BOOK REVIEWS

Public School Choice: Current Issues/Future Prospects
Myron Lieberman
Lancaster, Pa.: Technomic, 1990, 199 pp.

Educational choice is currently America's hottest idea in school reform. Disappointed by the lackluster results of the traditional reforms aggressively adopted during the 1980s—primarily more money and higher standards—reformers have been turning to nontraditional reforms such as school-based management, political decentralization, and educational choice. In theory, choice is the most radical of the new reforms because it shifts the control of schools away from political institutions such as school boards and district offices and toward parents, students, and the schools themselves. In theory, choice counts on market forces—competition among schools for students—to stimulate the kind of improvement that political and administrative efforts have been unable to bring about. In practice, however, choice may not be successful.

The single greatest problem with choice is that it is seldom implemented in a way that makes serious use of market forces, that subjects the supply of schools to the discipline of demand. Most forms of public school choice in place today provide families with a few alternatives to their neighborhood school, but the alternatives are not determined by competition. The alternatives are still largely those that school systems, through traditional political and administrative processes, decide to provide. Public school choice is seldom structured in a way that provides schools with meaningful incentives and opportunities to compete for students or that places bad schools—schools that no one wants to attend—at risk of being closed or taken over. Public school choice, in other words, is mostly a demand side reform that does little to influence supply.

As the idea of choice sweeps the nation—eight states have adopted statewide open enrollment for public schools, another twenty are debating it, and hundreds of districts provide some form of choice—the serious limitations of most choice plans need to be better appreciated. Myron Lieberman's *Public School Choice* does a thorough job of exposing these limitations—and of explaining why the major interest groups involved in education policymaking strenuously resist choice plans that are not so limited. In straightforward fashion, Lieberman asks how well choice plans satisfy the standard assumptions that economists make about competitive markets. For example, how easily can new suppliers enter the educational market? The answer is not very easily. Indeed, Lieberman argues, public school choice is not really about competition at all. Public school choice fails most market assumptions.

As Lieberman persuasively shows, public school choice does not provide schools with sufficient economic incentives to seek new students. Choice plans also typically fail to provide schools with sufficient flexibility to compete. State and district regulations limit their ability to differentiate themselves from one another. And personnel rules, in statutes and collective bargaining agreements, make it exceedingly difficult for schools to create distinctive staffs through hiring and firing. Lieberman is especially insightful in discussing labor-management issues. Besides his productive academic career, Lieberman has worked as a consultant or negotiator in numerous collective bargaining processes. His knowledge of the many tensions between union objectives and school competition is impressive.

This hard-hitting and highly accessible book should jolt those reformers who so often argue that public school choice will transform American education in much the same way that markets are expected to transform socialist economies. Reformers need to be so alerted, for an educational system truly based on principles of competition and choice could bring major improvements in the organization and performance of America's schools. Yes, reformers also need to know that there are problems with markets—for example, uninformed parents, principals and teachers who are currently incapable of running competitive schools, and economic savings associated with some forms of centralized educational organization. Lieberman discusses these problems and more. Still, it would be a shame for American education if the current enthusiasm for market-oriented school reform was squandered on choice plans that do not give markets a real chance and do not provide families with real choice. Lieberman fears that such a sad scenario is a likely one, and I quite agree.

John E. Chubb
The Brooking Institution

The Political Economy of American Monetary Policy
Thomas Mayer, ed.
New York: Cambridge University Press, 1990, 314 pp.

A dramatic shift has occurred in recent decades in the thrust of academic research regarding the operations of the Federal Reserve System. Scholarly studies used to concentrate on technical aspects of Federal Reserve operations. In each of the Fed's domains—monetary policy, lender of last resort, and bank regulator—investigators asked what the Fed was doing and how it was doing it. These studies presupposed that only the public interest animated Federal Reserve activities.

