



# PolicyMatters

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# VICTIMS NOT CRIMINALS:

## RESPONDING TO COMMERCIAL SEXUAL EXPLOITATION OF CHILDREN IN ALAMEDA COUNTY

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EDITED BY CATHERINE MERESAK, IGNACIO CAMACHO, ALLISON DOMICONE, AND SUZANNE MERKELSON

Every night, there are fifty to one hundred commercially sexually exploited children (CSEC) on Oakland's streets, representing a significant, deeply rooted human rights issue in Alameda County. When identified by the police, these girls are arrested, detained, and prosecuted, a punitive move that necessitates closer examination and change. In this paper, I examine CSEC's current pathways through the juvenile justice system and envision a child welfare alternative that represents their unique set of needs. To truly support these girls, it is necessary to radically change legal protocol and respond to the sexual exploitation of children from the child welfare system, rather than the criminal justice system.

### INTRODUCTION

The commercial sexual exploitation of children is a pervasive issue in Alameda County. The FBI has designated the Bay Area as one of the nation's thirteen "high intensity" areas for child trafficking, with Alameda County a particular hotspot for sexual exploitation.<sup>1</sup> In Alameda County, 267 cases were identified between January 2011 and December 2012.<sup>2</sup>

Social services and legal responses are administered on the county level. In Alameda County, the Adult Division District Attorney is spearheading efforts to address the issue. While social services are increasingly directed to support commercially sexually exploited children, legal responses fail to address complex accompanying health and psychosocial problems and may even exacerbate these problems. Commercially sexually exploited children (CSEC) are often arrested, detained, and prosecuted for sex crimes. They can be held in detention at the Juvenile Justice Center for days and months upon their arrests, which can add unnecessary trauma upon already severe trauma histories. Most CSEC leave the Juvenile Justice Center with criminal records, starting or continuing long trajectories of involvement with the juvenile delinquency system. Sixty percent of young women arrested for solicitation are at some point re-arrested.<sup>3</sup>

The Alameda County District Attorney's initiative, H.E.A.T. (Human Exploitation and Trafficking) Watch, focuses on aggressive prosecution of pimps, community education, and training of social services and law enforcement.<sup>4</sup> However, discussions that explicitly recognize that CSEC are arrested, detained, and prosecuted are on the periphery of the dominant political discourse in Alameda County. Alameda County should reform the current system so that CSEC do not become enmeshed in the criminal justice system, and instead enter a reworked child welfare system.

Written from the perspective of a social worker, this article traces the current trajectory of girls through the juvenile delinquency system. As 99 percent of all CSEC are girls, policy responses largely focus on addressing their needs.<sup>5</sup> As a critique of current policies, this paper focuses on the issue as it pertains to girls, though future policy work should address the needs of boys as well. The paper details another path through a reworked child dependency system—a path on which girls are not arrested for their abuse and instead, are offered resources to address their specific needs. The goal of this paper is to provide an alternative discourse and begin the process of imagining a system that adequately supports CSEC.

## PATHWAYS THROUGH THE JUVENILE DELINQUENCY SYSTEM

### THE PROCESS OF EXPLOITATION

Children are vulnerable to exploitation for a litany of reasons. Victims of trauma are particularly at risk of future trauma and sexual exploitation.<sup>6</sup> In a study of CSEC in Alameda County that draws upon the experiences of 113 girls, the majority (75 percent) have experienced prior, ongoing victimization, including neglect, emotional abuse, sexual abuse, physical abuse, family violence, and community violence, all of which can normalize exploitation.<sup>7</sup> Trauma can lead to risk-taking behavior, struggles with mood regulation, disruption in caregiving relationships, lack of supervision, and social isolation.<sup>8</sup> Poverty and homelessness also play a part—84 percent of CSEC in Alameda County are runaways, many of whom are fleeing abusive or neglectful living situations.<sup>9</sup>

Pimps can seemingly play a role of emotional or economic support that masks exploitation, emotionally manipulating girls to believe they are in caring, supportive relationships. Many CSEC call their pimps “boyfriends,” while other CSEC are pimped by their own families or other girls. Pimps actively recruit girls at group homes, at schools in impoverished neighborhoods, through other CSEC, and with the use of drugs.

Sixty percent of CSEC surveyed in one study were recruited before the age of 14.<sup>10</sup> The average age of exploitation is decreasing as pimps increasingly recruit from middle schools and younger populations, with girls as young as 10 recruited.<sup>11</sup>

### THE JUVENILE DELINQUENCY PROCESS

The response to CSEC is currently punitive, beginning with an arrest that draws girls into the juvenile delinquency system. Police officers usually arrest these girls while on patrol, although girls are occasionally arrested on intentional sting operations as well. Throughout the criminal justice process, a variety of officials—including the arresting officer, members of the District Attorney’s Office, and the judge—have the discretion to release the girls.

Following a first arrest, many girls get caught in a cycle of probation violations and re-arrests. Often, they are released to a family member with an ankle monitor, only to fall back under the sway of their pimps, run away from home, and cut off their ankle monitor. Police may

### QUICK FACTS:

## DEMOGRAPHICS

99% of all CSEC are girls.<sup>34</sup>

53% have lived in a group home at some point in their lives.<sup>35</sup>

82% are young women of color.<sup>36</sup>

re-arrest CSEC for prostitution, probation violations, or other charges, like theft or assault.

Alameda County is taking some positive steps to address child trafficking, including the formation of Girls Court. Girls Court is designed for the most at-risk young women, including CSEC, with the goal of providing a gender-responsive alternative to the traditional juvenile justice system. Here, the judge frequently lowers the original charges, and the girls are connected with social services. However, even within this configuration, CSEC are still arrested, detained, and prosecuted. In an ideal system, sensitive to the needs of CSEC, these three things would not take place.

### SOCIAL SERVICES THROUGHOUT THE JUVENILE DELINQUENCY PROCESS

From arrest to post-release, several social services in Alameda County provide support to CSEC. For example, an advocate from BAWAR (Bay Area Women Against Rape) provides on-the-scene support to girls as they are arrested. When in detention, the girls also have access to the Alameda County Behavioral Health Care Services outpost in juvenile hall, the Guidance Clinic. After release, CSEC continue to have services available, including SafetyNet meetings among representatives from the Juvenile Division of the D.A., the Public Defender’s office, community-based organizations, hospitals, probation, and the Guidance Clinic. Together, these organizations provide legal and residential aid, as well as access to public assistance, mental health services, and advocacy both within and outside of the courts.<sup>12</sup>

### EVALUATING THE CURRENT SYSTEM

Treating CSEC as criminals does not help them get off the streets or away from pimps. Both research and anecdotal evidence show that many barriers exist for girls getting off the streets and away from exploiters. The current system does not address these barriers. Some CSEC have not made a commitment to extricate themselves due

to emotional manipulation, shame, need for material resources (e.g., money and shelter), and fear of physical abuse or retaliation by the pimp.<sup>13</sup> Housing instability also contributes to vulnerability and re-exploitation; turmoil at a family or group home often drives girls back into the hands of their exploiters, especially when the pimps are actively seeking them out.<sup>14</sup> These factors also keep CSEC entrapped in the criminal justice system.

## QUICK FACTS:

PSYCHOLOGICAL AND HEALTH-RELATED NEEDS OF  
COMMERCIALLY SEXUALLY EXPLOITED CHILDREN

**More than 8 of 10 are runaways.**<sup>37</sup> Many of these girls have prior histories of **victimization**, have experiences of **substance abuse**, and are dealing with **mental health** challenges.<sup>38</sup> They have specific reproductive health issues concerning **sexually transmitted infections (STIs)**, **unplanned pregnancy**, and often need treatment for **injuries stemming from physical abuse**.<sup>39</sup> Exploitation involves deep emotional **manipulation and abuse**.<sup>40</sup>

According to the WestCoast Children's Clinic data, one quarter of CSEC display trauma-bonding with their exploiter, and 11 percent actively protect their exploiters from legal repercussions.<sup>15</sup> CSEC are often resistant to offer the names of their pimps or press charges once detained in juvenile hall. Girls cycle through levels of commitment to change, where extrication is not a linear process.<sup>16</sup> They may recognize their exploitation and express desire to leave their pimps, only to be re-arrested a month later for alleged prostitution.

Viewed in terms of re-arrest rates, the situation is bleak. As previously mentioned, 60 percent of young women arrested for solicitation are at some point re-arrested,<sup>17</sup> compared to 45 percent of all young people who have received court-ordered probation in Alameda County.<sup>18</sup>

The current system fails to get girls out of the cycle of exploitation and re-arrest. It is imperative to create systems that honor CSEC's emotional and material realities. We should take a closer look at how we can support CSEC through the use of the child dependency system.

## CURRENT ALTERNATIVE MODELS

Across the country, social workers and law enforcement professionals realize that the current system needs fixing.

The legal system and child welfare system can both be entry points for considering how to better work with these children, rather than against them.

## ALTERNATIVE MODELS: LEGAL SYSTEMS

The diversion model connects CSEC who have been arrested and detained with the child welfare system or other similar services before or after adjudication.<sup>19</sup> Several states, including Washington, mandate diversion for first time prostitution-related offenses.<sup>20</sup> While some states will drop charges if a girl is explicitly being coerced,<sup>21</sup> the burden of proof varies as to whether it falls on the prosecution or defense.<sup>22</sup>

Other systems give CSEC immunity from prosecution, though they can still be detained in facilities varying according to the girl's age.<sup>23</sup> In Tennessee, girls are released upon being identified as CSEC and given an emergency hotline.<sup>24</sup> Other states, like Illinois, usually hold CSEC in temporary protective custody, such as foster homes, mental health facilities, or hospitals.<sup>25</sup> Despite the increased sensitivity provided by these methods, CSEC can still be arrested or detained in a locked facility.

The idea of decriminalization is also put forth as an alternative. However, the term is not clearly defined and has been used to represent many permutations of the policies mentioned above. I have intentionally avoided using the term in order to highlight the operative issue: CSEC should not be arrested, detained, or prosecuted.

## ALTERNATIVE MODELS: CHILD WELFARE SYSTEM

Advocates have challenged the ban in federal court on Other models focus on collaborations between the child welfare system and juvenile courts. Across the United States, states are increasing funding for services for CSEC and modifying laws to better identify and serve them. Connecticut, Florida, Illinois, and Oregon have made child trafficking an element of mandated reporting guidelines, a departure from the status quo in other states.<sup>26</sup> In Connecticut, child welfare workers screen every child who comes across the system for commercial sexual exploitation.<sup>27</sup> This is a good first step toward a responsive system.

Additionally, some state governments have increased funding for specialized placement options for youth, offering training to transitional-housing staff and foster-care providers to educate them on the specialized needs of CSEC. However, in most cases, state and county systems lack culturally competent and sensitive placement options for these girls.<sup>28</sup>

States and counties are implementing systems to carefully

## COMMERCIAL SEXUAL EXPLOITATION OF CHILDREN IN ALAMEDA COUNTY

coordinate service delivery and data tracking, including efforts to collect and share data on CSEC between the juvenile justice system and child welfare system. Alameda County is beginning to use this model at SafetyNet meetings, the multidisciplinary case review meetings organized by the District Attorney. This works toward adequate coordination among the services available to support CSEC, but it is not sufficient.

### CHANGES IN ALAMEDA COUNTY

Alameda County needs to critically consider other states' experiments with different legal responses and service delivery options for CSEC. In order to truly support these girls, Alameda County should not arrest, detain, or prosecute them. Additionally, these legal changes should be made in tandem with alterations in the child dependency system.

### LEGAL RESPONSES TO CSEC IN ALAMEDA COUNTY

As described above, Alameda County's legal response to CSEC is largely punitive, with girls getting drawn into

*A minor may be subject to juvenile dependency court if the minor is a victim of human trafficking, or was paid to perform sexual acts, or if the minor has solicited, agreed to engage in, or engaged in an act of prostitution.*

*The juvenile dependency court will place the juvenile victim with a specialized program for victims of human trafficking, or if none is available, foster care.<sup>32</sup>*

the juvenile justice system and amassing criminal records. Even if we look to the dominant reform models described above, they still incorporate arrest and punitive elements, causing further trauma.

There are alternatives to arrest and detention on a legal level. Multnomah County, Oregon is pioneering a radical new approach. The police, working closely with child welfare and the Sexual Assault Resource Center, a community-based organization, do not arrest CSEC.<sup>29</sup> Instead, CSEC are connected with clinicians and advocates through referrals from the police, families, CSEC themselves, the Department of Human Services, and community organizations.<sup>30</sup> They provide trauma-informed care and work with girls to create safety plans.<sup>31</sup>

The commitment to collaboration already in place in Alameda County, the District Attorney's H.E.A.T.

(Human Exploitation And Trafficking) Watch, is promising for future efforts. Community-based organizations, Social Services, the District Attorney, Public Defender, law enforcement, and Probation are working to coordinate a response sexual exploitation. Taking these steps further to stop arrests of CSEC in Alameda County would require continued collaboration among these players. To encourage them to do so, we must increase public awareness around the current punitive system, combining with political advocacy of front-line providers and supporters within the legal system.

### CURRENT MOVES

State Senator Leland Yee has drafted a bill proposing changes to the legal response to CSEC that incorporates the child dependency system. As described by the Coalition to Abolish Slavery and Trafficking, this bill states:

The bill calls for the California Health and Human Services Agency to develop a protocol regarding care in the community, as well as stressing that secure, locked placements like detention should be used as a last resort.

While this bill represents a move away from arresting, detaining, and prosecuting CSEC, it is not sufficiently defined. No language in the bill defines how to identify CSEC, leaving girls to be arrested and detained if a judge or the District Attorney does not quickly identify them.

Additionally, the language on the diversion of CSEC is conditional, leaving room for treating detained girls as criminals. This occurs in several states; diversion and immunity are restricted to those with first-time offenses or those under a certain age. Such exclusions should be eliminated to ensure support for CSEC.

### ENVISIONING CSEC IN A NEW CHILD WELFARE SYSTEM

The juvenile justice system is not effectively supporting CSEC, deepening trauma and leading to a cycle of probation violations and re-arrest. Doing so would require implementing child dependency programs to replace the current punitive structure. The current child welfare system is not yet equipped to subsume responsibility for commercial sexual exploitation of children, though with some major changes, it could do so in the future. I describe a new child welfare system that can address these issues in detail below.

Instead of arresting CSEC, police officers should identify

the girl on the scene and call a trained advocate from either a community-based organization or the county to confirm identification. Police involvement should be minimal, as their presence can send the message to CSEC that they have committed a crime.

The trained advocate and first responder should then bring CSEC to the Alameda County Child Assessment Center, a confidential location where advocates can take children who are removed from homes due to abuse or neglect. At the Assessment Center, a trained clinician would assess the CSEC using a Screening, Stabilization, and Transition technique.

This clinician is an important part of the new system. The clinician should be trained in issues facing CSEC and remain culturally competent, nonjudgmental, and supportive. It is important that the clinician develops a positive relationship with the girl that will make her more likely to access social services when needed. The clinician should be familiar with available community resources to introduce them to girls in an accessible way. The clinician should also provide the girls with education on commercial sexual exploitation, discussing potential vulnerabilities, safety plans, and troubleshoot challenges.

Once educated, the Assessment Center should orient and explicitly connect CSECs to available social services. For example, the Assessment Center could assign each a girl to a therapist and case manager to provide direct linkages and support.

To make this system work, Alameda County would need a safe house for CSEC. The safe house would provide a trained staff available to CSEC if they run away from either an exploiter or their foster home. As so many CSEC run away, it is crucial to have a place for them to go so they have another choice besides their exploiters.

This process should be informed by the understanding that it can take CSEC many attempts to leave their exploiters and that progress is not linear. Providers must be nonjudgmental and sensitive to relapses and recidivism, as both will invariably happen. CSEC must know that there are services available and that they can access them on their own terms. As such, there can be no detention during this process. Rather, a girl must take ownership over the process. Supportive environments must encourage her agency and self-determination, both of which are stripped from her during exploitation.

A successful system must hold itself accountable. Ideally, data should be collected on engagement with social services, stability of housing, engagement in risk-taking behavior, any type of re-arrests (for charges other than prostitution), employment status, school engagement, extracurricular involvement, and reported sexual exploitation. This data gives the system the basis for self-assessment.

## POTENTIAL CHALLENGES

SB 1029 is not a panacea. It does little to address fundamental issues of poverty, hunger, and criminal justice. It will take a fundamental shift in American attitudes about these issues to even consider policy proposals that change those systems. That sounds perhaps more difficult than it is; half the battle is being able to define the “problems.” In the past, the list of urgent problems demanding policy attention included rampant crime, drug use, and welfare dependency. Though those are still salient issues for a portion of the electorate, our idea of what deserves public attention and public resources has changed. Conversations around income inequality and ending the now-50-year War on Drugs have become more common and more nuanced in just the last three years.

The relatively high cost of living in California means many of our neighbors struggle to afford enough food. Yet Californians are often surprised to learn that no other state does worse at ensuring its residents have access to a program designed specifically to alleviate this condition. I argue that the lifetime ban on SNAP for California drug felons represents a missed opportunity to increase food security and invest in our communities economically.

Unexpected allies have come aboard. Elderly soup kitchen volunteers, saddened by seeing the same faces in line for what used to be called “emergency food” for weeks on end, have joined forces with probation officers tired of repeatedly locking up the same people. Uniting their vastly different perspectives can show the public nothing is gained from the ban. In fact, talking and thinking about the ban may help us raise fundamental questions about these broken systems.

It does not serve us, fiscally and morally, to punish children for their parents’ crimes. Nor is it fair to punish certain offenders decades after they have passed through a system called “corrections.” Should sufficient access to food be considered something less than a human right?

CONCLUSION

Given the current punitive legal response to CSEC in Alameda County, major changes featuring alternatives to arrest and detention are necessary. Crafted from the child welfare system, these alternatives can honor these girls' agency, ending abuse and empowering them to be active advocates for themselves. Respecting CSEC's rights and agency without detainment allows girls to make meaningful changes in their own lives.

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# THE RULING EIGHT PERCENT: HOW REPUBLICAN PRIMARY VOTERS CONTROL CONGRESS

DAVID JONAS

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## INTRODUCTION

On January 25, 2013, Republican Senator Saxby Chambliss of Georgia announced that he would retire at the end of his term, which expires in 2014. The announcement caught many Georgians by surprise. Senator Chambliss was only in his second term and was a heavy favorite against any Democratic opponent. He had earned one hundred percent scores from the National Rifle Association, the National Right-to-Life Committee, Americans for Tax Reform, and a slew of other typically conservative causes. These political viewpoints fall largely in line with the ideological leanings of the majority of Georgia voters as the Republican Party generally performs six points better than Democrats in a Presidential election.<sup>1</sup>

So why would Senator Chambliss retire from one of the most coveted positions in American politics when the odds were so dramatically in his favor? As he told the Washington Post: <sup>2</sup>

(T)his is about frustration, both at a lack of leadership from the White House and at the dearth of meaningful action from Congress, especially on issues that are the foundation of our nation's economic health... The debt-ceiling debacle of 2011 and the recent fiscal-cliff vote showed Congress at its worst and, sadly, I don't see the legislative gridlock and partisan posturing improving anytime soon.<sup>3</sup>

While Senator Chambliss cited frustration with gridlock as his motivation, there is another, more likely, reason for his withdrawal: the threat of a primary battle.

