Editor’s Note: This is an abbreviated version of RF’s conversation with Randall Kroszner. For the full interview, go to our website: www.rich.frb.org/pubs/regionfocus.

The Council of Economic Advisers (CEA), created in 1946, consists of three members who counsel the President on a wide variety of economic issues. The Council’s work is most visible on macroeconomic issues. But its members and their staff also research microeconomic issues, several of which have been prominent of late, including corporate governance reform.

Randall Kroszner, professor of economics at the University of Chicago’s Graduate School of Business, joined the CEA in 2001. Much of his academic work has focused on political economy questions, such as what drives deregulation of select industries. His position on the Council gave him an opportunity to witness the give-and-take of the policy process that he had researched from outside government. His time in Washington also demonstrated why neoclassical economics provides a powerful analytical framework for examining new policy questions, such as those that arose following the terrorist attacks of Sept. 11, 2001.

Kroszner recently left his position at the CEA to return to the University of Chicago, where he edits the Journal of Law & Economics. He has been a visiting scholar at the Federal Reserve Board of Governors, the International Monetary Fund, and the U.S. Securities and Exchange Commission. Aaron Steelman interviewed Kroszner at the Cato Institute in Washington, D.C., on Sept. 23, 2003.

RF: Much of your work has focused on political economy questions. Did your time at the CEA affect your view of the policymaking process?

Kroszner: It was interesting to be lobbied by various interest groups. I had written about lobbying, but I actually got to be a participant in the process, perhaps even becoming a data point for one of my future papers. Virtually everyone couches their private interest in a public interest rationale. I don’t think that’s anything new or surprising. But it’s interesting the way that everybody is obligated to talk about the broader good. And what’s also very interesting is that I think most people really do believe that. If you gave most of these lobbyists a lie-detector test, they would pass. They really do believe what they are telling you, even if as an economist I would say that what they are arguing for would benefit only a very narrow group. In addition, most of them were quite reasonable about accepting and trying to answer the questions I would pose. No one would just come in and say, “Support this or lose our vote.” That’s not how these things operate. They always try to give substantive reasons for their positions.

When you spend much of your career working in a certain industry, you begin to see more nuances, you are more willing to give the benefit of the doubt to arguments that to an outsider might seem questionable. That may be why you find so many people who, in general, are free-market advocates but when it comes to their industry, they are willing to say we need this regulation or barrier. And in some cases they may be right—there may, in fact, be a market failure. But the real question is: Should the government take action? I don’t believe that markets work perfectly all the time. Virtually all markets are imperfect in some way. But what is the relevant alternative? The alternative can be much, much worse. I am a great believer in the power and importance of free markets for advancing human good. But it’s not because those markets work perfectly—it’s because I can’t think of a better alternative.

RF: What role do you think the CEA can play in formulating economic policy?

Kroszner: I think the tradition at the CEA basically has been to prevent bad policies from being implemented. Often proposals can sound great and very creative, but economists have a frame-
work to look at them and explain their unintended consequences.

In addition to trying to stamp out bad policies, we also tried to promote good policies. For instance, many of the tax changes—particularly the tax cuts on capital—were things economists had been talking about for decades. There wasn’t a big constituency for such proposals, but we said this is the right thing to do if you want to get the most bang for the buck. The President understood this well and did a good job of presenting it to the public.

In a crisis situation, you really get to see the power of economics—especially in Washington, where most people derive their power from having knowledge of the institutions. That was no longer very useful after Sept. 11, because we were in a different world. No one had dealt with the type of issues we needed to deal with after such an astonishing terrorist attack. Do we need something like terrorism-risk insurance? Do we need some sort of support for the airline industry? As economists, we could say, “We understand that demand curves slope down. We understand that there are opportunity costs. We understand people’s incentives.” That was very important, because we could bring that framework to a new situation and describe what’s most likely to happen under a variety of different scenarios. In contrast, people who just had knowledge of the institutions didn’t have that, because they had no framework. And since the institutions had changed and their applications were going to be very different in a post-Sept. 11 world, economists got the upper hand and had much more influence. It’s really nice to see the power of economics to explain the situation and be very useful as a tool for policy development.

