commercial policyholder faced premium increases of 20% to 25%. Yet the majority of businesses that are due to renew their policies in January 2005 will see decreases. This is hardly the profile of a captive, crooked market. The broker business is intensely competitive, and the idea that a broker would risk a long-standing client relationship by delivering a lousy policy for the sake of a one-time commission is hard to credit.

In any case, Mr. Spitzer is coming late to this party. Commissions have been declining in importance since the 1990s, when the insurance industry went through a slump and brokers began branching into more stable fee-based services such as research or risk management. JP Morgan estimated in January that contingent commissions accounted for some 5% of brokerage revenues for publicly traded brokers. By contrast, some brokers today generate as much as one-quarter to one-third of revenues from non-commission fees.

In his previous crusades, Mr. Spitzer has been able to rely on the industries to cave early and agree to settle before he had to prove anything in court. Worried about reputational risk and watching their stock prices fall, they decided to put the issue behind them. In this case, Marsh has already surrendered and announced it will suspend incentive commissions. We can understand the business decision, especially since the press corps is helping Mr. Spitzer conflate bid-rigging with legal business practices.

But there is something troubling about a public official unilaterally deciding that an industry's business model must change—especially when other regulators have blessed it for years. All the more so because the tort bar lurks in the background of this issue and may well have alerted Mr. Spitzer to its political potential by filing a few well-targeted suits against PSAs. After Mr. Spitzer's intervention, his legal friends will have a field day.

Mr. Spitzer increasingly views himself as all three branches of government—legislator, regulator and judge. But he has yet to explain how the public benefits from having one man set the rules, with little debate and no political check or balance.

Progress in Iraq

With polls showing a tight Presidential race, it's possible John Kerry could be our commander-in-chief soon. So it would be nice to think he's paying enough attention to what's going on in Iraq to know that conditions there aren't, as he said a few days ago, "getting worse each week."

More help from Iraqis, and targeting Fallujah.

The kidnappings, mortar attacks and roadside bombs continue—and will until the insurgency is defeated. But recent weeks have actually seen progress by American and Iraqi forces toward reasserting control over Saddam's old stronghold in the Sunni Triangle. That, in turn, means credible nationwide elections in January are more likely than ever.

The first of the troublesome cities to return to Iraqi government control was Samarra early this month. In recent days American and Iraqi forces have also carried out successful anti-terrorist raids in several towns just south of Baghdad populated by disgruntled ex-employees of the old regime's military-industrial complex. Insurgent cells in Mahmudiya, Yusufiya and Latifiya are the reason the road between Baghdad and Najaf has been so dangerous.

Most important, allied forces seem poised finally to take control of Fallujah, which has been a no-go zone since the end-of-April deal that turned the town over to ex-Baathists called the Fallujah Brigade. That decision was easily the biggest mistake of the war, since it caused both friend and foe to question American resolve and gave the thugs a safe haven from which to stage car bombings and other attacks.

At the moment, the Marines have established a cordon around the city and the Iraqi government is negotiating with local tribal leaders to give up the couple thousand foreign fighters—including arch-terrorist Abu Musab al Zarqawi—thought to be in the city. Meanwhile, some locals are providing intelligence that has allowed us to kill a lot of those foreign fighters via airstrikes. Presumably the White House and Iraqi Prime Minister Ayad Allawi won't make the same mistake twice, and once they begin a Fallujah assault they won't stop short of unconditional surrender.

One reason for this progress is that we're finally being helped by a substantial number of Iraqi troops. The force that took Samarra included 3,000 Americans and 2,000 Iraqis, with the latter providing local knowledge and helping secure sensitive sites like mosques.

More recently around Mahmudiya, U.S. forces rounded up a number of suspects, but it was only the arrival Monday of Colonel Mohamed Essa Baher of the Iraqi National Guard that allowed them to identify one captive as a top Zarqawi paymaster. Colonel Baher was ambushed and almost killed on Tuesday—one of his sons has already been killed—but he vows to pursue the terrorists "to the last breath."