Two developments account for a new direction in academic research. First, the Federal Reserve was not responsive to critics. It defended its performance and rarely conceded past mistakes. Second, the influence of public choice theory on the analysis of the behavior of government agencies, including monetary authorities, has expanded rapidly. Public choice theory assumes that actions by public bodies are motivated by the preferences of their leaders. The theory further notes that these preferences are not necessarily limited to serving the public interest. Public servants may be more motivated by attempts to promote their institutions' franchises and their own private interests. Public choice theory leads investigators to focus on why the institution has performed the way it has.

Determining the factors that influence Federal Reserve behavior involves a multidimensional investigation. The institutional setting must be related to the policy choices the Fed makes. But the institution itself is complex and subject to both international and domestic pressures. The Fed's interactions with other central banks can affect its decisions, and domestically the Fed is an agent of Congress and is accountable to the president who appoints the board of governors and the chairman. The Treasury Department wants the Fed to be obedient to its agenda. The Federal Reserve chairman and individual governors often seek to influence the selection of district bank presidents, thus limiting the number of independent voices within the system. Political choice theory needs to trace the paths that lead from all these sources of power as well as to identify the personal motives of staff and governors in making the Fed's decisions. These decisions affect what the price level will be, whether the Fed will play the short-run Phillips curve game, under what circumstances it will intervene as lender of last resort, and what position it will maintain as bank regulator relative to its rivals in bank supervision.

The Political Economy of American Monetary Policy, edited by Thomas Mayer, includes 19 chapters that attempt to explain the Fed's behavior in light of public choice theory.

Some of the chapters reject models the literature has previously applied to the Fed. Take, for example, the bureaucratic theory that regards power and prestige as the primary goals of the Fed, eager to maximize its autonomy and the size of its staff and its budget. Power, prestige, and autonomy do seem to play a role, but Thomas Willett dismisses budget and staff maximization as significant influences on monetary policy. He similarly dismisses the theory that decisionmakers at the top levels of the Fed are engaged in significant rent seeking, but Willett notes that the extent to which Congress and the executive branch are engaged in rent seeking can have an indirect influence on Fed policy.

The nature of the relationship between Congress as principal and the Fed as a congressional agent is also in dispute. It is not clear whether Congress is a behind-the-scenes manipulator of banking regulation and monetary policy or whether Congress does not seek such control.

Contrary to earlier studies, Nathaniel Beck provides evidence in support of the view that Congress does not seek control and shows why inactivity is in the interest of the legislators.

Although evidence indicates that executive branch pressure dominates monetary policy, Michael Munger and Brian Roberts argue that a new theory is needed that encompasses all sources of political pressure on the Fed. The executive branch supports the Fed in return for its maintenance of a desired level of nominal interest rates, and the Fed accepts the role of scapegoat for the Congress—when interest rates are rising and exchange rates fluctuating, for example—in return for relative autonomy.

The book includes chapters with contradictory findings on the validity of the political business cycle. Beck reports that M1 growth rates support the existence of a political business cycle while the federal funds rate provides no such support. Meanwhile, Willett finds evidence that a political business cycle exists based on Treasury bill rates.

Political pressure is also exerted within the Fed. Thomas Havrilesky and Robert Schweitzer attempt to determine which of eight career characteristics of members of the Federal Open Market Committee (FOMC) accounted for dissenting votes, which were discouraged, over the period 1960 to 1983. Assuming that the central government favors inflation, Havrilesky and Schweitzer attribute votes for easier monetary policies to those characteristics that indicate greater proximity to the central government. Votes for tighter policies were attributed to characteristics reflecting less proximity to the central government. In contrast to earlier results, the authors of this chapter found that occupational background did make a difference in FOMC dissents.

John Gildea presents a different model of FOMC voting behavior. He considers each member's voting record—dissents as a percentage of total votes—from 1960 to 1982. Gildea includes politico-economic constraints, individual preferences, career variables, and social-background variables. He reports results for four different samples, and he concludes that members voted for more expansionary monetary policy as presidential popularity declined and as the ex ante real interest rates rose relative to inflation. Governors cast their split-decision votes in accordance with the appointing president's party. Voting behavior accommodating short-run political pressures was associated with government experience and private industry background; voting behavior resistant to such pressures was associated with an Ivy League education, an economics Ph.D., and a position as a regional Federal Reserve Bank president.