Since the inauguration of President Barack Obama in 2009, the ideology of voters who participate in Republican primaries has changed dramatically. In states where they once sailed to re-election without fear of primary challenge, Republican congressional incumbents must now defend themselves against challenges from more conservative, grassroots-oriented candidates. As a result, America now has a Congress that, to appease the political preferences of those primary voters, shuns compromise notwithstanding the consequences.

Senator Chambliss likely recognized these developments in his base in Georgia. Less than two months before he announced his retirement, Public Policy Polling released a poll suggesting Senator Chambliss was "vulnerable in a primary." When potential primary voters were asked whether they would support Senator Chambliss over Herman Cain, the former CEO of Godfather's Pizza and 2012 presidential candidate, primary voters favored Cain over Chambliss fifty percent

to thirty-six percent.<sup>4</sup> In the same poll, a plurality of voters (forty-three percent) said they wanted a Senate nominee more conservative than Senator Chambliss.

What had Senator Chambliss done to deserve a plurality of disapproval among what should have been his most loyal base of voters? As ABC News reported shortly after his announcement: <sup>5</sup>

During the recent standoff over the fiscal cliff, he famously was one of the few Republicans who spoke publicly about believing that his hands were not tied by anti-tax crusader Grover Norquist tax pledge. ...

'It's unacceptable to have somebody who votes with the Democrats more than they do with the conservatives, and he has proven time and time again he is all about the spending,' [Tea Party Express Chair Amy] Kremer told CNN earlier this month. 'We're a red state, we deserve a conservative senator.'

Amy Kremer's assertion about Senator Chambliss's voting record is factually incorrect. A Washington Post analysis from 2011 and 2012 found that Senator Chambliss voted with his party ninety one percent of the time.<sup>6</sup> Yet Kremer's comment illuminates the way in which Senator Chambliss alienated his base in Georgia.

Much of this alienation arose from a compromise Senator Chambliss made with Senate Democrats over the fiscal cliff. The fiscal cliff was a political crisis stemming from the expiration of the Bush tax cuts and a host of other tax breaks for individuals and businesses, as well as the onset of the "sequestration" spending cuts from the 2011 Budget Control Act, which would have dramatically reduced agency budgets. The fiscal cliff created a circumstance that forced Republicans to offer concessions to Democrats because an absence of legislative action would have resulted in substantially higher taxes for nearly all Americans. Senator Chambliss and many other Republican senators publicly stated they needed to compromise with Democrats to ensure that if taxes did rise, their increases would be as limited as possible.

Senator Chambliss's experience is no longer an isolated one. The real cause of Congressional dysfunction is not merely a failure of moderates to compromise, but a triumph of electoral politics by a swath of voters who are actively opposed to compromise and moderation.

Republican primary voters comprise roughly eight percent of



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voting-age Americans,<sup>7</sup> but they have been able to leverage their relatively small numbers to dramatically reshape how Congress functions. These eight percent of voters have successfully shaped today's Congressional climate: it is now a place where compromise is practically unachievable.

Nearly every policy battle since the 2010 midterm elections has proceeded on the eight percent's terms. When incumbent Republicans defied their preferences, the eight percent have mobilized to punish those incumbents. Their ability to control the contours of Congress is not unprecedented. It is another example of how a small band of voters can leverage America's system of separated powers and representational government to override the wishes of the majority of voters.

America, meet the ruling eight percent, the nation's most powerful band of voters their size today.

### MY BASE, MY ENEMY

To understand the depth of the political power Republican primary voters hold in America, one need only examine the incentives facing modern-day congressional Republicans. While Democrats do face similar incentives, the political preferences of Democratic primary voters include more compromise and moderation.

In the Senate, gridlock has reached historic levels.<sup>8</sup> The minority's use of the filibuster—a procedural rule that requires sixty votes out of one hundred to end debate and move forward on almost all legislation—is supposed to encourage compromise, but it has instead reinforced these dynamics.<sup>9</sup> While many political observers view increased partisanship,<sup>10</sup> spending,<sup>11</sup> and a polarized media<sup>12</sup> as causes of gridlock, the root causes are the motivations of the average Republican Senator.

Consider this: of the forty-five current Republican senators, only ten represent states that President Obama won in the 2012 election, an election that saw impressive Democratic turnout compared with previous cycles. The other thirty-five face little risk of defeat from outside their party.

The prospect of being outflanked by a more right-leaning candidate in a primary election is the greatest threat facing the vast majority of Republican senators. Recall the fates of former Senator Bob Bennett of Utah (who voters booted out in 2010), former Senator Richard Lugar of Indiana (who lost a primary in 2012), and current Senator Lisa Murkowski (who survived a primary loss by winning a general election as a write-in candidate) to see the trend influencing political outcomes.

Today, that trend is more pronounced. Republican Senators Thad Cochran of Mississippi, Mike Enzi of Wyoming, Lamar Alexander of Tennessee, Lindsay Graham of South Carolina, and Mitch McConnell of Kentucky each face primary challenges in 2014. All of these challengers are claiming that

### REPUBLICAN SENATORS CHALLENGED FROM THE RIGHT

2014	Thad Cochran (MS)	Primary challenge
	Mike Enzi (WY)	Primary challenge
	Lamar Alexander (TN)	Primary challenge
	Lindsay Graham (SC)	Primary challenge
	Mitch McConnell (KY)	Primary challenge
2012	Richard Lugar (IN)	Lost primary
2010	Bob Bennett (UT)	Lost primary
	Lisa Murkowski (AK)	Lost primary, won general as write-in

### DEMOCRATIC SENATORS FACING SERIOUS PRIMARY CHALLENGES

2010	Arlen Specter (PA)	Lost primary after switching parties
2008	Frank Lautenberg (NJ)	Won primary
2006	Joe Lieberman (CT)	Lost primary, won general as independent

these incumbents are not sufficiently conservative. Nearly half of the fourteen Republican Senators up for reelection in 2014 will face or have already faced a serious primary challenge.<sup>13</sup>

Democratic Senators, by contrast, have twenty seats to defend in 2014, and only one of their incumbents has faced a primary challenge this election cycle: the late Frank Lautenberg of New Jersey, who faced a challenge by Cory Booker shortly before his death. The past few election cycles show only few instances of Democrats seriously challenging other Democrats. In 2006 Senator Joe Lieberman of Connecticut lost to the more-liberal Ned Lamont but won the general election as an independent. In 2010 Senator Blanche Lincoln of Arkansas survived an intra-party contest but lost in the general election. Also in 2010 the late Senator Arlen Specter lost the Democratic nomination to Joe Sestak, but Specter had recently switched to the Democratic Party from being a Republican, which made it hardly surprising that Democratic voters went with another candidate.

The ruling eight percent has had a more important effect on politics than merely on the number of serious challengers. That has been their effect on sitting senators. Senators normally inclined to support compromise on legislation have instead filibustered it. When facing a 2011 primary fight, former Senator Olympia Snowe filibustered a bill she co-authored, a reauthorization of the Small Business Innovation Research program.<sup>14</sup> In 2012, Senator Orrin Hatch abandoned his positions on healthcare, immigration, and tax reform, and

routinely took to the Senate floor to publicly embrace more conservative positions.<sup>15</sup>

While most Democratic senators moderate their stances as an election approaches in order to win over general election voters, Republican senators now act even more conservatively when up for reelection, driven by the incentive to avoid alienating the Republican primary voters they depend on rather than appealing to a broader base.<sup>16</sup>

In the House of Representatives, the incentives to placate Republican primary voters are even stronger. Of the 233 Republican House members, only sixteen are in toss-up or lean-Republican races, according to Larry Sabato's often cited Crystal Ball at the University of Virginia.<sup>17</sup> Even the October 2013 government shutdown and debt ceiling showdown are unlikely to place enough House Republican seats into play to threaten their majority.<sup>18</sup>

How did this happen? During the 2010 midterm elections, Republicans took control of an astounding nineteen previously Democratic state legislatures.<sup>19</sup> The timing was crucial: these new legislatures were responsible for redrawing congressional districts following the 2010 census. Their victories led to a successful gerrymandering campaign that shored up the sixty-three Republican House seats they won that same election in 2010.

Pennsylvania provides a particularly striking example of this effect. A state that Obama won in 2008 and 2012 is currently represented by Republicans in seventy-two percent of its districts today. Republicans control seventy-five percent of House districts in Ohio, another state Obama won in both elections. Indeed, state Republicans have done an impressive job of ensuring that rural and suburban districts contain a healthy majority of Republican votes, while also creating extremely safe Democratic seats in urban areas.

As a result, roughly ninety percent of Republicans are essentially immune to a general election challenger. The only threat to the vast majority of Republican House members is a challenge from within their own party.<sup>20</sup> For the average Republican primary voter who participates in these challenges, the message to their representatives could not be clearer: work with Democrats, and you will be looking for another job in January.

## PORTRAIT OF THE REPUBLICAN PRIMARY VOTER

So, what does the average Republican primary voter want?

A survey of Republican and Republican-leaning voters by the Pew Research Center in 2012 showed that fifty-four percent of those surveyed wanted GOP leaders to head in a more conservative direction.<sup>21</sup> By contrast, only thirty-five percent of Democratic primary voters said their party should head in a more liberal direction. Among Republican primary voters,

a plurality of thirty-five percent said that Republicans had compromised too much.

More conservative Republicans now turn out in greater numbers for primaries than their moderate Republican counterparts, which makes these trends even more pronounced. As Pew puts it:

Overall, [Tea Party Republicans] make up a minority (37%) of all Republicans and Republican-leaning independents nationally. Yet this group is more likely than other GOP voters to say they always vote in primary elections; as a result they make up about half of the Republican primary electorate (49%).<sup>22</sup>

Far more Tea Party Republican voters identify as conservatives than as moderates. But conservatives also make up about half of GOP voters who disagree with the Tea Party or have no opinion. Overall, 27 percent of all GOP voters are non-Tea Party conservatives, while 29 percent are moderates who do not agree with the Tea Party.

The absence of moderate Republicans at the primary ballot box dulls their power to push the party toward compromise.

## GRIDLOCK IS A CHOICE

Gridlock and refusal to compromise are choices made by political actors, not necessary elements of the legislative process. With Democrats occupying the Senate and the White House, Congressional Republicans cannot pass any legislation without some degree of compromise. As a result, Congressional Republicans have a simple choice: they can reach across the aisle to get things done and be at cross-purposes with primary voters, or they can force gridlock and win over their base, preserving their jobs.

On nearly every policy issue facing Congress today, the ruling eight percent are guiding the political process away from compromise and toward principled inaction. Bipartisan efforts to reform our nation's gun laws, overhaul immigration, and simply pass legislation to keep the government open are supported by wide margins of the voting electorate. Yet political pressures exerted by Republican primary voters has hampered or halted progress on these issues.

For example, a Quinnipiac poll from March 2013 shows that eighty-eight percent of Americans support universal background checks for gun buyers.<sup>23</sup> Yet in April of this year, the Senate could not overcome a filibuster to pass a universal background check provision, 54-46. To be fair, five Democrats voted against the measure. Even if it had passed, however, the gun control legislation had no chance of passing a Republican House, where supporting gun control would run counter to the policy preferences of conservative primary voters.<sup>24</sup>

More compelling evidence comes on immigration reform, which commands support nationally in the range of sixty to eighty percent.<sup>25</sup> Both the Chamber of Commerce,

## THE RULING EIGHT PERCENT

which traditionally supports Republicans, and the country's leading unions, stalwart supporters of Democrats, support immigration reform. The Senate passed an immigration reform bill on a 68-32 vote, and despite wide support among Republicans voters as a whole,<sup>26</sup> the House is unlikely to introduce or pass a similar bill soon. The House's most conservative primary voters, who are most strongly opposed to immigration reform, continue to mobilize against any bipartisan effort. These voters are likely to punish Republican House members who don't follow suit.

The October government shutdown illustrates this trend, as well. Before the shutdown, Rasmussen Reports released a poll showing that forty-two percent of likely Republican voters supported shutting down the government until Congress defunded the Affordable Care Act. A later poll noted: "Tea Party voters overwhelmingly support a government shutdown."<sup>27 28</sup> Again, these more conservative members of the Republican base make up majority of Republican primary voters.

### **DON'T BLAME IT ON MONEY OR THE MEDIA**

The most frequently cited explanations for these trends in Congress are the polarization of media, the influx of political money, or simply the fecklessness of politicians.<sup>29,30</sup> But these factors alone are not sufficient to explain a broken Congress.

It is not clear whether, for example, conservative media is dictating or simply reflecting the opinions of their consumers. It is a chicken-or-egg problem. Largely, that is beside the point: members of Congress, by and large, have a symbiotic relationship with the media, especially partisan media, which helps them convey their message through less-critical outlets.<sup>31</sup> The average senator and representative do not decide how to vote based on the media's reaction: they are far more concerned about their constituent's reaction. Many sharply criticized the mainstream media's coverage of the government shutdown. Yet, House Republicans largely hewed to the wishes of their primary voters—never compromise—throughout the ordeal. Certainly, conservative media encouraged and reinforced Republican tactics. Yet no conservative media outlets called for a majority, led by Democrats, to pass a compromise bill in the House, which was what ultimately resolved the government shutdown. The media only played a tertiary role.

As for the rise of Super PACs and "dark money" (large, secret political donations), most studies on the issue cast doubt on the relationship between money and winning elections. As the Sunlight Foundation put it: "We can find no statistically observable relationship between the outside spending in House races and the likelihood of victory."<sup>32</sup> The Campaign Finance Institute reached the same conclusion in a study examining campaign spending in 2012.<sup>33</sup>

In the 2012 Iowa Caucuses for the Republican Presidential nomination, Rick Santorum essentially tied Mitt Romney for

the win. Romney's campaign (and affiliated Super PACs) spent over \$5 million on their campaign to Santorum's \$170,000.<sup>34</sup> Ultimately, Mitt Romney secured the nomination, but outside spending was not necessarily pivotal. On lobbying and issue spending, the example of immigration reform casts even more doubt: proponents have heavily outspent opponents, yet reform remains unlikely.<sup>35</sup>

### **THE POWER OF THE PRIMARIES**

Elected officials, above all, care about getting reelected,<sup>36</sup> and that usually means pleasing their constituents. Today, a large portion of Republican legislators risk losing their jobs if they try to work with the other side.

Congressional Democrats face similar pressure, but their primary voters more highly value moderation and passing legislation, so the effect is far less pronounced.<sup>37</sup> The separation of powers in the Federal government makes achieving those goals difficult without compromise.

The ruling eight percent have the ability to compel their Republican representatives to refuse to compromise with Democrats. For nearly every piece of legislation or nomination that goes through Congress, Republican primary voters can either lobby to stop the presses, or they can vote out the people who failed to listen to them. As a result, the ruling eight percent possess and actively use a "constituent veto power" far beyond that of any other segment of the American public that size.

The majority of Americans routinely say they dislike gridlock and the dearth of compromise on Capitol Hill.<sup>38</sup> Yet the voice of this majority is essentially muted. Republican primary voters hold the power to prevent the other members of the political system from forming coalitions and passing bipartisan legislation.

For now, the ruling eight percent are here to stay. In large part, this is the result of gerrymandering and the withdrawal of political moderates from the primary system. Under these conditions, our Congress will continue to make as much progress as these Republican primary voters will allow. Anything else will require an abundance of courage among singular Senators and Representatives to represent the greater good in a way that significantly risks their jobs. If recent history is an indication of future events, those moments of compromise and moderation will be few and far between.

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# JOINT PROBABILITIES LEAD TO FUNDAMENTAL UNCERTAINTY

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Outside of the sterile context of a simple game, probabilities are calculated on the basis of fallible assumptions, where new events cannot merely be attributed to an unlikely draw. Every new event gives us new information as to the accuracy of the assumptions themselves. This issue arises most prevalently in the case of joint probabilities, where error terms can compound in a single direction. Although updating the calculations is possible in theory, the combination of events will often be so unique that there is no statistical basis for proper updating. As a result, fundamental uncertainty surrounds joint probabilities beyond calculable error. Policy and economic analysis where extreme joint probabilities are commonplace, most notably in finance, must recognize the inherent fallibility of their assumptions and analysis, accounting for downside that can never be ruled out mathematically.

As a rule, we should be skeptical anytime we hear that the joint probability of multiple events happening together is incredibly low. It is only possible to calculate probabilities on the basis of well-defined assumptions about a given system. In a game, where probabilities arise from rolling dice or selecting playing cards, these assumptions are immutable. Unusual events can happen without giving any reason to suspect that the assumptions are incorrect. In the real world, unusual events should signal the need to reexamine assumptions because if they are wrong, the repercussions could be drastic. This is especially true in the realm of economic policy, as demonstrated by the 2008 economic recession, which was precipitated by incorrect assumptions about the reliability of mortgage-backed securities. As long as policymakers have to make policy in a dynamic world, they should act accordingly by recognizing that their assumptions could be wrong.

Models of real interactions can resemble games in many ways. For the sake of analysis, economists and statisticians make assumptions that allow for the same probability calculations. In many cases, these assumptions will be reasonable; the usual behavior of the relationship will strongly resemble the random processes of a dice or a card game. As a first approximation, these assumptions give us a prediction of the relationship.

However, making assumptions for the sake of analysis differs from the immutable rules of a game in one key respect. Assumptions are fallible, while rules of a game programmed into a simulation are not. When calculating the implications of very unusual joint probabilities, this difference becomes a critical distinction.

When assumptions are fallible, every new event gives us new information as to the accuracy of the assumptions themselves. An unlikely event is not simply attributable to an unlucky draw; it may also indicate that one of the underlying assumptions is incorrect in a way that makes the event more likely than was predicted, differing sharply from games, where we can disregard this possibility entirely.

This issue arises most prevalently in the case of joint probabilities. Joint probabilities, defined as the probability that multiple events will happen in succession, differ from standard probabilities in three key respects. First, they allow for the possibility of compounding error terms, where interrelated error terms cause joint probabilities to diverge rapidly in a single direction. Second, the existence of multiple events allows the probability of the subsequent events to be updated in light of the results of the first. Third, the combination of events may be so unique that there is no statistical basis for completing proper updating.

This paper is organized in the form of three articles around a central theme. The first article uses a trivial example from baseball, the odds of a fan catching four foul balls in a single game, to introduce the concept of Bayesian updating for joint probabilities. The second expands the example to explain the improper risk calculations leading up to the financial crisis. The third combines these insights to examine their implications for economic methodology that arise from the fundamental uncertainty of joint probabilities. Finally, the article will end with a discussion of the policymaking implications of joint probabilities and reviewing assumptions.

### AGAINST THE ODDS OF CATCHING FOUR FOUL BALLS

On July 14, 2013, a baseball fan named Greg Van Niel caught four foul balls at a Cleveland Indians game. This is astoundingly unlikely. How unlikely? According to Darren Rovell at ESPN and countless articles that picked up the story, the odds are roughly one trillion to one.<sup>1</sup> This figure was found using a simple binomial probability calculation. There were 15,432 fans in attendance at the given baseball game, and there were thirty-five foul balls hit into the stands that game. Using just these numbers and the binomial distribution, we can calculate that the probability of four successful catches of a foul ball in thirty-five opportunities is about one in 1.09 trillion. However, this assumes that each of the 15,432 fans had an equal probability of catching the ball. The calculation for the event is:

$$35! / (31! * 4!) * (1/15432)^4 * (15431/15432)^{31} = 9.21379 * 10^{-13} \approx 1/1,000,000,000,000$$

This calculation follows the textbook method of adopting reasonable assumptions given the information available, then using simple mathematical techniques to convert it to a probability. In the binomial calculation, the odds of catching the fourth foul ball are based on the same initial assumptions, with no updating. Unfortunately, our assumptions, seemingly reasonable at first, grow more questionable with each subsequent catch. First, Van Niel's initial odds of catching a foul were better than other fans' in several important ways. He was a relatively tall fan who brought his mitt and showed an active interest in catching foul balls. He also was seated in prime foul ball territory along the third-base line, where left-handed batters are likely to spray their foul balls.