Which brings us to another point that deserves more attention: the courage of the Iraqis. Young men continue to line up by the thousands outside the police and National Guard recruiting stations that have so often been targets of terrorist attack. On Tuesday a mortar struck the ING headquarters in Mushahidah, killing four. But recruit Qusay Hassan was quoted saying, "If I don't join the army, who is going to defend the country from the terrorists?"

If we have one reservation about the current progress in Iraq, it's the apparent truce with Muqtada al-Sadr. The good news here is that Sadr City in Baghdad has been pacified for the moment, and that Sadr's Mehdi Army has handed over some heavy weaponry. The bad news is that Sadr has American and Iraqi blood on his hands, and our failure to arrest or kill him may set another bad precedent. But unlike the April Fallujah deal, at least we're not ceding territory to the bad guys but gaining it.

Mr. Bush deserves credit for going on offense now, since the path of least resistance would be not to stir up the hornets' nest of the Sunni Triangle before November 2. Acting now and with urgency tells Iraqis we intend to honor our pledge to hold elections by January. There was always going to be violence in Iraq in the run-up to November 2 as the Baathists and Islamists sought to demoralize American voters. So why not attack instead of waiting for the bombs to hit? We're guessing we're not the only ones who will feel better about the Administration's Iraq policy on Election Day if the liberation of Fallujah is finally under way.

Why Do Americans Work More Than Europeans?

By Edward C. Prescott

Last week, The Wall Street Journal published a story describing a new method of measuring a nation's progress—"gross national happiness." Maybe it's because we're nearing the end of an election season, but one hopes that this indicator does not catch on. Of all the promises that candidates find themselves making, and of all the problems they pledge to fix, one shudders at the notion of pledges to make us happier. The mind reels at the thought of the ill-conceived policies that would be concocted if the stated goal were to increase gross national happiness. It's hard enough to make everybody more prosperous, educated and healthy, but imagine if the government was responsible for keeping you in a good mood. And just think about the data problems.

I mention this not to poke fun at the idea of happiness. Indeed, our Constitution, in its elegant wisdom, allows for individuals to pursue happiness. But individual pursuit is far different from the aggregate management of happiness. This point is at the core of how we should think about many government policies, especially tax policy, which is the subject of this essay.

* * *

Let's begin by considering a commonly held view which says that labor supply is not affected by tax rates. This idea holds that labor participation would remain steady when tax rates are either raised or lowered. If you are a policy maker and you subscribe to this, then you can confidently increase marginal tax rates as high as you like to attain the revenues you desire. Not only that, but you can move those tax rates up and down whenever you like and blithely assume that this will have no effect on output.

But economic theory and data have come together to prove this notion wrong, and we have many different laboratories—or countries—in which we can view live experiments. The most useful comparison is between the U.S. and the countries of Europe, because these economies share traits; but the data also hold when we consider other countries (more on those later).

This issue is encapsulated in one question that is currently puzzling policy makers: Why do Americans work so much more than Europeans? The answer is important because it suggests policy proposals that will improve European standards of living (which should give a boost to its gross national happiness, by the way). However, an incorrect answer to that question will result in policies that will only exacerbate Europe's problems and could have implications for other countries that are looking for best practices.

Here's a startling fact: Based on labor market statistics from the Organization for Economic Cooperation and Development, Americans aged 15-64, on a per-person basis, work 50% more than the French. Comparisons between Americans and Germans or Italians are similar. What's going on here? What can possibly account for these large differences in labor supply? It turns out that the answer is not related to cultural differences or institutional factors like unemployment benefits, but that marginal tax rates explain virtually all of this difference. I admit that when I first conducted this analysis I was surprised by this finding, because I fully expected that institutional constraints are playing a bigger role. But this is not the case. (Citations and more complete data can be found in my paper, at www.minneapolisfed.org.)