Thomas Mayer offers a mirror-image of public choice theory. He argues that the Fed is driven less by the wish to enhance power than by attempts to avoid feelings of responsibility when policy turns out to be mistaken. Mayer labels his approach a regret-avoidance theory, on the basis of a psychological phenomenon called cognitive dissonance. He cites behavior that suggests the Fed may be seeking to reduce cognitive dissonance, but Mayer notes that other explanations may be equally operative.

Two chapters deal with the Federal Reserve as a political power. The Fed's power arises from its control of monetary growth, its regulatory functions, and its role as lender of last resort. James Pierce shows how the Fed has worked to increase its power. This has been illustrated most recently by the Fed's opposition to recommendations that would limit its supervision to large (rather than all) bank and thrift holding companies. Edward Kane discusses the incentives of the Federal Reserve and Congress to avoid accountability. Efforts to impose a rule on the Fed in place of current discretionary policy will not succeed, Kane concludes, unless the shift is accompanied by some sort of compensation for those who would lose by the reform.

In some remaining chapters, the authors either do not draw political implications or they tack them onto essentially apolitical material. One chapter provides a Marxian explanation for Fed behavior, and its inclusion is a mark against the editor's judgment. According to Gerald Epstein and Juliet Schor, the Fed is inflation averse because it is primarily concerned not with the public's welfare, but with financial and nonfinancial profitability, which is reduced by inflation.

If judged by this collection, public choice theory as applied to the Fed lacks overall structure. Individual research findings relate to a particular aspect of the subject. Interesting as the explanations are, they offer only partial insights at best, and they are limited to the time and circumstances to which they apply. As a result, none of the explanations is fully persuasive.

The one attempt at structure is the chapter by Robert Hetzel, who provides a theoretical framework for the Fed's discretionary monetary policy. In this framework, congressional desires to redistribute income through inflation are constrained by the obvious costs of inflation. Congress can pressure the Fed for expansionary monetary policy without accepting responsibility for inflation because it has given the Fed nominal autonomy. The Fed for its part chooses procedures that defend its institutional autonomy while allowing it to provide the trend rate of inflation the political system demands. More structured public choice studies are a promising direction for future research.

Anna J. Schwartz
National Bureau of Economic Research

The Economics of Property Rights: Towards a Theory of Comparative Systems
Svetozar Pejovich
Boston: Kluwer Academic Publishers, 1990, 204 pp.

It is now generally recognized that socialist economies have failed to deliver on their promise of a more equitable and prosperous society. It is also generally recognized that the economic failure is a consequence of socialism's inability to provide the information and incentives necessary for the efficient allocation of resources. Despite the fact that the argument concerning the perverse consequences of collective ownership can be traced back to Aristotle, many economists have failed to appreciate the depth of the analytical insights that follow from pursuing a property rights approach to social and institutional questions.

Steve Pejovich can take a lot of credit for making the economics profession take notice of the theoretical and empirical power of the property rights paradigm. Beginning with his work on the Yugoslavian system of workers' self-management and continuing with his more recent work on the Soviet reforms, Pejovich has consistently chided fellow economists for not paying enough attention to the consequences of alternative institutional arrangements for economic decisionmaking.

In *The Economics of Property Rights,* Pejovich continues his reconstruction of economic thinking on alternative systems. The book contrasts the operation of capitalism with that of socialism. Pejovich combines theoretical discussion with historical illustrations in a very convincing manner. The book, however, attempts to cover a lot of ground—from the impact of religious thought on economic ideas to the analysis of concrete proposals for reform—in a relatively few pages. As a result, the book is divided into 19 brief chapters, and one is often left wishing that each particular subject was treated in more depth. Nevertheless, the work summarizes and synthesizes several important contributions to economic theory and history.