RF: There was some expansion of the federal financial safety net following Sept. 11, 2001—terrorism-risk insurance, for instance. What were the major issues of debate and what do you think of the legislation that actually emerged?

Kroszner: There was great concern immediately following Sept. 11 that the insurance markets were not going to be able to accommodate these new risks quickly. I think we all believed that, eventually, the markets would be able to adjust, but it would take a little time to figure out the calculation of risk and understand what appropriate pricing for that would be. Also, with more time, you have more data. With each passing day without a terrorist event, you now have better information about the likelihood of an event. Still, in the immediate aftermath of Sept. 11, many people believed that this was going to be a real problem for property markets—to be able to go ahead with projects that were underway or even for existing buildings. So the policy question was: Should there be some sort of role for the federal government in providing a backstop with terrorism-risk insurance? We argued that there potentially could be a temporary role the government could play. With that in mind, we thought about how to structure a program that would, in fact, be temporary and not with us forever, like so many other “temporary” government programs. We designed a multiyear program that increased private-sector risk-sharing over time, so that the proportion of losses that the government would cover would decline over time. The objective was to build private-sector capacity so that the government could eventually exit. When many temporary programs are set to expire, people say, “We can’t let that expire. The private sector can’t pick up the slack.” Well, of course it can’t, because the
government has been handling the problem completely and given the private sector no incentive to get involved. We wanted to avoid that trap.

There had been a concern among economists that we weren't charging explicit prices. It certainly would be natural to do that. But the problem was, if we know how to price it, then the private markets could easily do so and there would be no reason for the government to be involved in the first place. Also, I think there is an important lesson here about bringing economics into practice in Washington. If you were to collect premiums over the life of the program, you would have to set up a bureaucracy in order to process those premiums and then there would be discussions of what to do with that money. At the conclusion of the program, you have the bureaucratic infrastructure and a source of revenue in place, and I think it becomes much more difficult to exit from the program. And since we thought it was crucially important to make sure the program is temporary, we thought it would be better to avoid this possible problem.

At first blush, of course, the simple economic solution is always to charge for a good or service that you are providing. But you then have to think about the institutions and filter it through the political economy of Washington. Did we believe that the taxpayer will be better off by not charging a premium today but increasing the likelihood of eliminating this program and allowing the private sector to take over the risks? I thought the answer was yes, and we were able to convince the President of this. It was quite fun to see the usefulness of political economy—an area I had worked on quite a bit—in practice. It is not a deviation from the fundamentals of economics. Certainly, the first step is to always think about using the price system. But the second step is determining whether there is an additional cost in the government context that is not there in the private sector context.

RF: What do you think were the root causes of the recent corporate governance scandals? And how well do you think the Sarbanes-Oxley Act will address them?

Kroszner: When looking at the reasons for the corporate governance scandals, people focus a lot on expertise and the role of independent directors. But there is very little evidence in the case of Enron, for example, that it was a lack of expertise or independence that caused that firm's difficulties. It's similar to Glass-Steagall in a sense: People had a theory about the source of the problem and how to solve it, but they left a lot of pieces out. For example, there has been very little focus on the role of institutional investors. Where were the pension funds who owned 2 percent or 3 percent of these firms' stock? Why weren't they looking at the management practices and asking questions? I think part of the reason is there were a lot of other regulatory rules that discouraged active involvement by institutional investors. We should have been looking at those types of issues right from the start.

It's much too early to tell what the consequences of Sarbanes-Oxley are. I hear everything from it's just a minor cost, all the way to it's the death of the corporation. I think the answer is somewhere in between.

I should point out, though, that one of the big benefits of the way Sarbanes-Oxley was written is that most of the changes have to be implemented by the Securities and Exchange Commission (SEC). So where things may have gone a bit too far, the SEC has generally done a good job of trying to implement changes as reasonably as possible. For instance, the Sarbanes-Oxley definition of a financial “expert” would have permitted extremely few people to qualify. The SEC took a broader view of that, which made the law more sensible. I don't think that Congress had intended to make the definition so narrow originally, but in the desire to do something quickly it acted hastily.