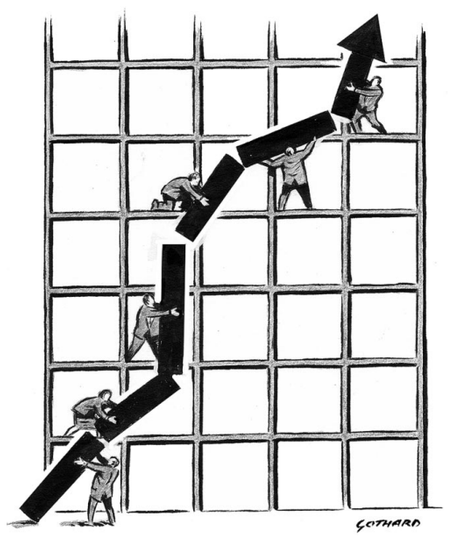
Let's take another look at the data. According to the OECD, from 1970-74 France's labor supply exceeded that of the U.S. Also, a review of other industrialized countries shows that their labor supplies either exceeded or were comparable to the U.S. during this period. Jump ahead two decades and you will find that France's labor supply dropped significantly (as did others), and that some countries improved and stayed in line with the U.S. Controlling for other factors, what stands out in these cross-country comparisons is that when European countries and U.S. tax rates are comparable, labor supplies are comparable.

And this insight doesn't just apply to Western industrialized economies. A review of Japanese and Chilean data reveals the same result. This is an important point because some critics of this analysis have suggested that cultural differences explain the difference between European and American labor supplies. The French, for example, prefer leisure more than do Americans or, on the other side of the coin, that Americans like to work more. This is silliness.

Again, I would point you to the data which show that when the French and others were taxed at rates similar to Americans, they supplied roughly the same amount of labor. Other research has shown that at the aggregate level, where idiosyncratic preference differences are averaged out, people are remarkably similar across countries. Further, a recent study has shown that Germans and Americans spend the same amount of time working, but the proportion of taxable market time vs. nontaxable home work time is different. In other words, Germans work just as much, but more of their work is not captured in the taxable market.

Here's a hint: It's not because of cultural differences.

I would add another data set for certain countries, especially Italy, and that is nontaxable market time or the underground economy. Many Italians, for example, aren't necessarily working any less than Americans—they are simply not being taxed for some of their labor. Indeed, the Italian government increases its measured output by nearly 25% to capture the output of the underground sector. Change the tax laws and you will notice a change in behavior: These people won't start working more, they will simply engage in more taxable market labor, and will produce more per hour worked.



David Gothard

This analysis has important implications for policy—and not just for Europeans, but for the U.S. as well. For example, much has been made during this election season about whether the current administration's tax cuts were good or bad for the economy, but that is more a political question than a policy consideration and it misses the point. The real issue is about whether it is better to tweak the economy with short-lived stimulus plans or to establish an efficient tax system with low tax rates that do not change with the political climate.

What does this mean for U.S. tax policy? It means that we should stop focusing our attention on the recent tax cuts and, instead, start thinking about tax rates. And that means that we should roll back the 1993 tax rate increases and re-establish those from the 1986 Tax Reform Act. Just as they did in the late 1980s, and just as they would in Europe, these lower rates would increase the labor supply, output would grow and tax revenues would increase.

Now, might there be a small increase in debt as we move to a better tax system? Sure, but remember that the most important measure of debt is privately owned government debt as a percent of gross national income, which has been flat over the past three years. Also, there is a sure-fire way to handle this increase in debt, and that would be to cut expenditures. Actually, there is another way to handle it, and that would be to pray to the Gods for another high-tech boom and the debt would go "poof," and we'll praise whoever is president for being fiscally responsible.

Some say that the 1993 tax-rate hike was responsible for erasing this country's debt problems because it increased government revenues. This is false. The ratio of U.S. debt to gross national income continued to increase in the years following those rate hikes and did not fall until the fortuitous boom that occurred in the late '90s. The high-tech boom meant that people worked more, output increased, incomes climbed and tax revenues followed suit. You cannot tax your way to that sort of prosperity. Imagine the outcome of the late-'90s boom if tax rates had been lower. And by the way, lower tax rates are good for all taxpayers. We're barking up the wrong tree if we think that "taxing the rich" will solve all our problems. You know who these rich people are? They're often families with two professional wage-earners. If you tax that family too much, one wage-earner will drop out, and that's not only bad for the income of that family but also for the output of the whole economy—and will result in lower tax revenues.