The fact that a fan catches one foul ball makes it significantly more likely that he or she is similar to Van Niel—a tall, attentive fan wearing a glove in a prime seat. This gives us new information that makes it more likely that he will catch a second ball than if he were just any random fan. We can virtually eliminate the possibility that he is very young, elderly, or sitting in an unreachable section where his odds would be near zero. Once he catches a second and third ball, it becomes still more likely that he will catch another ball.

Every successful catch, an unlikely event for any fan, gives us new information that may enter our calculation using Bayesian updating. Bayesian updating requires estimation of the degree to which probabilities would change with various characteristics, in this case of a particular fan.<sup>2</sup> It is not an impossible calculation in this simple case, but it will not be calculable based on the information in a box score.<sup>3</sup>

Because we are dealing with a joint probability, where the error of our initial estimate is compounded in our calculation, our final result is very sensitive to our estimate of Van Niel's probability. For example, if we were to find that his positive traits made him approximately four times as likely to catch a

foul ball as the random fan, then our calculation of his odds would rise to one in five billion from one in one trillion.<sup>4</sup> This estimate, seemingly well within the error bounds considering how many fans have very little opportunity, changes our final estimate by orders of magnitude.

Dealing with the consequences of Bayesian updating requires some discipline and severely limits the calculation of probabilities. How much do the odds of catching a foul ball really improve once we know that a fan has successfully caught multiple foul balls in a game? Not only do I not know, but I do not know how I would come to know. The typical way of learning this type of information would be to collect enough data on similar occurrences to have a reliable sample.<sup>5</sup> Unfortunately, because the event is so rare, our calculations suggest that we might be waiting tens or even hundreds of thousands of years to reach a reasonable sample. In other words, this information is outside the realm of immediate and practical science.

The key point is that joint probabilities compound the error of our initial assumptions. New events give us a chance to update our assumptions, but if the joint events are unusual enough, as multiple foul balls seem to be, then we will not have enough information to accurately update our calculations. Ignoring the chance to update will be misleading and will significantly underestimate the probability of the joint event, but full updating is practically impossible. The probability of such an unusual event is, in essence, uncertain.

### AGAINST THE ODDS OF WALL STREET FAILURE

Even, or perhaps especially, among Wall Street's strongest critics, there is a misconception that the stock market crashed in 2008 because investors were betting on assets that were riskier than most investors believed them to be. The litany of press following the crisis often focused on the loans offered to homebuyers without showing any ability to pay. It does not take an economist to see that it is a risky idea to lend money to a borrower who has shown no ability to repay. When these loans failed in large numbers after the crisis, it looked like a classic example of foolish gambling that cost us all.

It is not that straightforward. An individual loan necessarily fails more often when the loan is more risky. A financial asset based on risky mortgages does not necessarily fail more often if it is properly diversified.<sup>6</sup> Take a simple example of betting on a coin flip. If you bet all your money on either heads or tails, it is a risky bet that will fail 50 percent of the time. However, if you bet half your money on heads and half on tails, diversifying, it is a riskless bet that will fail 0 percent of the time. Each bet individually was risky, both carried a 50 percent chance of failure, but together, they were riskless. Diversification takes out all of the risk in this example.

Assets composed of risky mortgages, therefore, are not necessarily more likely to fail together. The riskiness of a

security asset is determined by the asset as a whole, not the individual mortgage components. If the assets had been properly diversified, the components could have been more risky without jeopardizing the asset as a whole. As noted economist and current Governor of the Reserve Bank of India Raghuram Rajan argued, “Put a sufficient number of subprime mortgages together from different parts of the country and from different originators ... and it is indeed possible to convert a substantial quantity of the subprime frogs into AAA-rated princes, provided that the correlation between mortgage defaults is low.”<sup>7</sup>

The correlation between mortgage defaults was not low. This is the key. Properly diversified risks must either be independent or negatively related, meaning that if one event happens, the other is less likely to happen. In the case of a coin flip, the probabilities are perfectly negatively related—heads happens when tails does not, and vice versa. This is perfectly diversified risk. If risks are independent, meaning that one event does not influence the odds of another, then diversification will reduce the risk imperfectly but predictably. Simply multiplying the chances of each happening individually gives the chances of both happening at once.

If mortgages within the combined mortgage assets are independent, then there should be no major declines in the national real estate market due to risky mortgages. On the other hand, if there were a national real estate decline based on an external catalyst, then these mortgages would fail at the same time, violating the assumption that they were independent. Diversification would have limited effect.

What are the odds of a national real estate decline? Risk analysts turned to data to solve this problem and found that a

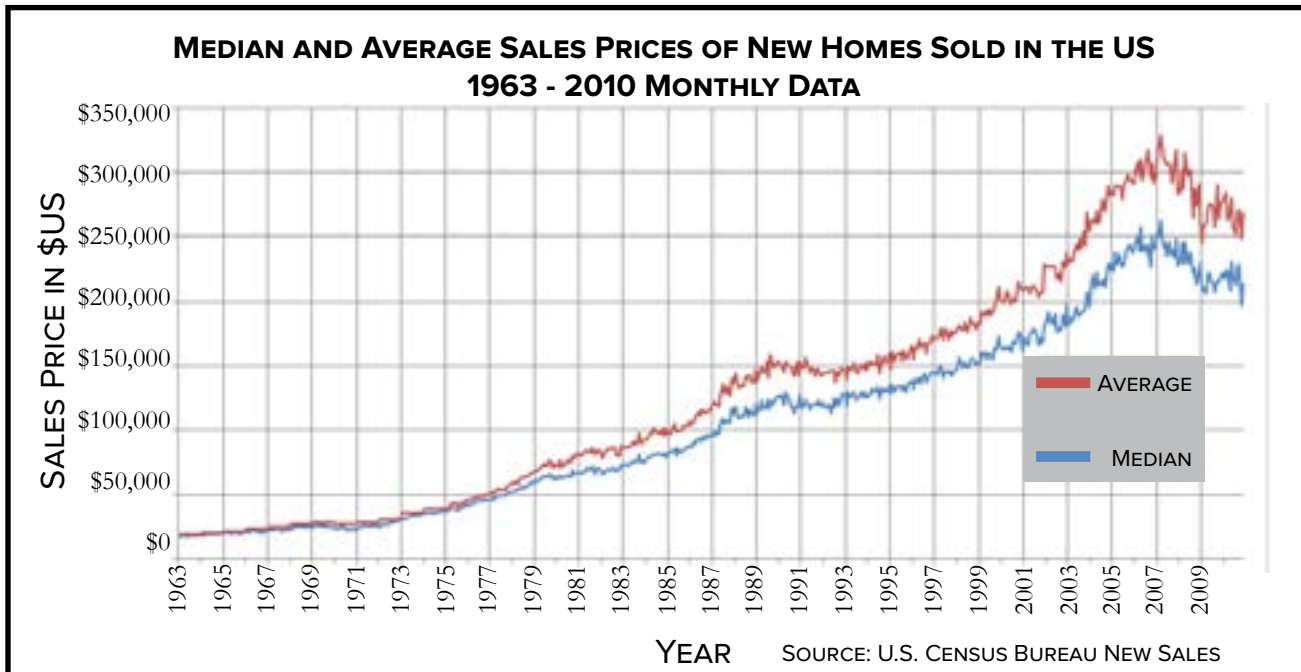
major national real estate decline had never happened in the modern U.S. housing market.<sup>8</sup>

A working assumption of independence seems justified. With that assumption come risk calculations such as Black-Scholes and Market Portfolio Theory that take independence to its most extreme logical conclusions. Using these models, Wall Street believed it could properly value its risk.

Unfortunately, as argued above, it is always necessary to reevaluate assumptions. Mortgage-backed securities put many mortgages from all over the country together into one security. If a mortgage-backed security fails, the failure itself is evidence that the real estate market is not independent. Failure of one is evidence that we cannot calculate failure of multiple mortgage-backed securities as if they were independent.

Here is an example of what I mean by reevaluating assumptions.<sup>9</sup> Say you have 100 coins in a bag. There are ninety-nine normal, fair coins, but one of them is unfair and has two heads. We are trying to calculate the chances of picking one coin and flipping twenty heads in a row. Because the probability of grabbing a fair coin is so high, we could operate under the assumption that the coin selected is fair. Using this assumption, we would find that there is below a 1/1,000,000 chance that a fair coin will come up twenty heads in a row. This calculation, which disregards the possibility of incorrect assumptions because they are initially unlikely, can be misleading. Like the calculation of catching four foul balls without updating, it would lead us to discount a possibility that is orders of magnitude more likely.

Our setup allows us to check our assumption of a fair coin mathematically. If we select a coin at random from the bag and calculate the probability that there will be twenty heads



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in a row, we should update our assumption of a fair coin with each new flip result. To do this, we will use Bayes' Rule, in the form of

$$\frac{P(\#Heads \text{ given Fair}) + P(\text{Fair})}{((P(\#Heads \text{ given Fair})+P(\text{Fair})) + (P(\#Heads \text{ given Unfair}) * P(\text{Unfair}))}$$

If coin flips once and comes up heads	98% chance the coin is fair
If 2 heads in a row	96.1% chance the coin is fair
If 3 heads	92.5% fair
If 4 heads	86.1% fair
If 5 heads	75.6% fair
If 6 heads	60.7% fair
If 7 heads	43.6% fair
If 8 heads	27.9% fair
If 9 heads	16.2% fair
If 10 heads	8.8% fair ...

If the randomly selected coin comes up ten heads in a row, there is a 91 percent chance that our fair-coin assumption was wrong. Notice that we started with a very low probability that the coin was unfair, only 1 percent, but after a string of ten heads, the new information prohibitively favored our assumption being wrong. If our assumption is wrong, then that the coin will keep coming up heads *ad infinitum* and any calculation on the basis of independence will be grossly misleading.

Applying this idea to securities markets, the assumption of a fair coin is analogous to the assumption that the national real estate market cannot fail simultaneously. Seeing twenty heads in a row represents a catastrophic failure of the mortgage market of the type that we saw in 2007-2008. Once a certain number of failures started happening all over the country, it became ever-increasingly likely that the assumption was wrong and failures would continue. Every failure made it more and more likely that we were in the situation that we assumed could not exist and that it would continue to get worse until there was bankruptcy or government intervention. Because mortgage assets came from similar pools of mortgages, they all shared in common the incorrect assumption that their risks were independent.

If any dependence is allowed, even as a small possibility, then calculations of joint probabilities based on independence will be misleading. By 2009, we discovered that there were interrelated and dependent probabilities in the housing market. The regulatory structures, based on the risk models that assumed independence, proved completely inadequate because the risks calculated erred by orders of magnitude.

However, if we want to prevent this type of catastrophe

in the future, we must critically evaluate the models and assumptions that led us to accept these mistaken regulatory structures. Assuming independence is dangerous and liable to lead to extreme failure. As this example shows, odds can run away very quickly if some dependence is allowed. However, we cannot ignore that the independence assumption is the primary assumption that makes a risk calculation possible. As the famous economist John Maynard Keynes argued, "The probability of an induction is only numerically definite when we are able to make definite assumptions about the number of independent equiprobable influences at work."<sup>10</sup>

If we allow finance to build up risks and leverage equity on the basis of independence without any form of Bayesian updating of their assumptions, the next crisis is inevitable. Rating agencies did not fail to appreciate the risk because the underlying assets were risky; they failed to appreciate the value of checking assumptions against new information, an exercise that would have called into question the models used to evaluate risk. Calculating combinations of improbable events is fundamentally flawed in practice because the occurrence of the first events inevitably challenges the assumptions used to make the calculation.

Instead of piling on mathematical calculations on the basis of an unrealistic independence assumption, it is exactly the interrelations between individuals that we should be studying. This is what investigating social dynamics can offer: a realistic view of the interactions among individuals, including individual debt instruments, that make predictions and calculations significantly more complicated, but much less susceptible to catastrophic failure.

### PROBABILITY AND UNCERTAINTY

The distinction between probability and uncertainty follows a traditional debate that tries to answer the question of whether we can reduce economic uncertainty to precisely calculable probability. In the classical economic theory that nineteenth century economists Francis Edgeworth and William Stanley Jevons developed, "The calculus of probability, tho [sic] mention of it was kept in the background, was supposed to be capable of reducing uncertainty to the same calculable status as that of certainty itself."<sup>11</sup> Keynes, however, claimed that uncertainty was often not reducible to mere probability, arguing that "we have, as a rule, only the vaguest idea of any but the most direct consequences of our acts."<sup>12</sup> Following in the tradition of the great French mathematician Henri Poincaré,<sup>13</sup> Keynes argued that we "cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist."<sup>14</sup>

The conception in this paper follows along the conception of distinct, irreducible uncertainty that Keynes contemplated. Keynes impeached models as "pseudo-mathematical" if "they expressly assume strict independence between the factors involved and lose all their cogency and authority if



this hypothesis is disallowed.”<sup>15</sup> This is the precise standing of the financial models discussed above, whose calculations assumed strict independence and lost cogency to the point of world economic crisis when the hypothesis was disallowed. As Keynes concludes, “Too large a proportion of recent ‘mathematical’ economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols.”<sup>16</sup>

### A GENERAL FORMULATION OF FUNDAMENTAL UNCERTAINTY

Following the distinction established by Keynes, economic models in the presence of significant joint probabilities and fallible assumptions necessarily lead to fundamental uncertainty that we cannot reduce to mere mathematical calculation. In the area of finance especially, which relies on understanding of joint probabilities, this limitation justifies conservative financial regulation and belies the notion that markets can be self-regulating.

In order to properly consider a model with fallible assumptions, we must look at what happens when the assumptions turn out to be wrong to get a handle on a model’s full impact in practice. This requires thinking beyond the straightforward mathematical implications of the assumptions to a more cautious and realistic view of predictions that acknowledges that crises can happen and predictions are uncertain at the extremes.

### FALLIBLE ASSUMPTIONS

Models are simplified versions of interactions that are designed to highlight key interactions in a particular real system. If the interactions of a model are substantially similar to the actual interactions, then models can serve to illuminate key relationships in a manner that is immediately comprehensible, even if the assumptions are simplifications. That they are comprehensible while the real world is distracting makes models valuable.

The Cartesian method seeks to build an intellectual structure from incontrovertible foundations. Starting from “I think, therefore I am,” René Descartes sought to build a metaphysical world from the ground up using a methodological skepticism, wherein he rejected any idea that can be doubted. As it proved for Descartes in building an entire metaphysical world under such strict methodology, it is almost certainly impossible to build complex economic systems under such limiting assumptions.

The price paid for pushing forward is allowing some fallible assumptions for the sake of analysis. That said, bringing in false assumptions to logical and mathematical calculations is a dangerous proposition. After much seemingly indubitable analysis, it can be difficult to tell which part of the conclusion

is the result of the perfect mathematical analysis and which follows from untrue assumptions. Like the “complicated partial differentials” that are mentioned and then ignored after several pages of simplified algebra calculations, the complexities and interdependencies are difficult to reintegrate into the simplified analysis.<sup>17</sup> If we accept untrue assumptions for the purpose of illuminating true relationships, then we must keep track of the relationships that we can regard as true, even given the untrue assumptions. In short, we must weigh the strengths of models against the weakness of basing logical reasoning on assumptions that are demonstrably incorrect.

The analysis ratchets up another level of difficulty when the economist is only aware of the possibility that his or her assumptions might be wrong. Rather than the certainty of dealing with known incorrect assumptions, this analysis simply deals with assumptions about which we are unsure. These assumptions are fallible. They could be false, meaning that they prove to be incorrect descriptions of the real concepts or events that they describe, or they could be true. In order to apply a model with fallible assumptions, the economist must understand not only the implications of his analysis when his assumptions are true, but also the implications when his or her assumptions are false. If he or she cannot capture the analysis using more accurate assumptions, there must be some expectation about what happens when the assumptions prove incorrect by later events. Allowing for fallible assumptions means that the economist must think beyond the mathematical implications of the model, given the assumptions, to a possible world where the assumptions are false and the math must venture into the complex and potentially incalculable world of non-linearities and chaos. Keynes explains the path forward:<sup>18</sup>

The object of our analysis is not to provide a machine or method of blind manipulation, which will furnish an infallible answer, but to provide ourselves with an organised and orderly method of thinking out particular problems; and, after we have reached a provisional conclusion by isolating the complicating factors one by one, we then have to go back on ourselves and allow, as well as we can, for the probable interactions of the factors amongst themselves. This is the nature of economic thinking.

### INSTRUMENTALISM

Probably the most influential argument on analysis from untrue assumptions, following Keynes, came from Nobel economist Milton Friedman in his essay, “The Methodology of Positive Economics.”<sup>19</sup> Friedman argues that “a completely realistic theory is in part a straw man. No critic of a theory would accept this logical extreme as his objective; he would say that the ‘assumptions’ of the theory being criticized were ‘too’ unrealistic and that his objective was a set of assumptions that were ‘more’ realistic though still not completely and

## JOINT PROBABILITIES LEAD TO FUNDAMENTAL UNCERTAINTY

slavishly so.”<sup>20</sup> Instead of the veracity of the assumptions, the realism of the model may only be judged by the discrepancy of the predictions from actual behavior. The assumptions and structure of the economic categories are idealized, but the relevant question is not whether they are, in fact, perfectly ideal, but whether they are sufficiently close to be regarded as such. Assumptions are sufficiently close if they lead to accurate predictions.

This is an instrumentalist interpretation of determining “whether a suggested hypothesis or theory should be tentatively accepted as part of the ‘body of systematized knowledge concerning what is.’”<sup>21</sup> It puts aside the truth or falsity of assumptions and simply bases its evaluation on comparing the predictions of the model to reality. A useful model has accurate predictions, and the truth of its assumptions is irrelevant.

This argument is appealing if only for the fact that it allows economists to put aside philosophical debate, an area where economists have no expertise and often fall short. However, it has a weakness if we apply it to policy recommendations. Namely, if a model serves as the basis for regulation and policy, then we must have a clearer interpretation of the meaning of the “accuracy of the predictions.” Should a model be judged by the frequency of accurate predictions, or by the net result over time of adopting the policy? Specifically, if the adoption of a model leads to catastrophic loss when it fails, will we still give it credit for accurately predicting many previous episodes?

In practice, the cost of one failure may outweigh the benefits of countless successes. It is not enough to know how often a model predicts correctly, but also the extent of the damage that could come from a large failure. Even if it does not matter that the assumptions are false, it does matter what happens when the assumptions are wrong. The possibility of incorrect assumptions is part and parcel of the predictions of the model. We consider the reliability of the assumptions so that we may have a proper grasp of the full predictions of applying a model in practice.

### FUNDAMENTAL UNCERTAINTY

Once we allow for the possibility of incorrect assumptions in our analysis, a funny thing happens to our predictions. Rather than focusing only on the mathematical predictions of the models given the assumptions (realizing that mathematical predictions are often possible only given our assumptions), we have a new variable: the accuracy of our assumptions. However, this new variable is not exogenous; the mathematical predictions of the model given the assumptions are not independent from our estimation of the accuracy of the assumptions. This dependence creates fundamental uncertainty when calculating joint probabilities within the confines of an economic model.