Part One (chapters 1–3) introduces the reader to the basic notions of scarcity and competition and describes how alternative social institutions arise to cope with the problem of allocating scarce resources among alternative uses. The historical development of capitalism, as well as the intellectual history of socialism, are explored in two brief chapters (2 and 3).

Part Two (chapters 4–9) is devoted to an analysis of capitalism. In this section, Pejovich explains how the institution of private property and free-market pricing mobilizes and signals economic actors to allocate resources efficiently. Chapter 9, in particular, explains neatly the vital role financial markets play in the intertemporal allocation of resources.

Part Three (chapters 10–16) analyzes the Soviet-type economy. Unfortunately, Pejovich does not always fully grasp the radical implications for the Soviet economy suggested by his own work. He repeats many of the historical myths concerning the origin of the Soviet system, the experience of "war communism," and the establishment of the Stalinist system. Even a more fundamental problem, though, is his failure to appreciate the true nature of the Soviet "planned" economy. If socialist planners lack both the information and incentives to rationally plan the economy, then what do they do? On the one hand, they can attempt to plan in the absence of any market signals and can misallocate scarce resources. Or they can substitute political for economic rationales as a criterion for the allocation of resources. The consequences of such a substitution is what Michael Polanyi has called "conspicuous production." Planner's preferences take precedent over consumers. While Pejovich clearly recognizes this, the insights of Polanyi, G. Warren Nutter, Paul Craig Roberts, and Eugene Zaleski concerning the polycentric nature of the Soviet economy could have been conveyed with more power and conviction. Nevertheless, Pejovich correctly sees the Soviet economy as a system of monopoly privileges governed by the *nomenklatura*.

His chapters on the Soviet-type economy, therefore, represent a mixed bag. Chapter 12 on the basic institutions of Soviet planning is not as strong as it could be, but chapters 13, 14, and 15 contain important theoretical and empirical observations about the operation of the Soviet system. Pejovich's most important contribution in these chapters is to force economists to analyze the implications of the fact that "public ownership" is merely a "facade" hiding the fact that the Politburo has traditionally been the true owner of all nonhuman resources in the Soviet economy. Recognition of this fact forces analysts to pay attention to the way the Soviet system actually works, rather than focusing on how the central-planning text-book models say it is supposed to work. Understanding the actual—implicit and de facto—operation of the Soviet economy is a vital prerequisite to understanding the necessary and sufficient conditions of transformation of the system and the pressures that will come to bear on those efforts.

Part Four (chapters 17–19) provides a property rights perspective on the labor-managed economy. These chapters summarize much of the work that made Pejovich and Furubotn famous. As they have pointed out, labor-managed economies tend to favor current consumption over savings, thus retarding capital investment and innovation. Moreover, these economies are biased against employing additional workers since all workers share in their firms' earnings, but new workers did not participate in financing the additional capital. As a result, the high unemployment rate observed in labor-managed economies is a structural result of the institutional design of labor management.

The Economics of Property Rights is recommended reading to all students of economic systems. Pejovich has provided a useful summary of the findings and implications that follow from studying economic decisionmaking under alternative rules of the game.

Peter J. Boettke
New York University

Friedman in China
Milton Friedman
Hong Kong: The Chinese University Press, 1990, 144 pp.

Milton Friedman, Nobel laureate and the intellectual leader of the revival of monetarism, has again attempted to unlock the mystery of money for us in his new book *Friedman in China*. As the title indicates, the book reflects Friedman's thoughts on China on the basis of his knowledge of Western market economies. During his two visits to China in 1980 and 1988, Friedman gave a series of lectures and, on his second visit, met General Secretary Zhao Ziyang. These lectures form the main content of the book. One chapter is devoted to the dialogue between Friedman and the general secretary. Steven Cheung's reminiscences of Friedman's second visit to China are also included in the book.