Also, we need to get away from thinking of the rich as some sort of permanent class. Many of the individuals who show up on annual millionaire lists, for example, are people who happened to have a good year and who may never appear on that list again. Consider people who worked hard for many years and built a successful business that finally goes public. The big capital gain they realize that year is really compensation for the uncompensated effort they put into building the business. They should not be penalized for their vision and tenacity. If we establish rules that punish the winners, entrepreneurs will take fewer risks and we will have less innovation, less output, less job growth. The whole economy suffers under such a scenario—not just those few individuals who are taxed at a higher rate. And this doesn't just involve the Googles and Apples and Microsofts, but countless other companies that start small and end up making large contributions to the economy.

The important thing to remember is that the labor supply is not fixed. People, be they European or American, respond to taxes on their income. Just one more example: In 1998, Spain flattened its tax rates in similar fashion to the U.S. rate cuts of 1986, and the Spanish labor supply increased by 12%. In addition, Spanish tax revenues also increased by a few percent.

And that brings us back to our framing question about the labor supplies of the U.S. and Europe: The bottom line is that a thorough analysis of historical data in the U.S. and Europe indicates that, given similar incentives, people make similar choices about labor and leisure. Free European workers from their tax bondage and you will see an increase in gross domestic product (oh, and you might see a pretty significant increase in gross national happiness, too). The same holds true for Americans.

Mr. Prescott is co-winner of the 2004 Nobel Prize in Economics, senior monetary adviser at the Federal Reserve Bank of Minneapolis and professor of economics at Arizona State University.

Over a Barrel

By Steve H. Hanke

On Nov. 13, 2001, President Bush ordered the government to fill the Strategic Petroleum Reserve to its capacity of 700 million barrels. Since then, the SPR fill-rate has accelerated and oil prices have gone through the roof, increasing from $21.67 to a record-setting $55.33 per barrel. At least $10 per barrel of that increase can be attributed to the president's wrongheaded "fill" command. And that "Bush premium" has taken roughly $70 billion out of American oil consumers' pockets and transferred it into OPEC's coffers since December 2001.

Government stockpiles are nothing new. The U.S. has had a long and fatal attraction to hoarding commodities for national emergencies. Indeed, the government has squirreled away everything from aluminum to zinc. But the mother of all these commodity hoards is the SPR. Established in December 1975, it consists of five underground storage facilities hollowed out from salt domes in Texas and Louisiana. At present, they hold 670 million barrels of crude oil, more than double the amount in private U.S. inventories. Taking into account the grades of oil in the SPR, its market value is a whopping $31 billion.

The SPR—like the other government stockpile programs—has had a stormy history. One of the more outrageous episodes occurred in late 1978. The Saudis cut a deal with the Carter administration to stabilize oil prices by increasing their output. In return, the U.S. agreed to stop purchasing oil destined for its stockpile, giving the Saudis *de facto* control of the SPR. The Saudis knew the oil markets and the importance of seemingly small changes in the demand for inventories. The Saudis also knew that the Americans would keep their end of the bargain and that they would not.

Most oil is sold under fixed-priced contracts. In normal times, small excesses and deficits are absorbed by changes in private inventories. When the temporary supply-demand imbalances are too large for inventory absorption, they show up in the spot market for oil, where flexible prices clear the market.

When potential supply disruptions enter the picture—as they have done with increasing frequency since 2001—panic buying sets in. Nobody wants to be caught short and the precautionary demand for more storage shoots up. Contrary to popular characterizations, the ensuing price increases are primarily driven by changes in the demand for storage, not supply problems.

After the president issued the order to fill the SPR, in late 2001, the government's precautionary demand for storage increased and the government began to compete for inventories with the private sector. Not surprisingly, total U.S. oil inventories have increased by 9.4% since December 2001. But private stocks have actually decreased by 12.5%. The SPR has crowded out private storage and the government's share of the total has increased from 63% to 71%, giving rise to the Bush premium of at least $10 per barrel.