Many modern economic models take account of some element of randomness. Rather than requiring that a variable take a single fixed value, these models allow an element of random variation within a given distribution. Nowhere is this more prevalent than in analysis of risk decisions, where volatility prices and asset values are used as estimates for risk. These estimates of risk are then implemented into policy by providing a basis for regulating the finance industry.

As was shown above, the finance industry failed spectacularly because its regulations and risk models failed to take into account dependence in the national housing market. These “pseudo-mathematical” models, as Keynes labeled models that assume strict independence for the sake of mathematical calculation, can crumble if independence fails. Even if an assumption of independence was originally reasonable, the reasonableness of that assumption must be updated after an initial failure occurs. The fact that one mortgage-backed security failed changes the probability that the next one will fail. It makes it more likely that our assumption of independence was wrong. As more failures occur, it becomes less likely that our assumptions hold and an extremely rare event happened and more likely that our assumptions were simply wrong.

Once we allow for the fact that our assumptions are fallible and we realize that we must update the probability that our assumptions are wrong with new events, it follows that any calculation predicting unlikely joint events will be suspect. In the case of an unlikely probability, it will be more likely that our assumptions are wrong than that our joint event occurred as modeled because our interrelated error terms will not properly account for dependence. Moreover, the combination of events is so unique that there will be no statistical basis for proper updating. This is fundamental uncertainty. With fallible assumptions, extremely unlikely joint events will be incalculable because it will be more likely that our assumptions of independence are wrong than that the calculation of joint probabilities is correct.

### IMPLICATIONS FOR POLICY

Once we accept a fundamental uncertainty at the extremes of joint probability calculations, we are left with rather straightforward policy advice. Namely, we should conduct regulation of risk on the basis of joint probabilities, especially in the complex realm of finance, with increased conservatism. Even if calculations on the basis of standard assumptions indicate that dangerous failure is extremely unlikely, these calculations fall into the area of fundamental uncertainty. At the extremes, it is more likely that the standard assumptions are wrong, and there will always be the possibility of a residual chance for catastrophic failure. According to Keynes, “Mathematical reasoning now appears as an aid in its symbolic, rather than its numerical character,”<sup>22</sup> meaning that it can indicate relationships and bounds, but not exact estimates.<sup>23</sup>

We isolate the complicating factors of leveraging and risk-taking and conclude that we should not take these calculations to the edge of the calculated risk where interactions will create fundamental uncertainty, underestimating the odds of failure.<sup>24</sup>

In the end, this interpretation of economic methodology sets out a more realistic handling of fallible assumptions. Rather than simply ignoring the assumptions and focusing on the predictions, this interpretation uses the assumptions to expand on the predictions, realizing that predictions must account for the possibility of both true and untrue assumptions. Even if the model is a reasonable approximation of true relationships, the truth or falsity of the assumptions will have a direct impact on the possible interactions in an implemented framework. By analyzing false assumptions, economists are able to consider their downside. Moving away from an insistence on an infallible answer calls for regulation that accounts for the uncertainties as well as the probabilities.

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## ENDNOTES

- 1 His calculation, picked up widely, may be found at <https://twitter.com/darrenrovell/status/356573560522801153>.
- 2 The exact nature of Bayesian updating is beyond the scope of this paper. For the purposes laid out here, it is only important for the reader to be aware that Bayesian updating is a mathematical method that allows for updating assumptions using new information in each subsequent event.
- 3 This statement is not meant to put aside very real difficulties with establishing a Bayesian prior, which is beyond the scope of this article.
- 4 Taking his odds of catching as one in four thousand, the calculation is:  $35! / (31! * 4!) * (1/4000)^4 * (3999/4000)^{31} = 2.02952 * 10^{-10} \approx 1/5,000,000,000$ .
- 5 If the underlying probability is one in one trillion, we would expect the event to happen once every 13,500 seasons. More realistic assumptions might increase the likelihood above once every 1,000 seasons. To estimate the effects, a statistical analyst must wait for the event to happen enough times to have a large enough sample size for accurate calculations.
- 6 Diversified assets take advantage of the fact that independent or negatively correlated risks are unlikely to all fail simultaneously.
- 7 Raghuram Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (Princeton: Princeton University Press, 2010), 134.
- 8 Author's calculations using U.S. Census Bureau. "Median and Average Sales Prices of New Homes Sold in the United States." Monthly available at <http://www.census.gov/const/uspricemon.pdf>; annual available at <http://www.census.gov/const/uspriceann.pdf>.
- 9 Nassim Nicholas Taleb pursues a similar point in his seminal book on probability, *The Black Swan*, where he refers to the tendency to treat practical situations as if they followed the reductive assumptions of a game as the Ludic Fallacy, deriving from the Latin word for game. Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (New York: Random House, 2007), 122-125.
- 10 John Maynard Keynes, *A Treatise on Probability* (London: Macmillan, 2010), 259.
- 11 John Maynard Keynes, "The General Theory of Employment," *The Quarterly Journal of Economics* 51, no. 2, (February 1937): 209-233, 210.
- 12 *Ibid.*
- 13 John Maynard Keynes, *A Treatise on Probability* (London: Macmillan, 1921), 48-49.
- 14 John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace and World, 1964), 162-63.
- 15 *Ibid.*, 297.
- 16 *Ibid.*, 298.
- 17 *Ibid.*, 297-98.
- 18 *Ibid.*, 297.
- 19 Milton Friedman, "The Methodology of Positive Economics," *Essays in Positive Economics*, (Chicago: University of Chicago Press, 1966), 3-16, 30-43.
- 20 *Ibid.*, 27.
- 21 *Ibid.*, 3, quoting John Neville Keynes, John Maynard's father.
- 22 John Maynard Keynes, *A Treatise on Probability* (London: Macmillan, 1921), 316.
- 23 *Ibid.*, 160.
- 24 Following the method of economic thinking described by Keynes in John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace and World, 1964), 297.

# POLICY PROCESS AND INSTITUTIONAL CHANGE FOR RENEWABLE ENERGY IN DEVELOPING ECONOMIES: THE CASE OF CHILE

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INTERNATIONAL

This paper examines the legislative and executive actions behind renewable energy policymaking in Chile, to explore the elements underpinning the country's lack of renewable energy adoption. By exploring agents' choices in the policy process, the author finds that the main factors responsible are a combination of incumbent strength, bipartisan ideological devotion at the legislative level, entrenched technocracy at the executive level, and structural constitutional problems.

This paper uncovers a causal chain linking politics, policy design, and effect—political elements that define the policy process for renewable energy in Chile—and explains how they connect to its slow and small adoption of non-conventional renewable energy (NCRE).<sup>1</sup> Chile lags behind its neighbors in renewable energy deployment despite the fact that it is relatively wealthy, has ample resources, an increasingly carbon intensive regime, and high energy costs that restrict competitiveness.<sup>2</sup> These contrasting perspectives raise the question: Why did Chile, with its modern, innovative, and relatively wealthy economy, extensively adopt no economically and socially beneficial NCRE sources? This paper addresses this query.

Latin American countries vary widely in their adoption rates of NCRE.<sup>3</sup> What explains this variation? First and foremost, leading adopters have generally adopted specific policies designed to remove barriers and/or introduce incentives to attract investors. Second, the most successful efforts toward adoption have included diverse state intervention political schemes, rather than sophisticated instruments and thorough revisions of the current electricity sector framework. These findings suggest that, in order to understand why a particular region is able—or unable—to adopt renewable energy sources, we must carefully examine its policy and political processes.

## RESEARCH QUESTIONS AND METHODS

I present my analysis in three stages. First, I discuss Chile's electricity sector, its renewable energy potential, and its policymaking process. Second, I consider the political component of policymaking by tracing the progression of NCRE policy in Chile through Congress. Finally, I link policy choice and the agents behind it, highlighting the elements of

the discussion that explain the central question.

My methodology centers on the Senate's Bill Tracking System, which contains the legislative documents for each bill in this discussion. I examine the original NCRE bill, the opinions in the commission discussion, the origin and content of indications, the plenary discussion in chamber, and the use of urgencies. I also examine Congressional proceedings to understand partisan and interest group preferences and the dynamics of legislative-executive relations in the context of policy design in Chile. Next, I critically analyze this design to explain Chile's failure to adopt NCRE policies as a function of this political process. Finally, I use several theories of the policy process as lenses through which we can interpret the events. These conceptual frameworks help us identify the actors behind policy change, their influence on its content, and the specific timing of the change.

## BACKGROUND

### CHILE ELECTRICITY SECTOR

The Chilean electricity sector's organization is the result of profound neo-conservative measures deployed in the 1980s to provide "private solutions to public problems."<sup>4</sup> The country spearheaded electricity-sector reform worldwide by being the first to extensively privatize the industry, designing novel markets to provide efficient long-term investment signals, and applied a modern and liberal regulatory approach. These reforms brought stability and confidence for international investors to pour capital into the country, prompted efficient and least-cost operation of the different segments, and supported the growth of a thriving economy.<sup>5</sup>

The system's generation mix and strategy is largely governed

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by private decisions made by three prominent actors whose capacity is 85 percent of total supply: Endesa, Colbun, and AES Gener. As of 2012, about two-thirds of Chile's electricity came from coal, oil, and natural gas sources—all imported—and a third from hydroelectricity, with minor contributions from biomass and wind farms. Transmission and distribution are not vertically integrated and have their tariffs regulated by the government, as opposed to the generation sector. Therefore, two key elements characterize the Chilean sector: private ownership of all assets and operations and oligopolistic competition for supply.

Three markets currently exist in Chile's electricity sector: a long-term auction market for distribution companies' regulated customers, a bilateral-contract market between non-regulated customers—with over two megawatts (MW) of capacity—and suppliers, and a short-term spot market for inter-generator transactions. The country has been facing tight supply conditions over the last five years that have significantly increased prices in the spot markets and for regulated customers through elevated auction bids. This has been the result of an unsuccessful effort for the auction to attract new investment and reduce prices through competition.<sup>6</sup>

An uneducated explanation of Chile's reliance on imported hydrocarbons to generate large portions of its electricity might attribute it to its lack of alternative resources to fuel its energy needs. However, a recent study shows that the country has large untapped sources totaling over 190 gigawatts (GW), which is over ten times its current installed capacity of sixteen GW.<sup>7</sup> Some evaluations show that it is technically and economically feasible to add at least ten GW by 2025, which would triple the current renewable energy generation goals set by existing policy.

### POLICY MAKING IN CHILE

This paper focuses on the outcome of the policy process in a political context. I include a brief and simplified account of how the policy process works in Chile, the agents involved, and the role that institutions play.<sup>8</sup> Prior to the legislative discussion, the executive carried out an intense process of pre-legislative work to reduce intra-Congressional friction by incorporating partisan opinions and business interests' views.

In Chile, bills enter Congress as messages from the Executive or motions from members of Congress. They follow a cycle through each chamber—Representatives and Senate—that includes analysis by an appropriate commission formed by thirteen representatives or five senators and a plenary vote. Commissions hear stakeholders, who voice their preferences, while in plenaries, partisan positions are evidenced, as only Congress members—and sometimes Ministers—are allowed to intervene.

A key element of the legislative institution in Chile is the

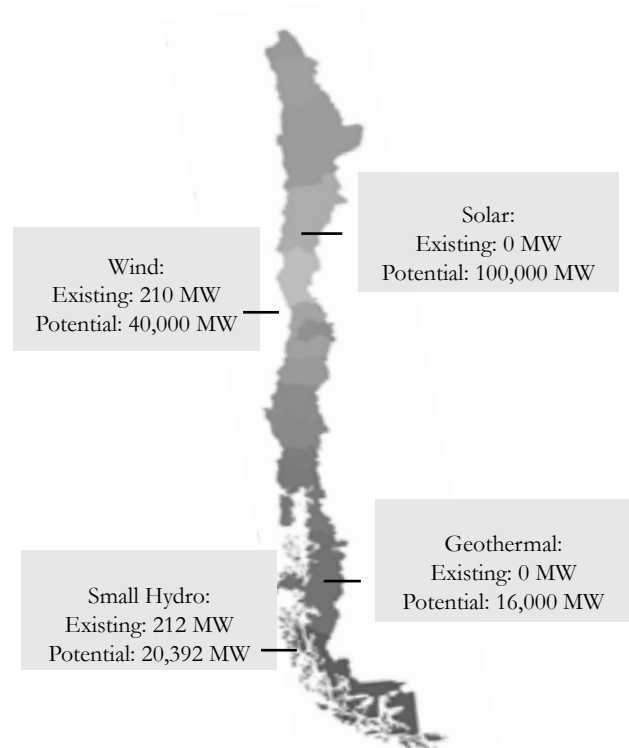


Figure 1. Renewable Energy Resources in Chile

power that the Constitution provides to the president to control discussion. Introduction of bills related to matters such as political and administrative division, taxes, public debt, labor, social security, budget, and organization of the Army is exclusive to the president. The executive manages the timing of the legislative agenda through urgencies that mandate short-term or immediate discussion and voting. Finally, the president has suppressive, additive, and substitutive veto power over any approved bill.

While Congress counterbalances the executive's power through quorums and the technical prowess members build through commissions, the statistics overwhelmingly support Chile's hyper-presidential regime in explaining legislative outcomes. Over seventy percent of the Congressional motions are never discussed in chamber commissions, while ninety percent of Executive messages are discussed. Furthermore, even though fifty-seven percent of bills are introduced through motions, only twelve percent of passed laws arise from that origin. This means that the executive branch introduced close to ninety percent of all the laws passed since Chile reinstated democracy in 1990.<sup>9</sup>

### RENEWABLE ENERGY POLICY IN CHILE

This section presents the main policy instrument that Chile has approved to incentivize renewable energy adoption or remove barriers against it: Law 20257, the "NCRE Law." In this section, I carry out an analysis of the legislative discussion

Environmentalists and NCRE advocates	Generators with hydroelectricity assets	Other generators and neoliberal think-tanks
Impose more stringent fines Increase target gradually to 20% by 2025 Decry lack of explicit economic incentives	Increase eligibility limit from 20 MW to 40 MW for hydropower Remove limit for run-of-river	Decry higher costs, which contravene the principles of competitiveness, efficiency Reject preferential treatment for NCRE

Figure 2. Interest group positions in the Lower Chamber

process that led to its inception to clarify the political process behind its design elements. I also critically analyze the process, to determine whether we might blame the design of the policy for the country's failure to adopt NCRE.

The NCRE law was not the first time that NCRE reached the public agenda in Chile. In the past, Chile had already discussed two broader bills that later became laws: Short Law I in 2004 and Short Law II in 2005. Neither of these had NCRE policies in their inception; Congress added these during discussion.

First, Short Law I exempted or reduced transmission charges for projects below twenty MW, a size that would usually be attractive only for run-of-river hydro and not NCRE. As transmission costs are less than five percent of the overall cost for wind and geothermal installations, this was a meager incentive for their deployment. Second, Short Law II opened the door for NCRE to provide up to five percent of the energy required from electricity distributors through a bidding process, akin to a Renewable Portfolio Standard<sup>10</sup> or RPS. However, the auction pricing scheme and quantity were earmarked for larger, conventional projects. In reality, the sole generator that participated in an auction—Monte Redondo wind farm—bid as a conventional energy source to secure a contract at a suitable price. Taking advantage of generally high bidding prices, the wind farm held a 275 GWh/year contract at \$124/MWh.<sup>11</sup>

#### NCRE LAW: RPS REVISION

Revision of the scheme designed in Short Law II brought the first specific renewable energy law, NCRE Law, in April 2008, which replaced the previous arrangement in its entirety. As with the other two laws, this was also put forth through a message. Considering that this bill was entirely focused on renewable energy, I analyze its changes as it proceeded through Congress in order to identify their origin, support, and outcome.

#### ORIGINAL BILL

The bill was originally designed as an obligation imposed on generation companies with capacity over 200 MW to demonstrate that at least five percent of their annual energy

sales came from NCRE. It allowed banking up to fifty percent of the annual obligation for one year—either by using surplus from the year before or postponing its commitment—and transferring surplus injections to other liable entities. For non-compliance, the bill defined a \$28/MWh fine. Proposed eligible energy sources included biomass, geothermal, solar, wind, marine, and below-twenty MW hydropower. The requirement would start in 2010, include only energy contracts after 2007 (for liability purposes), and require that eligible sources be installed after May 2007, as well. The scheme was designed to operate for twenty years, which translates into a fixed five percent target until 2030.

#### LOWER CHAMBER

Through commission discussion, I examine the positions of interested parties in key elements of the policy design, as shown in Figure 2.

While NCRE advocates used the window of opportunity to push this agenda, non-hydroelectricity generators and think tanks broadly attacked the initiative on an ideological free-market basis. Managers of hydroelectricity generators pushed to shape the law to fit their portfolios. A CEO from one of these companies preferred to “go back to the original value proposed by the CNE of 40 MW, for this energy source,” which highlights the pre-legislative involvement of businesses mentioned before, as this value was unknown to the public at this point.<sup>12</sup>

Intra-commission and plenary discussion reveal partisan preferences for NCRE in the Low Chamber. While right-wing members were neutral, left-wing parties proposed modifications to increase fines to \$42/MWh from the second year of non-compliance and gradually increase the target from five percent in 2010-2014 to eight percent by 2024. It was acknowledged that the five percent target was inherited from the benchmark contained in the previous RPS attempt included in Short Law II, whose nature and origin was never identified. In addition, no technical validation for any of these numbers seemed to be available at this point. Given high prices at the time, there was a general consensus that this bill would not do significant harm. Although its benefits were unclear, many argued it would contain positive innovation spillovers. Finally, as Carvallo (2013) notes for the Latin

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Environmentalists and NCRE advocates	Generators with hydroelectricity assets	Other generators and neoliberal think-tanks
More stringent fines and higher targets	Increase eligibility limit from up to 70 MW for hydropower Reduce target to 5% Flexible banking	Changes not needed: NCRE projects are underway, so no need for further support instruments

Figure 3. Interest group positions in the Senate

American case, environmental effects were not mentioned as a reason to incorporate NCRE.<sup>13</sup>

### SENATE

In the Senate commission discussion, stakeholders generally maintained their prior preferences from the Low Chamber. The managers of hydroelectricity generators refined their position, as an attempt to make a larger number of projects eligible for compliance than allowed in their existing portfolios. These managers also demanded flexibility to surrender their certificates, which may be connected to the seasonality in hydroelectricity generation.

As opposed to the Low Chamber, the plenary discussion in the Senate revealed not partisan, but mostly constituency positions, favoring biomass and hydropower for the south and wind and solar for the north. A governmental-coalition senator decried the lack of scientific argument behind the twenty MW and five percent figures and embraced all run-of-river generation regardless of size. Another governmental coalition senator highlighted that the initial five percent threshold was reached “too slow[ly], and the target was not bold, not brave.”<sup>14</sup> Right wing senators aligned with other right-wing stakeholders, insisting on the need to avoid higher prices and on changing the entire mechanism so as to avoid distorting market prices.

The Mining and Energy Commission in the Senate conducted the final stage of the discussion and revision, where members of the chamber presented over fifty indications. The three critical elements were resolved as follows:

- **Targets:** Several indications changing the initial and final target, its increments, and duration, were proposed. Right-wing senators preferred a conservative five percent, while left-wing members preferred a fifteen to twenty percent target. The executive suggested generators fulfill an incremental five to ten percent target by 2024 and this approach was the one that finally gained traction.
- **Hydroelectricity limits:** Legislators bargained with the executive for the limit on small hydro. Right-wing senators pushed for raising the limit, while senators from governing coalitions were pleased with the twenty MW limit; the executive proposed a limit of thirty MW. Finally, the

twenty MW mark was kept and a sliding scale from twenty to forty MW was incorporated to allow larger projects to partially enjoy the benefits.