In the years between Friedman's two visits, China undertook first agricultural reform and then industrial reform. Lands formally owned by communes were divided and leased to households for 50 years. Each household was responsible for its own output. Output in excess of a government-mandated purchase could be sold at free-market prices. The so-called "household responsibility" system soon created a miracle: Food was suddenly abundant in most parts of China, and millions of peasants were released from their lands through the dramatic increase in efficiency. Between 1980 and 1985, agricultural output grew at an annual rate of 8.2 percent, compared to an annual rate of 3 percent between 1952 and 1977. The "surplus labor" released from the countryside was either absorbed by newly formed county and township enterprises or laborers migrated to big cities and coastal areas looking for a better life.

As the wave of economic reform swept to industrial sectors, however, Deng's blueprint for economic reform began to face some real challenges. The "managerial responsibility" system, which was copied from the household responsibility system, was not as successful as its predecessor. After all, managers and workers in a state enterprise are not household members who want to work together to improve their well-being. Besides, according to Marxist doctrines, workers are supposed to be the "owners" and managers are the "servants" of state enterprises. Therefore, the interests of managers and workers may not be the same. As local government officials and enterprise managers were granted limited power in making decisions on production and revenue-sharing, they tended to use the power to benefit themselves. So, the interests of local governments and enterprises also clashed with the interests of the central government. Although industrial output grew at an annual rate of 16.6 percent between 1985 and 1988, the central government revenue, as a percentage of national income, actually decreased by more than 4 percent during the same period.

Moreover, as local government officials and state enterprise managers enjoyed increasing autonomy, they soon realized that it was to their mutual benefit to get more loans from either the central government or the local branches of the People's Bank of China, which is China's central bank. More loans meant more revenue to local governments and a larger share of the nation's economic pie that belonged to nobody. In this sense, China's bank loans have become government grants that represent no risk to state enterprises at all. As total outstanding loans dramatically increased, the People's Bank of China was forced to inject more money to ease the liquidity shortage. Inflation then soared. According to the official consumer price index, inflation was 7 percent in 1986, 9 percent in 1987, and 21 percent in 1988, the time when Friedman was in China.

Although China's central bank recognized that "substantial inflation is always and everywhere a monetary phenomenon," it apparently lacked the ability to control the money supply. Because of public ownership (i.e., both banks and enterprises belonged to the state), money could be created either from the top as the central government demanded more spending or from the bottom as local governments and their subordinated enterprises competed for more loans in an effort to expand their shares of the nation's income. Since the nation's total income did not change overnight, money soon lost value as inflation rose.

Besides the issues of inflation and property ownership, many other thorny issues also began to surface in the process of industrial reform. These issues included, for example, how to use the market mechanism in connection with central planning, how to disentangle the relationship between state-owned banks and state-owned enterprises, whether to pursue economic reform drastically or gradually, and whether to relax exchange rate controls and eliminate the two-tier price system. Friedman has elaborated these issues, not only persuasively and eloquently, but also simply. Therefore, this 144-page book is suitable for anyone interested in economic reforms in either China or other countries trying to make the transition from central planning to a free market.

Three years after Friedman's second visit, China began to loosen control on foreign exchange rates and to allow prices of many commodities to be determined in markets. Stock markets were established in both Shanghai and Shenzhen, and future markets on certain agricultural commodities were emerging in some areas. All these changes indicate that China is again moving solidly toward market-oriented reforms. But these markets are neither "free" nor "private." Furthermore, the central government is again tempted to use the cheap way to lift China's sagging economy—printing money, this time under the sacred name of the Keynesians. By the end of the third quarter of 1990, the money supply was growing at an annual rate of 20 percent, the highest level since the last quarter of 1988, and Chinese officials have attributed the rebound of industrial production in 1991 to their successful effort in "fine tuning" the economy.

Alas, I begin to wonder if the Chinese officials still remember Friedman's advice and whether they know why Friedman is so famous.

Jeffrey Liang
American Enterprise Institute