Applying common sense, and in an effort to eliminate the Bush premium, Sens. Carl Levin (D., Mich.) and Susan Collins (R., Maine) have repeatedly argued for the suspension of oil purchases for SPR. On three occasions, they have offered amendments that would have put a halt to government buying. But the amendments have not seen the light of day. The last attempt on Sept. 14 did narrowly squeak by on a 48-47 vote but that wasn't enough to overcome a technical point of order raised against the amendment. This is unfortunate. Unless purchases are halted, we will have to live with the Bush premium until May 2005, when the SPR is scheduled to be at full capacity.

Sens. John Kerry and John Edwards recently jumped on the "stop the fill" bandwagon. However, the strength of their convictions is in doubt since neither bothered to cast votes on the Levin-Collins amendments.

Interestingly, one of the major objections to the idea of suspending government oil purchases is that they are small potatoes. After all, they only amounted to 1.3% of total U.S. oil imports in 2004. Those who embrace this argument don't know what the Saudis knew in 1978. They also don't understand the economics of storage. At present, spot oil prices exceed futures prices, indicating that private inventories are "low." Under these conditions, what appear to be "small" changes in inventory levels have outsized impacts on prices, particularly spot prices.

The power of inventory changes is best illustrated by revisiting the Gulf War of 1991. On Jan. 16, the first day of the war, George H. W. Bush threatened to release oil from the government's stockpile. The results were dramatic: The spot price of oil fell from $32.25 per barrel to $21.48 in one day. More importantly, the positive spread between spot and four-month futures prices also fell, from $5.90 per barrel to $1.65, indicating a higher comfort level with the adequacy of private inventories.

The Gulf War experience suggests that the Levin-Collins amendments have been too timid. Why not threaten to lend the government's oil freely, without limit and change what the market would bear? That would yield more than the elimination of the $10 per barrel Bush premium.

Better yet, why not replace government-mandated release rules with a market-based approach? To do this, the government should sell call options on its oil stockpile. By doing this, it would generate revenue to defray some of its stockpiling costs. More importantly, the market would decide the release rates for the SPR. In consequence, the volatility in the oil markets would be dramatically reduced. In addition, spot prices would fall like a stone and once again be lower than futures prices.

Mr. Hanke is a professor of economics at Johns Hopkins and a senior fellow at the Cato Institute.

Patriot at the ACLU

By Viet D. Dinh

The ACLU's decision to reject $1 million from the Ford and Rockefeller foundations was the right thing to do—but for the wrong reason. At issue is the foundations' caveat that grant recipients not "promote or engage in violence, terrorism, bigotry, or the destruction of any state."

"Bigotry"? That's not even speech; it's *thought*. Protecting bigotry is how the ACLU made its name. Remember the Nazis in Skokie? But the current ACLU leadership, bowing to political correctness, barely raises an eyebrow at the restriction against bigotry. Instead, they point to the prohibition against *terrorism*, which it characterized as "vague" and "ill advised."

Now this is where things really get interesting. According to a New York Times report this week, ACLU Executive Director Anthony Romero advised the Ford folks to adopt the definition of terrorism in the—brace yourself—Patriot Act, legislation the ACLU has always railed against. What Mr. Romero seems to understand is that the definition in the Patriot Act is narrower than the prior definition of international terrorism, as criminal activities that involve "violent acts or acts injurious to human life." Congress recognized that "violent acts" may sweep too broadly to include protest activities protected by the First Amendment. So it limited the definition to live up to the letter and spirit of the Constitution.

Baseless, therefore, are ACLU claims that WTO or abortion protests may come to constitute "terrorism." These are protected by the Constitution and unaffected by the Patriot Act's terrorism definition. Terrorism arises only when protest is linked with a criminal act, e.g. murder. So to turn down money on grounds that it would blunt the ACLU's ability to defend a right to "protest" is specious.

But a donor's curb on "bigotry"? Now that's different.

Mr. Dinh, a Georgetown law professor, was assistant attorney general for Legal Policy from 2001 to 2003.