- **Fines:** The position of the executive of not increasing the \$28/MWh fine prevailed with an argument that the total possible fines to a fully non-compliant generator would be much larger than any fine applied by any governmental agencies. According to the discussion transcript, this fact seemed to deter legislators that attempted to increase the fine to induce compliance from obligated entities. A \$42/MWh fine beginning in the second year of non-compliance was included.

In addition, the Senate proposed two broader changes. First, a proposition for a complete overhauling of the policy through a competitive fund for NCRE was declared inadmissible insofar as it involved matters of exclusive jurisdiction of the executive to propose. Second, two indications that were presented to incorporate a specific tendering process for NCRE encountered a reluctant executive. The bargaining process settled that fifty percent of the annual increments from 2014 onwards should come from a competitive and transparent tendering process performed by the obligated generators.

### DISCUSSION

Using the Congressional discussion, I present a critical analysis of the current NCRE framework from a policy perspective to explain results from a political perspective. Overall, NCRE adoption results have been positive, but the general assessment is that Chile is still far from tapping its economically viable resources, especially considering their ample availability. Since 2006, 190 MW of wind power have been built, all owned by incumbents; however, no geothermal or solar projects have commenced construction. Biomass capacity has increased by self-generating timber companies that are taking advantage of the high price juncture in the nation’s system. However, they have decreased the actual energy injected to the SIC, as they self-generate to avoid high tariffs and to reduce their overall costs.<sup>16</sup> All in all, there is no firm evidence that causally connects any Chilean NCRE policy with its current deployment levels. Most, if not all, of Chile’s

current projects seem to be profitable from a mix of the high price juncture, payments from the Clean Development Mechanism, and public image.

### **POLITICS: GAINING STABILITY, RESISTING CHANGE**

Two specific theories of the policy process are useful to interpret the political aspects of NCRE policymaking in Chile. First, the Advocacy Coalition Framework, ACF, identifies belief systems as the primary source for an agent's political decisions. The stability or change of policies in the long-term—usually decades—will depend on the level into which the coalition can keep its shared beliefs solid in the face of external or internal shocks or gradual learning and negotiations.<sup>17</sup> Second, John Kingdon's Multiple Streams (MS) framework holds that policy entrepreneurs monitor problems and political streams to deploy their preferred solution when streams come together in a "window of opportunity."<sup>18</sup> Policy timing and content will be informed by the salient problem and political environment that opened such a window.

Though the Multiple Streams framework's "window of opportunities" explains how the previous two laws "extraneously" incorporated NCRE elements through the larger Short Law I and II bills, no windows are evident for the NCRE Law. The absence of a crisis—the last one being the 2004 shutdown of gas imports from Argentina—leaves this policy's timing unexplained in the short-term. Following the ACF, a gradual change in policy beliefs regarding NCRE—spurred by cross-national learning and past crises—is evident in some House and Senate member's discussions and actions. Shortly after Short Law II's debate was finished, two motions—legislative initiatives spurred within Congress—were introduced in mid-2006 to significantly alter the existing framework to favor NCRE adoption.

I hypothesize that the bill leading to the NCRE Law, introduced eight months after these initiatives, was designed to appease legislators and route the discussion toward a definition more comfortable for the executive. The evidence shows that after the NCRE Law was passed, the two aforementioned motions were never discussed and were later archived. Moreover, Marcelo Tokman, an economist with a strong background and technical prowess in financial macroeconomics, spearheaded the NCRE Law. Tokman was named Minister on March 29, 2007, while the bill was introduced a week later into Congress. It is likely that the bill was already written and waiting for the incorporation of the appropriate policy entrepreneur—a "champion"—to guide it through legislative discussion. Tokman's preferences might also have played a role, as after exiting the Ministry in 2010, he became Regional Director for the wind manufacturer Vestas, a signal of his fondness for NCRE.

Using the Advocacy Coalition framework, I further argue that the Chilean core belief in a neoliberal paradigm with large discretion for businesses, self-regulating markets, and low

power for regulators solidified a formidable cross-partisan coalition over the last thirty-five years. Since the Advocacy Coalition framework is especially formulated to fit American pluralism—of which Chile has transformed into an extreme example—it helps us to understand institutional resilience in this nation. The main elements behind the failure of NCRE adoption in Chile are the unwillingness of the executive to change the economic "rules of the game" through policymaking, the inability of Congress to intervene, and the coincidence in this coalition of the main political parties and businesses.<sup>19</sup>

The logic stems from the fact that, even though the initial Chilean economic reform contemplated decentralization in all segments, it never put in place any mechanisms or antitrust institutions to avoid future concentration. As Schamis (1998) convincingly argues, economic-liberalization policies in Latin America concentrated benefits in small industrial groups that acted concomitantly with reforming elites, forming distributional coalitions seeking profits.<sup>20</sup> Moreover, for Chile, the literature shows that close interaction between business groups and policymakers has flourished since neoliberal reform, and productive benefits to the former increased from even closer—and more fruitful—contact after isolated technocrats were withdrawn from office.<sup>21</sup> These connections have provided incumbents with strong leverage to guide the content of the sectorial agenda, having the chance to command future policy revisions and, therefore, allow a permanence of institutions convenient to the interest group. The electricity sector, whose prices affect the whole economy and whose incumbents are powerful entrenched entities with large investment, fits perfectly into this picture.

Several elements support the idea that the executive did not want to modify electricity institutions—namely the spot market, contracting mechanisms, and procuring schemes—in a way that would allow NCRE to thrive. First, the initial reforms incorporated by Short Laws I and II did not include a single reference to NCRE; it was the legislative work that added specific clauses for cost exemption and market share. Second, the message that initiated the NCRE Law explicitly stated that "this bill [...] honors the fundamental principles included in the Electricity Law, insofar as it protects the efficiency, competition, and entrepreneurial freedom, and drives the concretion of those NCRE projects which are deemed most convenient to develop the electricity-generation market."<sup>22</sup> This provides further evidence of reluctance to change the required institutions. Lastly, the lack of incentives, poor enforcement of small fines, and conservative targets all suggest that the bill was designed to minimally change the investing environment for generators.

Of course, institutional resilience is further guaranteed by the extensive power that the Constitution endows the President to set the legislative agenda, as we have seen already. The attempts of a group of senators to suggest an alternative



design for the NCRE Law based on a competitive funding trust were rejected because financial legal modifications are the prerogative of the President. In addition, the use of urgencies prevented further discussion and forced voting on the executive's design with minimal modifications and no in-depth analysis.

Based on these explanations, I hypothesize that the NCRE Law was a strategic political maneuver to avoid opening the debate on the electricity sector's regulation again after the 2004 and 2005 laws. Despite the change of beliefs in some Representatives and Senators, the need for the executive to provide a stability signal to investors and resume capacity deployment informs this choice.

### **POLICY: MISSING ELEMENTS FOR A COMPLETE REFORM**

The revised RPS used a five percent target derived from a previous attempt and even though a gradual escalator was incorporated, it remains conservative compared to other Latin American nations and Chile's resource endowment.<sup>23</sup> As indicated by Spain's National Renewable Energy Center—whose opinion was requested as part of the Low Chamber revision—the project lacked an explicit incentive mechanism that would likely prompt extensive small hydro and biomass deployment to comply. This is precisely what happened. With fines that are capped at \$42/MWh—lower than the cost of almost any NCRE technology—incentives for innovation are further diminished.

The attempted “certificate” trading system was never implemented nor considered a proper market, but a forum for individual agreements between generators with deficit and others with surplus. As expected, the transaction costs of this arrangement are large, since generators do not need to make their deficit public, and smaller NCRE owners have to bargain with much larger counterparts under the pressure of a small fine. To implement the law, the CDEC improvised a balance calculation similar to the one used to settle sales and purchases in the spot market. As of 2012, the price used to value these transactions was roughly \$15/MWh—the regulated energy nodal price—much lower than the fines and the average cost of energy for any generation source.

Throughout the Congressional discussion, in particular the NCRE Law, the lack of technical and scientific support for figures and definitions is astonishing, both from the executive and the legislators. Even when denounced at general discussion in the Senate, as I have shown, there was no change in behavior. One member of the appropriate commission justified the increment in NCRE quota from five to eight percent for the sake of boldness and bravery. The multiple sizes for fines were unsupported by each proponent, as was the final choice of \$42/MWh included in the final executive indication.

All in all, the analyzed bills, particularly the NCRE Law, portray a passive Congress with few tools to modify the original proposal from the executive and, even then, with willingness to accept most of its further amendments and suggestions. There was no clear partisan preference regarding NCRE, as it seems that every member of Congress found something of interest for his or her constituents to justify pushing for it. Only right wing UDI exhibited a constant wariness for observing economic neoliberal principles, decrying any distortions to a “free market” operation. Incumbents were cautious and timid in their opinions, which may reflect the degree into which they have already participated in the bill's content through pre-legislative work and their confidence in pervasive institutional resilience.

### **POLICY PRESCRIPTIONS**

We can distill a number of policy prescription lessons from this case study. First, national consensus on the overall social net benefit of adopting renewable energy must be reached for actors to accept the distributional consequences and assess its trade-offs. In this context, governments need explicit agreement on what technologies will be pushed. Preference for already-exploited renewable sources—such as run-of-river hydropower or biomass—is markedly different from incorporating new technologies such as photovoltaic panels, wind turbines, and geothermal energy. Literature about technological innovation shows that the transition to new technological regimes requires profound change in socio-technical systems, which is particularly applicable to cleaner electricity systems.<sup>24</sup> If new technologies are deemed necessary, then high-resolution publicly available resource surveys, maps, and mechanisms to attract foreign experts or to develop local intellectual capacity are required. The present case shows how the executive avoided any transition by shaping the policy in a way that matched incumbents' resource-use experience, namely hydropower and biomass.

The Chilean choice of a RPS, a quantity-based policy, in lieu of a price-based instrument such as feed-in-tariffs, may be explained by the control that a RPS has over actual NCRE incorporation.<sup>25</sup> Feed-in-tariffs, as decried by NCRE advocates, would have provided a clearer incentive for these technologies and possibly caused a larger disruption of the existing market. Moreover, properly setting and managing these tariffs is critical for fiscal and private efficiency. In this case, the RPS with a low target, achievable by existing technologies, was probably the most conservative move by the reluctant executive.

Second, technical assistance for determination of potential, economic impact, market incentives and fines, target-setting, and enforcement should be procured at the legislative level. The imbalance between a technocratic executive and a less-prepared legislator became evident in the NCRE Law discussion, as well as the previous deliberations on Short Laws

I and II. On one hand, a source of relatively neutral technical advice may have helped the legislators to understand and replicate the governmental indications. On the other hand, support for critical numerical figures such as targets and fines would allow Congress to form a clearer view of the trade-offs that a specific policy entails.

Finally, appropriate changes in rules, organization, and markets—aligned with the new paradigm that NCRE implies—require careful examination of domestic electricity institutions. In Chile’s case, the negligence of the executive to create the certificate trading market for renewable energy and unwillingness to modify the existing auction mechanism were formidable barriers for NCRE adoption. The obscurity of the electricity system operator’s decisions—which, far from independent, is managed by incumbents—and its relevance in financial settlement of the electricity market are also barriers for new entrants. The co-existence of strong, resilient, and advocacy-coalition-backed energy institutions with a new relatively isolated NCRE policy will invariably reduce the effectiveness of the latter, as the Chilean case shows.

## CONCLUSION

Chilean NCRE policy was never meant to spur widespread adoption of non-conventional energy sources, despite technical evidence that supported its economic logic. Two instruments were the result of improvised changes with a negligible result. The major instrument—the NCRE Law—responded to a political strategy for sectorial regulatory stability to appease Congressional initiatives on renewable energy policy. The absence of a major shock or crisis made it difficult for major changes to be introduced and prompted a much more tempered and conservative approach to the reform.

A careful examination of the technical content of NCRE policy reveals that it has failed to put in place adequate incentives due to an inability to change the required electricity institutions—namely markets, contract mechanisms, dispatch

rules, and procuring schemes. Even though around 600 MW of NCRE currently exists in the country—including biomass, wind, and small hydro—the present analysis does not support the idea that it occurred as a response to any NCRE policy, but rather to junctures in prices and the influence of public opinion. Strong institutional resilience stems from a shared devotion to neoliberal tenets for market operation that involves left- and right-wing parties, governmental agencies, and businesses interests supported by excessive executive power over the legislative agenda. The lack of tools for Congressional members to provide meaningful feedback worsens the policy process scenario when relevant changes are required, particularly if no crisis informs adoption, and therefore, salience is low. The discussion in Congress is anecdotal and lacks scientific basis, particularly in relevant technical and quantitative issues such as target setting, capacity limits, and fine determination, although more evidence would be needed to assess whether this is a widespread problem or particular to this subject.

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## ENDNOTES

[1] For the purposes of this paper, non-conventional renewable energy technologies are devices that use solar radiation, wind, geothermal, biomass, or marine energy as their primary source for electricity production. Solar panels and wind turbines are common examples.

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[3] *Ibid.*

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[9] *Ibid.*

[10] A RPS is defined as a quantity-based market instrument, where the regulator forces a certain proportion of electricity to be generated from specific technologies. As of 2012, 29 US states plus the District of Columbia have a form of RPS in place, as well as several countries worldwide.

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- [14] Chilean Senate, 2007. 73th Session of the Senate, Legislature No 355.
- [15] The most recent NCRE-related bill, introduced to Congress in January 2013, explicitly indicates in its foreword: "Given the precarious development that non-conventional renewable energy has in the country . . . ."
- [16] Comisión Nacional de Energía, 2011, Balance de Energía 2010.
- [17] Sebatier, Paul, A, "The advocacy coalition framework: revisions and relevance for Europe," *Journal of European Public Policy* 5(1) (1998): 98–130.
- [18] Kingdon, John W., *Agendas, Alternatives, and Public Policies*, 2nd ed. (New York: HarperCollins, 1997).
- [19] This broad coalition is mostly built around shared beliefs for economic performance and choice. This means that there are still different political arrangements to discuss diverse matters such as labor, social welfare, health, and education, to mention a few, although almost always a neoliberal economic vein will persist through these discussions, since they all depend on the budget, economic performance, and private actors.
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# THE POLITICS OF PENSION REFORM: THE CHILEAN EXCEPTION THAT PROVES PIERSON'S RULE

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Adapting the theoretical discussion of the welfare state to regions outside of wealthy democracies has been a difficult task. Typically, contextual differences directly affect the plausibility of applying those explanations to similar phenomena. However, the theoretical framework of “credit claiming” and “blame avoidance” that Paul Pierson developed to explain different moments of welfare state evolution is useful in explaining social policy changes throughout other regions of the world. In this article I analyze the last two major reforms of the Chilean pension system: the implementation of an individual capitalization system in the 1980s as well as a counter-reform process initiated by a socialist president in 2008 and expanded by a right-wing president. In spite of Chile’s particular context—a tough dictatorship that implemented the first reform and a long process of transition to democracy that initiated the counter-reform – Pierson’s twin concepts of “credit claiming” and “blame avoidance” explain both movements particularly well. The article concludes with a reflection on democratic institutions and their ability to promote long-lasting reforms that support the most disadvantaged people that the welfare state pledges to protect.

## INTRODUCTION

In the early 1980s, Chile pioneered a pension system later used a model for the World Bank as it confronted the “Pay as You Go” pension systems crisis, which relied upon current workers to finance the pensions of retirees. The collective capitalization system was scrapped in favor of one based on individual capitalizations—each person accumulating savings to pay for his or her own future pension benefits. The collective capitalization system originated in the 1920s and was rooted in the Bismarckian model of social security, which defined pensions by occupation.

Pinochet’s tough dictatorship implemented reforms in the 1980s, after which nearly twenty years of democratic governance in the country elapsed before counter-reforms were pioneered, led by the Concertación, a center-left coalition, which held power between 1990-2010. Despite the recent return to power of a more conservative government with the presidency of Sebastian Piñera (2010-present), the exceptional model of individual capitalization created during the previous administration has not regressed, but has expanded.

Welfare state literature describes various forms of democratic capitalism in “rich democracies”<sup>1</sup> like Europe and the United States. The literature offers different explanations for the welfare state expansionary era, initiated in the 1940s and lasting until the 1970s. Some explanations emphasize the economic development of nation-states (Wilensky), others the power of the left (Korpi), and still other arguments emphasize institutions (Skocpol)<sup>2</sup> as the main drivers in the evolution

of the welfare capitalism. In the case of Latin America, explanations emphasize elite responses to development of social welfare policy (Mesa-Lago, 1987)<sup>3</sup> and the distinctive process of state building in the region (Filgueira, 2002).<sup>4</sup> Due precisely to a lower development of the welfare state in Latin America, some authors, among them as Huber and Stephens (2012), have proposed a more modest definition of “social policy regimes.”<sup>5</sup> These conventional theories of welfare states serve to illustrate the role that institutions, political parties, and national elites have had in previous case studies on development. This trio of arguments will be what I refer to as the “conventional theory.”

Adapting that theoretical tradition to other regions has been difficult. In the case of Latin America, the main trouble arises from contextual differences, such as slower economic development, weak democratic institutions, and, especially, distinct class structures. Paul Pierson’s concepts of “credit-claiming” and “blame avoidance” are particularly instructive in discussing how politicians react to changes in the welfare state. In this paper, I argue that Pierson’s categories of “credit claiming” and “blame avoidance,” which describe the expansion and retrenchment movements of the welfare state evolution, can also explain particular social policy changes in different contexts. To probe my case, I analyze the major changes in Chile’s pension system over the last thirty years that contradict the predictions of the aforementioned “conventional theory.” Neither the recent expansion of the system, nor the retrenchment in the 1980s fits the “conventional theory” that Pierson challenges. Thus, the events of radical retrenchment in the 1980s—rather

than contradict the common explanations of welfare state evolution—can be presented in terms of Pierson’s categories of credit claiming and blame avoidance as an exception to the accepted conventional wisdom of welfare state evolution. The concepts of “blame avoidance” and “credit claiming” prove more instructive than institutions or the role of any particular political party. The exceptional model of Chilean pensions motivates the further discussion of possible redistribution policies for the most unequal region in the world.<sup>6</sup> The paper will conclude with a final reflection of the development of democratic institutions in the region and how the Chilean example demonstrates the importance of those institutions in realizing long-lasting social welfare throughout the region.

### **WELFARE STATE THEORY: CREDIT CLAIMING AND BLAME AVOIDANCE AND THEIR EFFECT ON EXPANSION AND RETRENCHMENT OF THE WELFARE STATE**

Decades of rapid expansion of welfare states came to a close in the 1980s in various parts of the world, including Chile. A common initial explanation for retrenchment in the industrialized world was globalization, followed by changes in demography, family patterns, and expansion of service sector. In Latin America, the key factor in the development of the “economic adjustment” period was the influence of the “Washington consensus”<sup>7</sup> led by international financial institutions (such as the World Bank and the International Monetary Fund),<sup>8</sup> which emphasized the need to limit welfare programs and pushed for neoliberal models of welfare reform.