One of the projects that I’m now starting on with Phil Strahan is to try to document how boards of directors have changed since 2000 and really understand both the private market responses to the scandals and also the responses that have been driven by Sarbanes-Oxley. This is an example of an issue that I worked on in Washington, where we had our theories of what the consequences would be from a regulatory change, and now coming back to academia I will have the time to actually look at the evidence.

RF: For most of American history, the Democratic Party was known as the free-trade party, while the Republicans tended to favor protectionism. Since the 1940s, though, those roles have largely shifted. What do you think accounts for the change?
Kroszner: The Reciprocal Trade Agreements Act (RTAA) of 1934 fundamentally transformed both the process and outcome of U.S. trade policy: Congress delegated much of its authority over tariff-setting to the President—a precursor of more recent “fast-track” and “trade promotion authority” legislation—and explicitly linked reductions of tariffs abroad with reductions of tariffs at home. This was the start of a sharp move towards trade liberalization. The durability of this change in the post-war United States was achieved only when the Republicans, long-time supporters of high tariffs who originally vowed to repeal the RTAA, began to support this Democratic initiative in the 1940s. The key to the shift was the institutional structure of the RTAA itself, which increased the incentives for exporters to organize and lobby in favor of trade liberalization, as well as the increase in foreign trade following World War II.

An important lesson from this episode is that the organization and strength of interest groups are not simply given but are shaped by incentives embodied in the laws and regulations governing different areas of economic activity. Policymakers should take this type of response into account when structuring or restructing any type of economic policy, not just in the trade arena.

RF: As editor of the *Journal of Law & Economics*, are you concerned about the state of academic publishing?

Kroszner: The typical trajectory for an academic is to have a large stream of papers coming out, say, three or four years after your first academic appointment, and then after you have tenure you turn to doing more book chapters and other things that don't require being bothered by referees. One of the major reasons that people don't want to submit papers to journals is the referee process. The judgments that the referees make are often seen as arbitrary and not particularly thoughtful. I think part of that is because the referees don't have much of a stake in what they are doing. Their comments are anonymous and they typically aren't compensated. So at the *Journal of Law & Economics* we pay referees for their work. I'm not sure that is the best way to handle the process. I have often thought that a Board of Editors, who would take responsibility for the decisions and not hide behind the referees, would act much more responsibly.

Also, at the *Journal of Law & Economics* I reject about one-third of manuscripts out of hand, and I think that saves everyone time and effort. In those cases, I try to get back to people very quickly and suggest an alternative venue. For instance, some of the papers we receive would be much more appropriate for a law journal. There is no point in wasting referees’ time by sending those papers out for comment. But the question of how you get a better review process is very important for people involved with scholarly journals.

In scholarly publishing, there also is a very big tradeoff: You can either say nothing precisely or precisely nothing. And, unfortunately, there is a lot of emphasis on precision and getting absolutely everything right. Getting things right is important. But sometimes people forget about trying to answer important questions and taking a look at the bigger picture.

At the *Journal of Law & Economics*, we have tried to take more chances on interesting papers that may be a bit out of the mainstream, because they are attempting to tackle big issues and are not simply making very incremental contributions to the literature. Unfortunately, it's often hard to find those types of papers. People aren't willing to take chances, because the profession places so much emphasis on precision, often at the expense of originality. At many schools, publishing four or five papers that discuss minor questions will be enough to get tenure. But you really have to take risks to move the discipline ahead. It will generate a lot more research to be wrong in an interesting way than to be right in a boring way.

RF: Which economists have influenced you the most?

Kroszner: In terms of people's writings, I think Hayek was the greatest influence. He had a very broad perspective and thought very much about the fundamentals of equilibrium concepts in economics. Another person whose work has been of great influence and whom I have met a number of times is Milton Friedman. He made extremely important contributions to economic science and also had a very good sense of how to bring economics to bear on important practical questions. That is very much the Chicago tradition. Economics is not just a set of analytical tools—economics is a way for us to understand how people behave. It’s a framework for looking at behavior individually, in the family, in the firm, and in politics.