Pierson’s analysis of the austerity era (1973-2010)<sup>9</sup> led him to identify a key distinction in welfare state evolution. Unlike the expansion era, this period has been characterized by many different features. Among the most prevalent are the evidence of political shifts to the right, and the privatization or deregulation of particular economic sectors. These features led to a post-industrial era, which shifted from manufacturing to service-based production. Changes in family structures, including an aging population, made it more difficult to internalize the traditional aspects of the social policies. While Pierson agrees with the “conventional theory” as it relates to economic development, the power of left-wing political parties, or relevant institutions, to explain the expansion of the welfare state, he defines a new framework to comprehend the retrenchment era when many of the common drivers of welfare state expansion were considerably weakened. According to Pierson, “the welfare state expansion involved the enactment of popular policies in a relatively undeveloped interest-group environment.”<sup>10</sup> In that sense, Pierson argues that expanding social benefits is generally a process of political “credit claiming,” where those in power act to maintain popular support. However, he realized that there is a profound difference between extending benefits to large numbers of people and taking them away. Contrary to the

expansion era during the “golden years,” “the welfare state retrenchment requires elected officials to pursue unpopular policies.”<sup>11</sup> Since “the costs of retrenchment are concentrated (and often immediate) while the benefits are not,”<sup>12</sup> different political strategies are more likely to be deployed during retrenchment among them championing reforms where negative effects are opaque and responsibility is hard to trace. For this reason, he states that “retrenchment is generally an exercise in “blame avoidance” rather than “credit claiming,” where pain and costs of the policy can be distributed across an entire populace.

In order to support his claims, Pierson analyzes the existing theories and their predictions for the years of austerity.<sup>13</sup> Based on each of those theories, he says that we should expect “a lot of changes and mostly in a particular direction.” However, as he shows, “the evidence suggests a surprising level of stability.”<sup>14</sup> For instance, the reforms promoted by conservative British Prime Minister Margaret Thatcher “achieved some nontrivial incremental cutbacks in various programs” but “radical retrenchment efforts failed, often at considerable political costs.”<sup>15</sup> That example illustrates that, contrary to what the conventional theory of the welfare state anticipates, the retrenchment era failed to reduce the welfare state as one could have expected. Therefore, Pierson argues that the politics of retrenchment are “not simply the mirror image of the welfare state expansion.”<sup>16</sup> The main point here is that developing social programs produces “new organized interests, the consumers and providers of social services, that are usually well placed to defend the welfare state.”<sup>17</sup> In Pierson’s estimation, the welfare state has proven itself resilient, “far more durable than what would be expected in the former theory.”<sup>18</sup> In that manner, the main difference between expansion and retrenchment is the durability of the welfare state itself.

### **THE PENSION SYSTEM**

According to Pierson, old-age pension systems provide a good example of the new politics of retrenchment. Old-age security represents a remarkable and expensive policy developed during the welfare expansion. Due to its high costs, old-age security is expected to face great changes during years of austerity. In that sense, Pierson argues that expectations for greater change rest in part on the implicit application of conventional models from the period of welfare state expansion.<sup>19</sup> However, as illustrated in the Thatcher example described above, he found little evidence to prove that the conventional theory explains welfare state expansion. He goes even further, claiming that “with few exceptions, the size of the welfare state for the elderly in the next century will be larger than it is now if [for] no other reason than demand for benefits will rise more quickly than the capacity of policy makers to cut entitlements.”<sup>20</sup> Old-age pensions are a central element of the welfare state around the world. Social welfare

PERIOD	PRESIDENT	POLITICAL COALITION-PARTY
1964-1970	Eduardo Frei Montalva	Center-left (Christian Democrat)
1970-1973	Salvador Allende	Left (Socialist)
1973-1990	Augusto Pinochet	Military Dictatorship
1990-1994	Patricio Aylwin	Center-left (Concertación)
1994-2000	Eduardo Frei Jr.	Center-left (Concertación)
2000-2006	Ricardo Lagos	Center-left (Concertación)
2006-2010	Michelle Bachelet	Center-left (Concertación)
2010-2014	Sebastián Piñera	Right (Renovación Nacional)

states face two main challenges: changing demographics<sup>21</sup> and stagnant wages. For most pension systems, this means sufficiently accounting for the demographic shift of the population they serve, in which more people are dependent on a pension program, while also confronting “slow growth in real wage that most policy makers assume will continue into the future.”<sup>22</sup> Most countries operate on a pay-as-you-go basis (PAYG) in which current workers pay contributions that finance the previous generation’s retirement. According to Myles and Pierson (2001), a particular combination of economic, demographic, and political conditions prevalent during the post-war “Golden Age” for social welfare policies created a unique opportunity to consolidate generous PAYG systems. The trouble is that the “parameters that made pay-as-you-go the model of choice in the 60s<sup>23</sup> – rising wages, full employment, and comparatively high fertility – have changed dramatically.”<sup>24</sup> Many governments recognize the impending crisis of the old system. In fact, since 1994 the World Bank has promoted a multi-pillar system as the solution to avert the “old-age crisis” that tackles both the efficiency and distribution problems created by today’s demography. This approach would replace collective provision of pensions with a privatized model based on individual retirement savings in which the state would retain only the residual responsibility of meeting the income of those with the greatest need. However, as Pierson states, certain courses of development are hard to reverse. During the austerity era, the networks associated with mature welfare state programs constituted a barrier to radical change.<sup>25</sup> The main changes happened only in the so called “latecomer countries.” Those are the nations that “never or only belatedly initiated significant PAYG defined benefit schemes.”<sup>26</sup> On the contrary, those countries with a mature PAYG system have made only incremental cutbacks. Countries’ are reluctant to shift to a private system because it would require today’s worker pay double, which would place an “untenable burden on current workers, requiring them to finance the previous generation’s retirement while simultaneously saving for their own.”<sup>27</sup> Therefore, “the dominant track of reform in the mature PAYG nations has been two-pronged. Current retirees, or those near retirement,

undergo a series of accommodations of austerity, typically modest in scale. Future generations then often face substantial changes as reforms are phased in.”<sup>28</sup> As Pierson states about Thatcher’s reforms in the pension system, “these changes, though criticized, failed to generate the kind of outcry that often led the government to back off from other reforms. Offering the carrot of personal pensions diminished the pain of the cuts in public pensions.”<sup>29</sup> This allowed Thatcher to shift from avoiding the blame for cutting public pensions to claiming credit for the development of personal pensions.

#### THE CHILEAN PATH

Chile presents a rare case in which both retrenchment and expansion movements seem to contradict the main theories about welfare states evolution. In the 1980s, Chile replaced one of the most developed PAYG pension schemes of the region for a very radical new system based on individual capitalization. Capital is tied to savings of the individual rather than a collective pool of savings in many PAYG systems, a major change that mostly eliminated government influence on the security system. In a sense, we could say that it represents a real radical retrenchment because pensioners’ benefits were dependent on individual savings rather than collective resources of the population paying into a central system.

Then, as the first measure of his final term (2010-14), right-wing president Sebastián Piñera introduced a 7 percent expansion of pension benefits, financed by public spending, and eliminated the 7 percent health care contribution rate for the elderly. These reforms have been recognized as some of the most significant contributions of his administration. This expansion not only consolidated the contra-reform movement that started under the previous Socialist president Michelle Bachelet (2006-2010), but also expanded the benefits for old pensioners. Conventional theory does little to explain these movements, illustrating the truly exceptional case of the Chilean pension program. However, as I argue here, they may fit very well under Pierson’s categories of credit claiming and blame avoidance. When faced with politically unpopular policies to rein in welfare programs, leaders from both sides of the ideological spectrum expanded the pension system.

## THE POLITICS OF PENSION REFORM

YEAR/PERIOD	PENSION SYSTEM	EVENT
1924 - 1979	PAYG (collective). Bimarckian model	Creation and consolidation of the pension system. In 1970 there were multiple pension regimes (150) and institutional atomization (thirty-five agencies)
1970	PAYG (Collective). Beveridgean reforms	Minor reforms towards the universalization of social security
1980-Present	Individual Capitalization System managed by the private sector	
1980	Individual Capitalization managed by the private sector	Creation of Private Agencies (AFPs) and mandatory individual savings account
1990s	Individual Capitalization managed by the private sector	Some minor adjustments to the capitalization system in the 1990s
2008	Individual Capitalization managed by the private sector	Reform: Consolidation of a new model based on three subsystems: Solidarity pensions (collective), individual capitalization and voluntary savings incentive mechanism
2010	Individual Capitalization managed by the private sector	Reform: Increase of the basic pension by 7 percent

Source: Alberto Arenas, *Historia de la Reforma Previsional Chilena: Una Experiencia Exitosa de Política Pública en Democracia* (Santiago: OIT: 2010).

Both sides of the ideological spectrum used credit claiming to justify their political regime.

This runs in stark contrast to the previous pension system. In the 1970s, Chile had a very developed system with high coverage and protection against all contingencies and generous benefits that had proven very resilient. It presented some serious differences for occupations (150 models) and an atomized structure (thirty-five agencies) that as Edwards (1998)<sup>30</sup> shows, had more than 100 different retirement regimes and high contribution rates (in 1973 it varied between 16 percent and 26 percent of wages depending on the type of job). Besides its complex form that also required complicated administrative process, the system was very resilient. Neither President Eduardo Frei (1964-70) nor President Salvador Allende (1970-73) were able to overcome pressure to make the system more uniform, by reducing the number of occupational groups or changing the complicated bureaucratic structure. Neither president was able to make the changes that would have allowed for welfare state expansion and the credit claiming that would have allowed their political factions to remain in power.

### AN EXCEPTIONAL RETRENCHMENT?

At the end of the 1970s, Pinochet's dictatorship (1973-1990) imposed personal reform preferences for an individual capitalization system under the guise of righting perceived "inequities" in the preexisting system. The reform was based on a system of defined contributions and mandatory private individual plan of savings: each worker should contribute 10 percent of his or her earnings to individual savings accounts and pay a private agency for administrative costs. As a result, the pensions were defined as a combination of worker contributions, investment returns, and additional variables such as gender, age, and the number of dependents. However, despite being implemented during a tough dictatorship, the reform faced various challenges that illustrate the obstacles towards implementing radical reform. José Piñera, the architect of the new system, recognized the stiff opposition to the reform that contributed to a yearlong delay.<sup>31</sup> Besides, as Edwards shows, with the support of politically potent high-ranking military officers, many interest groups, such as public sector workers, teachers, and healthcare workers, firmly opposed any changes. The opposition of the military officers was so strong that even Pinochet himself did not convince his military colleagues and, as a result, the army was the only

branch of the armed forces that did not participate in the reform.

This story shows that even dictators must marshal the support of necessary interest groups. In order to reduce the political opposition, Piñera implemented a compensatory bonus that intended to increase net take-home pay for those joining the new system (on average those who transferred to the privately run capitalization system experienced an 11 percent increase after-tax increase). The idea was to help improve the reform's popularity and to encourage workers to voluntarily shift to the new system. We see "blame avoidance" mechanisms in the Pinochet administration's arguments about the "total insolvency of the system and the inequitable benefits among workers of the old system" and the strategy of delaying the effects of the reform. Nevertheless, the fact that the Pinochet regime was a dictatorship was the key factor that allowed this radical reform to actually happen. Edwards supports that idea stating that "there is no doubt that given the dictatorial nature of the Chilean government of the time, the authorities faced a significantly lower degree of political opposition than they would have encountered in a democratic regime."<sup>32</sup> Similarly, Mesa-Lago concludes that, given the unique political context in which this kind of reform flourished, it is "not feasible to implement in any other country of Latin America."<sup>33</sup> Despite the exceptional political context of Chilean welfare state, the examples of blame avoidance and credit claiming still serve to demonstrate the counterintuitive expansion of the Chilean pension system when retrenchment was the expected outcome.

#### **SOCIAL WELFARE EXPANSION IN CONSERVATIVE REGIMES**

Chile not only pioneered the private individual capitalization system, but also has recently experienced a unique path of pension system expansion during both by both center-left and right-wing administrations. In this exceptional case, "credit claiming" (rather than "blame avoidance") seems to be the driver. In 2006, numerous political actors celebrated reforms presented by President Bachelet. That counter-reform against the Pinochet-era pension system has been recognized as the main achievement of Bachelet's government. Although the system still has a mandatory private pillar (individual capitalization administered by private funds) it includes a solidarity pillar (a minimum pension funding level guaranteed by the Chilean state). According to Arenas (2010), one of the architects of this new reform, these changes have renewed the fundamental role of the Chilean government in guaranteeing universal rights.<sup>34</sup> In 2010, President Sebastian Piñera, José Piñera's younger brother, went one step further by increasing the benefits provided to retirees by 7 percent (using public spending and eliminating the 7 percent health care contribution rate for the elderly). He says that promoting that increase of pensions for the elderly has been one of the

most important achievements of his government. Piñera's reform represents another exceptional movement in Chilean pension evolution, which may even contradict one of the key arguments of the conventional theory that drives the welfare state – the power of the left. Conventional welfare state theory would have predicted funding cuts and support of the current pension system under the Piñera presidency. Piñera's presidency has used the expansion of the pension system, which his primary opposition initiated, to "claim credit" for his own party to serve their future electoral interests. In the context of the democratic transition that started in Chile during the 1990s, this expansion aligns with the idea of "credit claiming" presented by Pierson.

#### **CONCLUSION**

Pierson's ideas have changed the way we understand the role of the state in social welfare reforms. Contrary to many theories about the evolution of the welfare state, the distinction of credit claiming and blame avoidance explains the exceptional evolution of the Chilean pension system. Although Pierson's ideas were developed to explain the policy changes in wealthy democracies, his theory provides a valuable frame of analysis that can be used to explain the way that states can develop social policies even in less developed regions. Using the distinction between conventional social welfare theories and Pierson's credit claiming and blame avoidance theory, we can explain why an authoritarian regime, like Pinochet, faced huge problems in implementing a radical reform to a popular social welfare program. At the same time, we can also start to understand why a right-wing administration, in this case the current presidency of Sebastian Piñera, not only lent support to the previous left-wing administration's social welfare policy expansion, but also took that expansion one step further to guarantee a better quality of life for the Chilean people. Although it is too early to argue that we are at the beginning of the "expansion era" of the Chilean welfare state, it does at least seem clear that a set of new conditions imposed by the last reforms to the Chilean welfare state, including different political problems and new supporters of the system, make regression to past policies more difficult. Removing the solidarity pillar or reducing the 7% benefit to retirees will prove difficult without new political strategies that counter the broad support of these social programs.

One of the primary causes of social policy reform in Latin America is the quality of democratic institutions. As Huber and Stephens (2012) state, "democracy is one of the most important determinants of redistributive social policy."<sup>35</sup> The quality of democratic institutions is a precondition for left-wing parties to gain access to political power. Those same institutions can also be important determinants in how redistributive policies persist under right-wing administrations. The way the current Piñera administration pushed the expansionist policies of the Bachelet presidency



## THE POLITICS OF PENSION REFORM

forward is a perfect example of how important the role of democratic institutions played in social welfare reform. Huber and Stephens (2012) using an example of health care of McGuire (2010) show that “the mechanisms through which (...) democracy favors expansion of basic health services is not just electoral competition but includes organization of advocacy groups, a free press, and the spread of expectations among the poor that such services be provided.”<sup>236</sup> In that sense, the main challenge is not to improve democracy in electoral terms but also to develop the democratic institutions that can help entrench recent achievements that protect and improve the quality of life of the most vulnerable populations. Without long-lasting democratic institutions, these policies will not be sustainable and resilient to eventual shocks. Radical retrenchment in Chile was only possible in the context of the extremely weak democratic institutions of the Pinochet dictatorship. Yet even then, the blame avoidance mechanisms that Pierson describes for retrenchment were evident. In that

sense, improving democratic institutions is indispensable to building a welfare state in Latin America that may challenge the region’s record as the most unequal region in the world.

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### ENDNOTES

[1] This concept was coined by Wilensky (2002). See Harold L. Wilensky, *Rich Democracies: Political Economy, Public Policy, and Performance* (Berkeley: University of California Press, 2002).

[2] Wilensky Harold L. *The Welfare State and Equality: Structural and Ideological Roots of Public Expenditures* (Berkeley: University of California Press, 1975); Korpi, Walter. *The Democratic Class Struggle* (Routledge and Kegan Paul, 1983); Skocpol, Theda. *The Limits of the New Deal System and the Roots of Contemporary Welfare Dilemmas in The Politics of Social Policy in The United States*, ed. Weir et al. (Princeton, NJ: Princeton University Press, 1988).

[3] Mesa-Lago, Carmelo. *Social Security in Latin America: Pressure Groups, Stratification, and Inequality* (Pittsburgh, PA: University of Pittsburgh Press, 1978).

[4] In spite of tremendous differences with the rich democracies it is important to recognize the different countries present important differences among them. Following a similar strategy as the classic work of Esping-Andersen (1990), Filgueira (2002) identifies three main typologies in Latin America: a stratified universalism (Uruguay, Argentina, Chile), dualism (Brazil) and exclusionary regimes (Guatemala, Honduras, El Salvador, Nicaragua, Bolivia). As Huber and Stephens (2012) state “they see stratified universalism as the product of contending elites seeking popular support, dualism as the product of elite statecraft and co-optation accompanied by repression of the popular sectors, and exclusionary regimes the product of predatory elites.”

See, Filgueira, Carlos and Fernando Filgueira. *Models of Welfare and Models of Capitalism: The*

*Limits of Transferability in Models of Capitalism: Lessons for Latin America*, ed. Evelyn Huber (University Park: Penn State University Press, 2002); Esping-Andersen, Gosta, *Three World of Welfare Capitalism* (Princeton, NJ: Princeton University Press, 1990); Huber, E. and John D. Stephens. *Democracy and the Left: Social Policy and Inequality in Latin America* (Chicago: The University of Chicago Press, 2012).

[5] Huber and Stephens (2012), 15.

[6] Ottone, Ernesto and Carlos Vergara, *La Desigualdad Social en América Latina y el Caso Chileno* (Santiago: Estudios Públicos, 108: 2007).

[7] According to Williamson (1990), it represents a set of policy instruments about whose proper deployment Washington can muster a reasonable degree of consensus. For a more general description, you can consider Rodrik’s definition as: “get your macro balances in order, take the state out of business, give markets free rein. “Stabilize, privatize, and liberalize” became the mantra of a generation of technocrats who cut their teeth in the developing world and of the political leaders they counseled.” See, Williamson, John. “What Washington Means by Policy Reform.” *Latin American Adjustment: How Much has Happened* 7 (1990): 7-20; and Rodrik, Dani. “Goodbye Washington consensus, hello Washington confusion? A review of the World Bank’s economic growth in the 1990s: learning from a decade of reform.” *Journal of Economic Literature* 44, no. 4 (2006): 973-987.

[8] Although how strong the effects were remain in dispute. For example, Huber and Stephens (2012) states “the smaller the Latin America country, the more powerful were the pressures from the IFIs.” p.17.

[9] According to Pierson, the expansion era or the “golden era” ended in 1973. That periodization is built “on the perceived link between growing difficulties and a harsher climate for the welfare state. Higher unemployment and slower growth generate fiscal pressure and mounting calls for austerity.” See Pierson, Paul, *The Welfare State in the Very Long Run* (Bremen: Center for Social Policy, Bremen University, 2011) 5-6.

[10] Pierson (1996) 144.

[11] *Ibid.*

[12] Besides, Pierson discusses other arguments: from the psychological perspective (negativity bias), or even from historical perspective preserving status quo -Pierson argues, the welfare states itself creates new supporters (interest groups). See Paul Pierson, “The New Politics of the Welfare State”, *World Politics* 48 (January 1996), 143-179.

[13] According to Pierson (2011) the main point here is that at 2010 the context of the welfare state is quite different than it was in the end of the “Golden Age.” Some of the main changes are: deregulation or privatization; a new post industrial era and the shift from manufacturing to services production; and the demographic changes with the population ageing and the changes in households structures.

[14] Pierson (2011) 6.

[15] Pierson (1996) 163.

[16] *Ibid* 156.

[17] *Ibid* 175.

[18] *Ibid* 144.

- [19] Pierson (2011).
- [20] Myles and Pierson (2001) 305-6.
- [21] In fact, the World Bank report in 1994 states, “Today, as the world’s population ages, old age security systems are in trouble worldwide.” See World Bank, *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth* (New York: Oxford University Press, 1994), p. 1.
- [22] John Myles and Paul Pierson, *The Comparative Political Economy of Pension Reform in New Politics of the Welfare State* ed. Paul Pierson (Oxford: Oxford University Press, 2001), 310.
- [23] Pierson also recognizes that at that time “since there was no preceding generation of entitled pensioners, politicians could immediately offer a potent combination of modest payroll taxes, generous promises of future pensions, and unearned benefits for those near retirement age.”
- [24] Myles and Pierson (2001) p311.
- [25] Myles and Pierson (2001) contrast both convergence analysis, and a naïve version of institutionalism. Against the latter, which stresses inertia and stability, they emphasize that big shifts are taking place in systems of retirement provision. On the other hand, they say, while the convergence analysis anticipates a move toward “one best practice,” it ignores the radically different starting points of different countries. In that sense, they propose that there “is no single destination,” and that any “change is powerfully shaped by the constraints and opportunities presented in distinctively constituted pension systems.” So, instead of a convergence direction, they present different clusters of nations each with their own dynamics.
- [26] Indeed, he says that the latecomer countries “have been busy creating a novel form of ‘welfare state for the elderly,’ that approximates in varying degrees the World Bank’s model of choice. In this design, governments provide a basic tier of protection against poverty but bear little or no direct responsibility for providing standard levels of wage replacement for middle-income workers.”
- [27] Myles and Pierson (2001) 313.
- [28] Myles and Pierson (2001) 331. Pierson (1996) also says: “Once in place (PAYG), such systems may face incremental cutbacks, but they are notoriously resistant to radical reform. Shifting to private, occupationally based arrangements would place an untenable burden on current workers, requiring them to finance the previous generation’s retirement while simultaneously saving for their own” 176.
- [29] Pierson (1996) 162.
- [30] Edwards, S. (1998). *The Chilean Pension Reform: A Pioneering Program in Sebastián*
- Edwards, *Privatizing Social Security* (Chicago: University of Chicago Press: 1998). Also available: <http://www.nber.org/chapters/c6246>
- [31] Edwards (1998) 39.
- [32] Edwards (1998) 39.
- [33] Alberto Arenas, *Historia de la Reforma Previsional Chilena: Una Experiencia Exitosa de Política Pública en Democracia* (Santiago: OIT: 2010).
- [34] Besides the solidarity pillar, the counter-reform wants to amend three main problems: to reduce gender inequities by giving a “child bonus” to each elder women in order to compensate the lower contribution that they have because of past pregnancy times; to solve some funding problems giving incentives on savings to vulnerable groups—women, young people, and independent workers—in order to increase their contributions; and to enhance the functioning of the capital market system —promoting a better competence between the agencies (AFP) that manage the pensions.
- [35] Huber and Stephens (2012) 3.
- [36] Huber and Stephens (2012) 17. See also, James Mc Guire, *Wealth, Health and Democracy in East Asia and Latin America* (New York: Cambridge University Press: 2010).

# WHAT IS “SUSTAINABLE” FOOD? A CONVERSATION WITH SUSTAINABLE FOOD ADVOCATE ANNA LAPPÉ

INTERVIEW BY ALLISON DOMICONE AND MIRANDA EVERITT



Anna Lappé is an author, educator, expert on food systems, and sustainable food advocate. She has written several books and contributed to many others. Her most recent is *Diet for a Hot Planet: The Climate Crisis at the End of Your Fork and What You Can Do About It*. She is the head of the Real Food Media Project and founder of the Small Planet Institute and the Small Planet Fund.

During her recent visit to the Goldman School of Public Policy, PMJ sat down with her to discuss sustainable agriculture, food activism, and how everyday consumers can influence policy.

CONVERSATION

**PolicyMatters Journal (PMJ):** *Globally, where is sustainable agriculture a more difficult sell? Is it in the industrialized nations of the Global North, where the focus is on profit, or in developing economies of the Global South that are looking for any possible competitive advantage?*

**Anna Lappé:** It's a harder sell in the places where there are bigger, more entrenched interests, where sustainable methods are a threat. It's a harder sell in places like the United States and Europe, whose agriculture systems have shifted almost entirely since the post-WWII period to relying on petrochemicals, enormous amounts of fossil fuels, and genetically engineered seeds.

In the United States, there are some crops that are virtually completely genetically engineered at this point. Sustainable agricultural methods are by definition a threat to those multi-billion dollar industries. It's not easy to have a conversation about the benefits of sustainable methods for dealing with pests and weeds when petrochemicals are currently the norm. It's very challenging to make a sell for sustainable practices when so much of the story of food is being shaped by those companies.

**PMJ:** *Can you contrast that with the conversation in the Global*

*South?*

**Lappé:** Through research and personal connections with colleagues from the Global South, I've learned that farmers are seeing incredible results from learning about and adopting sustainable practices. Some folks I interviewed for my last book are working in the Tigray region of Ethiopia supporting farmer-to-farmer education. They've been doing field-testing, working with villages to train farmers on sustainable methods. The farmers then develop their own research models, with plots that use no inputs at all, plots that use chemical fertilizer, and plots that use sustainable techniques such as green manure, planting nitrogen-fixing crops, integrating livestock on the farm, increasing crop rotation, and cultivating greater biodiversity.

In pilot programs the sustainable plots have had incredible yields while the other two plots have not. Given the heavy input costs of the chemical model, farmers are now considering sustainable agriculture and saying, "I want more of this. I want to share this. I want to teach my neighbors this practice." And they're developing networks in these villages to share and adopt their sustainable practices. If you ask why sustainable methods aren't more prevalent and more prominent in the Global South, I think it's because

there hasn't been enough effort put into farmer education.

**PMJ:** *So it's not just about getting people to say what best sustainability practices are—it's a matter of actually proving it, person by person.*

**Lappé:** One of the ways I like to describe sustainable farming, in contrast to chemical farming, is as “knowledge-intensive farming” as opposed to input-intensive farming. To really be a great sustainable farmer doesn't mean buying a whole basket of goods. It means having to learn a whole basket of knowledge. There are some really great models of farmer-to-farmer education all over the world that do exactly that kind of training. So you train a group of farmers to train another group of farmers to then train yet another group of farmers. We're seeing this model of knowledge deployment being really successful, like the international network called La Via Campesina, which the Oakland-based group Food First works with.

**PMJ:** *People are flocking faster than ever from rural and agricultural areas to urban regions. Does urban agriculture have a viable role to play in creating a healthier food ecosystem?*

I definitely am one of those people who doesn't believe there's one silver bullet. I don't believe that if we could just get urban agriculture right, we'd figure out all the food problems. But I feel like it can certainly be part of the solution. What I think has been so powerful about it has been that urban agriculture and community gardens have been this great way for some of the most disadvantaged communities to get access to fresh food, but it's also been this really great tool to build political power.

Of course, you need to always distinguish between what's happening here in the United States from other places. It's a very different political, economic and environmental context than what's happening in somewhere like India. In the Global South you're talking about small-holder farmers who have lost their land, maybe because of land-grabbing for commodity production, who migrate to these peri-urban areas. Whether you call them favelas or slums or shantytowns depends on your country. You're talking about all these former small farmers who have living conditions that are really challenging for a whole host of reasons. They would be really challenging places to grow food. It's very different

than talking about growing in a favela than in a community in the Bronx that's reclaiming an urban lot.

**PMJ:** *We've seen how the environmental movement has been “greenwashed” in many ways—everything is “green” and “eco-friendly” these days. We're seeing this more and more with the sharp increase in “organic” and “natural” food. Some fast-food restaurants even serve organic milk. What should people be paying attention to if we care about making healthy choices for ourselves and the planet?*

**Lappé:** The same phenomenon we saw with Clorox calling its bleach “green” we're now seeing with food companies painting food products as sustainable when they're not. One of the tools we can give people to encourage them to

Tens of millions of Americans can't vote with their dollar because they don't have any dollars! A huge portion of our population are disenfranchised eaters. They don't have the option to shop at a store that offers them the types of food they may want. ... It's like having no polling places in your neighborhood, or showing up at the poll and finding there's only one person on the ballot. That is the experience of many eaters in this marketplace.

be critical thinkers about their food is to not just think about what food we're eating, but also to be critical consumers of the media we're consuming around that food. We should be asking questions like, “Who's saying it? Who's funding that media or research? Who funded that report? Who funded that website?”

As consumer demand has grown for healthier food—for organic products or meat grown without antibiotics—companies feel threatened and have begun to push out more and more misinformation. That means the chemical

manufacturers, the processed foods industry, and the soda companies are spending tens of millions of dollars every year to feed us false information so we buy their products. Interest groups like the U.S. Farmers and Ranchers Alliance—which is a group that sounds really lovely—is funded by the biggest chemical companies in the country. They transmit information that says that antibiotics are harmless in animal agriculture and that there's no cause for public health concern around them at all.

There's a lot of misinformation out there. It's becoming more and more challenging to parse out the truth from the fiction, so it calls upon us to be more critical.

**PMJ:** *Sometimes that pushback results in companies actually changing their behavior. Do you have any good examples?*

**Lappé:** Unfortunately, one of the responses we're seeing from companies is to just tweak around the edges to try to

appease the consumer. To give you an example, Dow Chemical, one of the largest chemical manufacturers in the world, which makes some of the most toxic chemicals on the planet (it was one of the biggest makers of the toxic pesticide DDT), has been successfully sued by many communities around the country who have felt the effects of toxic runoff from their manufacturing plants. What did Dow do in response?

I got a call from a journalist reporting on a new water treatment plant that Dow was working on in the Netherlands. He asked me, "Isn't this a great example of this company really stepping up and creating a more sustainable world?" This single, isolated water treatment plant in the Netherlands might very well be great and sustainable. But the bottom line is to look at the quarterly reports to shareholders of Dow Chemical Company. Its profitability comes from the manufacturing and selling of toxic chemicals. Its DNA is selling toxic chemicals. They might want to spin around the edges, but until they change their core business model, they are in the business of making toxic chemicals. Those chemicals affect human life and affect the environment. One of their products is widely used on home lawn care and has been known to cause canine lymphoma. They're giving puppies cancer!

We have to be especially diligent to scrutinize a company's response to pushback from consumers. Is it really moving the needle or just making a small tweak around the edge?

**PMJ:** *Many people think of themselves as consumers first. When they hear about companies violating environmental or labor laws (or just our sense of what is right), they first ask where they should shop instead. What do you think it would take to help people who are passionate about these issues to think of themselves as citizen actors as well as consumers?*

**Lappé:** We're always both. Unless we are growing all of our own food, we are using our dollars in the marketplace for food. Hopefully we're also members of a community and therefore have the power to shift policy. The Slow Food Movement talks about individuals not as consumers, but as co-producers. We co-produce in the sense that our choices about what we're buying in the market are essentially production choices. We're saying, "What production model do we want? Do we want chemical production or non-chemical production?"

Others I know like to talk about people not as consumers but as co-creators. What is that food system that we are co-creating when we buy into a certain set of practices? Those ways of thinking about our engagement in the marketplace

are helpful.

One caution about talking about what we can do to "vote with our fork" or "vote with our dollar" is to be cognizant of the fact that there are tens of millions of Americans who cannot vote with their dollar because they don't have any dollars. There is therefore a huge portion of our population that is made up of disenfranchised eaters! They are not voting with their dollar because they don't have the option to shop at a store that offers them the types of food they may want. To take the voting analogy a step farther, we can liken it to having no polling places in your neighborhood or showing up at the poll and finding there's only one person on the ballot. That is the experience of many eaters in this marketplace.

I don't think it's helpful to only talk about what we can do as eaters. We should also talk about how we can work together to change policies, to change urban planning departments, to change school districts so that more people have a full range of choices about what they eat.

**PMJ:** *So it's about those places where people interface with larger systems? Where we're not going to take down Monsanto by ourselves, but we're going to make sure our school lunches have real vegetables in them.*

**Lappé:** One of the things that's great about the food system today compared

to even twenty years ago is that for those of us who can afford to buy food to feed our families, there are a lot more options in more places than there ever were before. As recently as the 1970s there were only a couple hundred farmers' markets in the United States. Had there not been a concerted grassroots movement to create farmers' markets all across the country, there would be zero today. Instead there are 8,144. It has doubled in just the past few years. That's incredible! What does that 8,000 represent? It represents thousands of people who had to proactively work to make markets thrive in their community.

So we've got farmers' markets, we've got direct-to-consumer initiatives like community-supported agriculture (CSA) and community-supported fisheries. Finding sustainable fish is a huge challenge. As a working mom with two young kids, trying to make it to the single sustainable fish market in the East Bay is really difficult. So my family partnered with a



Photo by Miranda Everitt

**Corn grows at a demonstration “Victory Garden” planted by Slow Food USA and partner food-justice organizations outside San Francisco City Hall in summer 2008. Produce from the urban, organic garden was donated to the San Francisco Food Bank.**

community-supported fishery for our home to be a drop-off point. Now every week fish comes to our house. Our friends and neighbors come through the back gate and pick it up from the cooler. It’s a great way to get affordable, healthy protein for the family, to support local fisheries, and to help our neighbors get access to sustainable fish.

That’s a great model, and that didn’t exist twenty years ago, even fifteen years ago.

**PMJ:** *You talk in your book about the real dangers of cynicism for consumers and advocates. What victories can people who are advocating for changes in food systems celebrate?*

**Lappé:** In a way, one of the biggest victories in this country is the existence of the organic certified program at USDA. When the organic program was first proposed, the original certification language included foods that were irradiated, contained genetically engineered ingredients, and were grown with sewage sludge. Organized groups led by the Center for Food Safety and a number of others came together to say, “This is not what any of us meant by organic.” They got 300,000 public comments to the USDA, a record for the time. Thanks to that pressure and a government at the time that listened, the organic certification now makes it really clear that those three things are not permitted under USDA as “organic.” It’s easy to take for granted something that exists now so commonly like the USDA organic seal. I’m a big advocate for farmers who go beyond what the USDA requires. I have also met many fabulous farmers who choose not to get USDA organic certified. I don’t see it as the be-all, end-all. But I raise it as a great example of how citizen pressure really shaped policy for the better.

**PMJ:** *What’s the latest effort for citizen-consumers?*

**Lappé:** The effort to label genetically modified foods. Were it not for so many groups engaging to make labeling happen, there wouldn’t be any conversation today about how prevalent [genetically modified organisms] are in the marketplace. The fact that the latest fight in Washington state about this lost by just two percent is really telling—especially given the fact that the industry spent [more than three times as much as supporters] trying to get it voted down. On the “no-labeling” side there were tens of millions of dollars coming from food manufacturers and the junk food industry. On the “yes-to-labeling” side, it was thousands and thousands of individual people showing their support. I think that experience woke a lot of people up to the question of why all these companies are trying to hide information from us about what we’re eating. There is now an enormous amount of popular education around the issues raised by these labeling initiatives.

**PMJ:** *So what are you working on now?*

**Lappé:** Right now, I’m working on the Real Food Media Project. We want to inspire, educate, and grow the movement for sustainable food and farming through creative movies, through a resources center online (foodmyths.org), and through grassroots events. [One project is a] film contest to reach out to graduate students in programs ranging from food studies to film to communications to journalism to create media around sustainable food issues. The idea is to encourage young people who are having these conversations on campuses around the country to think about how we can use film to tell the story of how we can get people to think critically about where their food comes from.

# LEGALIZED KIDNEY MARKETS AND PRESUMED CONSENT LAWS

## IMPLICATIONS, CONSIDERATIONS AND FEASIBILITY

DANIEL SMITH

EDITED BY SUZANNE MERKELSON, MIRANDA EVERITT,  
ANN HOLLINGSHEAD, AND WYATT DONNELLY-LANDOLT

As of October 2013, 120,138 U.S. citizens were on the waiting list to receive an organ donation and in 2012, 4,903 people died while waiting to receive a kidney. This paper considers two major policy options to address this shortage: full legalization of the kidney market and presumed consent laws. The paper considers both of these policy options in terms of their economic and ethical considerations and their political and logistical feasibility. This paper concludes that policymakers in the United States should focus on presumed consent laws in the short-term and a legalized kidney market in the long term.

### INTRODUCTION

As of October 2013, 120,138 U.S. citizens were on the waiting list to receive an organ donation.<sup>1</sup> This represents an increase of roughly thirty three percent since January 2006.<sup>2</sup> As of 2006, seventy percent of the people on the waiting list were waiting for a kidney.<sup>3</sup> In 2012, 4,903 people died while waiting to receive a kidney.<sup>4</sup> This high number of deaths creates a clear moral imperative to consider feasible and ethical policy solutions that can reduce or eliminate deaths of patients waiting for kidney transplants. Beyond the moral argument, each person who receives a kidney transplant instead of relying on dialysis is estimated to save the medical system \$27,000 per year.<sup>5</sup> Thus, there are strong practical and ethical reasons to reduce or eliminate the shortage of kidneys in the United States.

Many of the proposed policy solutions to this problem center on altering the incentives of organ donation. This paper focuses on two of these proposed solutions: 1) to fully legalize the buying and selling of human kidneys; or 2) to alter the laws on organ donation so it is assumed that individuals have agreed to donate their organs in the event of their death, unless they have explicitly stated that they do not wish to do so.<sup>6</sup> This paper assesses the economic and ethical considerations of both of these policy proposals, as well as their political and logistical feasibility. It opens with an overview of the current state of kidney transplantation in the United States. Next, it considers the legalization of a kidney market in the United States, coupled with an international market for kidneys. It then considers presumed consent laws. It concludes with a

recommendation that policymakers pursue implementation of presumed consent laws as an immediate goal and hold the full legalization of a kidney market as a long-term goal.

### I. THE CURRENT STATE OF KIDNEY TRANSPLANTATION IN THE UNITED STATES

In the United States, the Organ Procurement and Transplantation Network (OPTN) is the legal system that manages all organ donations and transplants. The United Network for Organ Sharing, a private nonprofit company contracted by the U.S. Department of Health and Human Services, oversees the OPTN.<sup>7</sup> This system places individuals on a waiting list to receive a kidney from a suitable deceased or living donor.<sup>8</sup>

Federal law bans any person from receiving a financial benefit from donating a human organ (including a kidney) beyond the necessary medical expenses and any compensation for wages lost due to the donation.<sup>9</sup> Therefore, the only motivation an individual in the United States can have for legally donating their kidney is altruism. Federal law also prohibits the donation of a deceased individual's organs unless that individual expressly specified that he wished to have his organs donated after death.<sup>10</sup> This is different from systems in some other countries, where a deceased individual's organs are automatically donated unless she expressly indicated otherwise.<sup>11</sup>

These laws contribute to a gap between the supply and the demand for kidneys in the United States. In 2012, 4,903

## CASE STUDY 1:

### IT'S LEGAL IN IRAN

Iran is currently the only nation that has a fully legalized market for human kidneys.<sup>63</sup> By 1999, just over ten years after the establishment of the kidney market, Iran had completely eliminated its waiting lists for kidney transplants.<sup>64</sup> Compare that to the kidney shortage in Iran just three years prior to the market establishment, where just 274 Iranians received kidney transplants, although 25,000 Iranians suffered from end stage renal disease (which is defined as a kidney functioning so poorly that either transplantation or dialysis is required).<sup>65,66</sup> The difference between the market for kidneys in Iran and the markets for human eggs and paid surrogacy in the United States are most likely due to differences in the per capita incomes of the two countries, adjusted for cost of living.<sup>67,68</sup> This difference implies that poor individuals in Iran are worse off than their U.S. counterparts and are thus more willing to sell their kidneys.

people died while waiting for a kidney, an indication of this shortage.<sup>12</sup> Both proponents and opponents of legalized kidney markets agree that the best way to solve this kidney shortage is to increase the supply of donated kidneys.<sup>13</sup>

The existing shortage of kidneys and international bans on organ trafficking have resulted in the formation of an international trade in black market kidneys.<sup>14</sup> As of 2011, the total retail value of the international black market in human kidneys was between approximately \$514 million and \$1 billion.<sup>15</sup> Between 5 and 10 percent of the total number of kidney transplants each year are performed with illegally purchased kidneys.<sup>16</sup> The combined price of the kidney itself and the transplantation procedure ranges from \$70,000 to \$160,000 U.S. dollars.<sup>17</sup> However, individuals selling their kidneys to black market kidney brokers often receive less than \$3,000 U.S. dollars.<sup>18</sup>

Since the market for organs is illegal in the United States, the government cannot regulate it like a legal market. This absence of regulation can result in significant unnecessary harm. For example, the survival rates of patients who receive kidneys illegally is often significantly lower than among those who undergo surgery legally, although there is significant variation in those figures.<sup>19</sup> In addition, there are frequent reports of kidney sellers experiencing fraud or abuse.<sup>20</sup> We should therefore see a reduction of this black market as an ethically desirable goal. Since the United States represents one of the main sources of demand for black market organs, the elimination or reduction of the kidney shortage in the United

States would contribute to this goal.<sup>21</sup>

## II. ISSUES SURROUNDING THE FULL LEGALIZATION OF KIDNEY TRAFFICKING

### A. OVERVIEW

It is possible to broadly envision a legal kidney market in the United States. If kidney trafficking were legal, with a functioning international market for human kidneys, the supply of kidneys would rise, reducing the current kidney shortage in the United States.<sup>22</sup> We must consider, however, the economic and moral costs and benefits, as well as the political feasibility, of such a market. I consider each of these issues in turn, below.

### B. ECONOMIC CONSIDERATIONS

The basic argument in favor of the legalization of kidney trafficking comes from standard economic theory. By prohibiting any financial compensation to those donating their kidneys (beyond that required to cover the costs of surgery), the government imposes a price ceiling of \$0 on the market for human kidneys. Partial equilibrium analysis (a technique developed by Alfred Marshall to analyze the effect of one factor on the economy holding all other factors constant) shows that such a price ceiling will inevitably result in a shortage in the market for human kidneys if standard economic assumptions are met.<sup>23</sup> Legalizing kidney trafficking would theoretically eliminate the price ceiling and the shortage of kidneys by increasing the supply of people willing to donate a kidney.<sup>24</sup>

Are these theoretical economic predictions applicable to reality? Arthur Caplan,<sup>25</sup> the Director of the Division of Medical Ethics at New York University Langone Medical Center, suggests that they are not. Caplan points out that full legalization may not increase kidney donation among citizens in wealthier nations since the legal U.S. markets for human eggs for medical research and paid surrogacy have relatively few sellers despite high prices.<sup>26</sup> These patterns also hold true for the general market for egg donations.<sup>27</sup>

Evidence from Iran suggests that legalized kidney markets could help alleviate the kidney shortage in the United States if there were a functional and legal international market in kidneys (see Case Study One). While the United States has an implied social contract that prevents individuals from becoming desperate enough to sell an organ to survive, this is regrettably not true in some developing countries.<sup>28</sup> To reduce the kidney shortage, organ donors would have to export kidneys to the United States from developing nations.

### C. ETHICAL CONSIDERATIONS

Next, we should consider the ethics surrounding a legal market for kidneys in the United States. Legalizing a kidney market would reduce the number of people who die while



waiting for a kidney transplant. It would also reduce many of the problems associated with the existing black market for kidneys. Taylor points out that if the United States legalized the market for kidneys, both donors and recipients would have recourse to legal protections from fraud and greater access to information on the pricing and reliability of different kidney brokers.<sup>29,30</sup> A legal market could counteract substandard and hazardous medical practices that occur in the black market by allowing sellers and buyers to compare the mortality rates of patients of different brokers. For instance, the legalization of abortion in the United States caused a dramatic reduction in the number of illegal abortions performed, which resulted in both better health outcomes and lower prices for individuals obtaining abortions.<sup>31</sup> The legalization of the market for kidneys in the United States could lead to similar outcomes.

There are many moral arguments against the legalization of kidney trafficking, chief among them the potential exploitation of the impoverished individuals who might sell their organs. Caplan argues that since only those in desperate circumstances are willing to sell their organs, organ trafficking is inherently exploitative.<sup>32</sup> This argument ignores the fact that banning the sale of organs will not provide individuals willing to do so with a better alternative. For instance, if an individual must sell his kidney or face starvation (as is common in the Indian village of Bindol), then preventing him from doing so may result in his death.<sup>33</sup> Starvation and malnourishment are not among the main causes of kidney damage in the developing world, so recipients of kidneys from food-deprived individuals should not experience any additional medical complications from their decision in this tradeoff.<sup>34</sup>

“Present bias,” a concept in behavioral economics, could incentivize an individual to sell her kidney if she grossly discounts the future value of the donated kidney.<sup>35</sup> Present bias could potentially result in more individuals choosing to sell their kidneys than would be optimal given the health issues associated with having only one kidney.<sup>36</sup> However, it is unlikely that present bias plays a significant role in the U.S. markets for egg donation and paid surrogacy (see Case Study Two). As Caplan points out, both of these markets are roughly analogous to the potential market for human kidneys and their experiences can inform this discussion.<sup>37</sup>

Another set of arguments levied against legalized kidney markets contend that it is inherently immoral to commodify any part of the body.<sup>38</sup> This argument rests on the idea that commodification would lead to a general devaluation of human beings in a society.<sup>39</sup> At its core, this argument is a slippery slope: commodification of the human body is not wrong in and of itself, but it would lead to other undesirable outcomes.<sup>40</sup> This argument is problematic because it ignores the important differences between allowing legalized kidney markets and a more generalized devaluation of human beings. It is ethical and logically consistent that one could arise but not the other.<sup>41</sup> Moreover, permitting legalized kidney trafficking

## CASE STUDY 2:

## EGGS AND SURROGATES IN THE US

Outsourcing can be biological. In the United States, some of those who wish to hire women to act as paid surrogates will hire a woman in India rather than one in the United States.<sup>69</sup> This is mostly likely the result of the difference in price for surrogates in those countries. In the United States, it costs about \$80,000 to hire a paid surrogate, compared to only \$18,000 in India.<sup>70</sup> This price difference is primarily due to the unwillingness of U.S. women to act as paid surrogates. Many women are concerned, for example, with long-term health repercussions from egg donation.<sup>71</sup> This suggests that U.S. women may not underestimate the future health costs of being a paid surrogate. Given these results, it seems reasonable to believe individuals would also give due consideration to long-term health costs associated with donating a kidney and would not underestimate the costs of doing so.

would save lives and could lead to a society that also places a positive value on human life.

In conclusion, legalizing a market for kidneys in the United States would, in conjunction with a functional international market, likely reduce the current kidney shortage confronting the United States. It could also reduce the harm caused by the existing black market in kidneys. While the literature has raised several important ethical objections to the legalization of kidney markets, there are also ethical arguments in favor of legalization.

**D. FEASIBILITY**

A widespread but ill-defined dislike among U.S. citizens hampers the political feasibility of legalized organ markets in the United States.<sup>42</sup> There is some evidence, however, that this dislike is easing. In 2012, a poll of 3,000 American adults found that 41 percent believed it is acceptable for organ donors to receive money as compensation.<sup>43</sup> While public opinion overall does not favor legalization of the market for kidneys, the difference is not significant enough to indicate that opinion will remain against an organ market for the indefinite future. Given that younger individuals are more likely to find compensating organ donors acceptable than older individuals are, it is possible a shift in public opinion could occur over the long-term.<sup>44</sup>

There are several major logistical issues associated with implementing a legalized kidney market. Most Americans would probably be reluctant to sell one of their kidneys even in a legalized market. It would therefore be necessary to import kidneys from abroad in order to significantly reduce

or eliminate the shortage of kidneys in the United States. This would require a functioning international trade in kidneys with at least one developing country.

The United States is unlikely to develop such a market for two reasons. First, international law prohibits all kinds of organ trafficking.<sup>45</sup> In addition to change in U.S. law on organ trafficking, a successful U.S. market for kidneys would also require a change in international law. Second, even with a change in international law, there is no guarantee that enough developing countries would allow their citizens to sell their kidneys to individuals in the United States. Even Iran, the only nation that permits the sale of human kidneys, has regulations prohibiting foreigners from purchasing Iranians' kidneys.<sup>46</sup> Thus, a successful U.S. market for kidneys would require changes to U.S. law, international law, and the laws of one or more developing nations. Combined with the challenges of creating a new regulatory framework to govern the market in kidneys, these logistical issues appear quite significant.

## II. ISSUES SURROUNDING PRESUMED CONSENT

### A. OVERVIEW

Many people in the United States feel strongly that kidney markets should not be legal and there is significant political pressure that aligns with these feelings.<sup>47</sup> As a result, it will likely take some time before the United States legalizes a kidney market—if ever.

So then, is there a more politically feasible alternative to legalized kidney markets that would achieve similar results (i.e., that would eliminate or significantly reduce the kidney shortage in the United States)? If such an alternative exists, it could save more lives than legalizing a kidney market because it would be implemented sooner.

One common alternative is to alter the existing law on consent for organ donation.<sup>48</sup> This would alter U.S. law so that any individual would be assumed to have agreed to donate their organs upon their death unless specifically indicated otherwise.<sup>49</sup>

[One argument holds that] since only those in desperate circumstances are willing to sell their organs, organ trafficking is inherently exploitative. This ignores the fact that banning the sale of organs will not provide individuals willing to do so with a better alternative. If an individual must sell his kidney or face starvation (as is common in the Indian village of Bindol), then preventing him from doing so may result in his death.

### B. ECONOMIC CONSIDERATIONS

Presumed consent laws would likely increase the supply of kidneys. In large part we attribute this to “status quo bias,” the tendency of individuals to remain in their current situations. Most people exhibit status quo bias, which means they would likely remain with the default option even if they are free to choose otherwise.<sup>50</sup>

Changing the default option in organ donation to presumed consent would likely result in a higher donation rate.<sup>51</sup> For example, European countries with presumed consent laws have between a 25 and 30 percent higher donation rate than European countries without presumed consent laws.<sup>52,53</sup>

Unfortunately, while presumed consent laws would alleviate the organ shortage in the U.S., they would not eliminate it entirely.<sup>54</sup> Even under the most optimistic assumptions, the projected increase in kidney donations from presumed consent laws would not be nearly enough to eliminate the

waiting list for kidneys in the United States.<sup>55</sup>

### C. ETHICAL CONSIDERATIONS

Presumed consent laws avoid many of the ethical objections that opponents raise over full legalization of kidney markets. The argument that it is inherently immoral to commodify the human body no longer applies because the law still does not allow any remuneration for donated kidneys.<sup>56</sup> If kidneys are removed from deceased individuals, no individual will be made worse off in a medical sense by presumed consent laws.<sup>57</sup>

Opponents have raised one major ethical objection to presumed consent, which is that it could exploit individuals who do not wish to donate their organs after death, but are not sufficiently informed or aware to opt out of organ donation.<sup>58</sup> While it is true that the will of such people would be disregarded if presumed consent laws were implemented, this must be weighed against the fact that the current system disregards the will of people who do wish to donate their organs but are not informed enough to register as organ donors.<sup>59</sup>

Altering laws on kidney donation to incorporate the concept of presumed consent would likely reduce the kidney shortage in the United States while avoiding many of the ethical objections that are raised against the full legalization of the market for human kidneys. However, since presumed consent

laws would not eliminate the shortage, if the United States only adopted this policy, U.S. citizens would continue to die while waiting for kidney transplants. Therefore, while presumed consent laws do save lives, they are not necessarily a substitute for the full legalization of a kidney market in the United States.

#### D. FEASIBILITY

Politically, implementing presumed consent laws would be difficult but not impossible. The United States already has a form of presumed consent codified into law—hospitals have the right to remove organs from a deceased individual if they cannot locate any of the individual's family members and the individual did not explicitly state that they did not wish to donate their organs after death.<sup>60</sup> This policy embodies the basic principle behind presumed consent laws and it sets a precedent that policymakers could use to promote a generalized presumed consent law.<sup>61</sup> In addition, since there are fewer ethical objections to presumed consent laws they are more politically feasible than a legalized kidney market.

Logistically, implementing presumed consent laws is also feasible. Hospitals and organ donation systems might require additional resources to manage the increased supply of donated kidneys. Beyond this shift in resources, however, the system would not need major changes. The American organ donation system would not need to change any of its underlying institutions nor would the United States would not need to create any additional institutions.

#### VI. CONCLUSION

In conclusion, a fully legalized kidney market in the United States in conjunction with a functional international market in kidneys may help reduce the kidney shortage currently confronting the United States. There are a number of ethical arguments for and against legalization. There is a strong ethical case for legalizing a kidney market, however. Such a market would save lives. The fact that many individuals sell their kidneys on the black market suggests there is a strong ethical case for legalization. Such a system would, however, be difficult to implement both politically and logistically, due in part to the necessity of a functional international market for human kidneys.

Implementing presumed consent laws would also help ease the kidney shortage.<sup>62</sup> In general, there are far fewer ethical issues surrounding presumed consent laws than legalization. In addition, presumed consent laws are easier to implement than legalization both politically and logistically. This paper advocates for the implementation of presumed consent laws as an immediate goal and holds the full legalization of a kidney market as a long-term goal.

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## LEGALIZED KIDNEY MARKETS AND PRESUMED CONSENT LAWS

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# A NEW FRONTIER FOR ILLICIT FINANCIAL FLOWS?

## DIGITAL CURRENCY AND IMPLICATIONS FOR ECONOMIC DEVELOPMENT

ANN HOLLINGSHEAD

EDITED BY DANIEL BAKER AND JONATHAN YANTZI

FEATURE

Every year hundreds of billions of dollars leave the developing world illegally. This money—termed illicit financial flows—includes the proceeds of crime, stolen assets by kleptocrats, smuggling, terrorist financing and, tax evasion. Policymakers worldwide continue to address this issue by promoting policies that would increase transparency and information sharing between governments in the international financial system. In the near future, technological advancements in currency will challenge these solutions by granting added flexibility and opacity to the international financial system for criminals, money launderers, and tax evaders. If trends continue on their current trajectory, these technological developments, namely digital currency, will represent a significant obstacle to stemming the continued tide of illicit financial flows from developing countries. Given the policy challenges associated with regulating them, they may soon represent a significant impediment to economic growth and development worldwide.

### ILLICIT FINANCIAL FLOWS AND ECONOMIC DEVELOPMENT

In 2010 the developing world lost an estimated \$859 billion in illicit financial flows (IFFs).<sup>1</sup> China's losses alone grew from an estimated \$142 billion in 2001 to \$420 billion in 2010. As a point of comparison, over this period, China's annual IFFs are just less than its total stock of external debt. Meanwhile, the cumulative resource drain of the last thirty years on the continent of Africa is roughly equal to its current GDP. A joint study by the African Development Bank and Global Financial Integrity finds that, as a result of illicit financial flows, the continent of Africa is a net creditor to the world.<sup>2</sup>

By definition, illicit financial flows are the cross-border flow of "money that is illegally earned, transferred, or utilized. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit."<sup>3</sup> In form, IFFs include stolen assets by kleptocrats, criminal gains, smuggling, terrorist financing, and tax evasion.

The economic effects of IFFs vary by the monetary and fiscal conditions of each nation; however, economists generally recognize three key economic impacts.

First, illicit financial flows can negatively impact economic growth and development. In particular, countries that lose large quantities of illicit financial flows face a shortfall of domestic savings and investment, which can result in stagnant economic growth.<sup>4</sup> A 2011 World Bank paper examines the experiences of Malawi and Namibia, showing that the experiences of both countries illustrate the drain that ill-gotten money places on economic development. According

to the authors:

Abuse of the financial system is harmful to the financial sector, its reputation and people's confidence in it. A reputation for integrity is one of the most valuable assets of a financial institution and of the financial sector as a whole. Consequently, money laundering is harmful to the welfare of entire economies, since trust in financial institutions is generally seen as a basic requirement for long-term economic growth.<sup>5</sup>

Second, as illicit financial flows are untaxed, they reduce the ability of governments in developing countries to mobilize domestic resources for public programs, and can therefore contribute to rising inequality.<sup>6</sup>

Third, illicit financial flows can foster underground economies. A 2013 study by Kar and Freitas finds that both illicit outflows and inflows are drivers of the underground economy in Russia, which creates "a snowballing effect, whereby both the underground economy and illicit flows continue to grow at an increasing rate until policy measures and institutions intervene."<sup>7</sup> While the economic consequences of underground economies are not straightforward, studies have shown growing underground economies can negatively impact official GDP growth.<sup>8</sup>

There are also negative, and complicated, social and political effects of illicit financial flows. The evidence suggests IFFs affect governance to the extent that they interact with stolen assets by corrupt officials.<sup>9</sup> Not only do these activities rob developing nations of desperately needed public resources,

they also promote and enable corruption, erode confidence in the public sector, and reduce governance.<sup>10</sup>

### TRADE ABSORPTION AND SECRECY

The outflow of illicit money is only half of the story. To address the problem of illicit financial flows, we examine not only drivers and consequences of their outflow, but also the economic incentives and political facilitators of their inflow. That is, we must also examine the absorption of these funds and the relative ease by which dictators, kleptocrats, and tax evaders are able to transmit their funds abroad. Reuter addresses the responsibility of the recipients of this money by framing the problem this way:

These funds do not mysteriously disappear from developing countries. In large part, they flow into legitimate and, often, even highly respected financial institutions in the developed world. Thus, governments of the rich countries that serve as the domicile for many of the recipient banks can ... more forcefully push the institutions to ensure they are not taking in illicit flows.<sup>11</sup>

Numerous policies and norms facilitate the absorption of illicit financial flows, but their commonality is secrecy. From the perspective of a criminal, a tax evader, or a venal politician, the ability to transmit money anonymously is a key motivating characteristic. As a result of this secrecy, we cannot directly observe the absorption of illicit financial flows. Kar, Cartright-Smith, and Hollingshead (2010), investigate this question and find illicit financial flows are generally deposited into secrecy jurisdictions,<sup>12</sup> offshore banks, and a handful of developed countries.<sup>13</sup>

Put simply, it is anonymity in banking and financial institutions in these jurisdictions that enables the absorption of illicit financial flows. Bank secrecy and other confidentiality laws are the major facilitator of this money. By preventing the disclosure of relevant information by financial institutions to domestic and international government authorities, these norms and laws delay and prevent law enforcement officials from tracking and pursuing criminals and tax cheats.

Anonymous companies also facilitate illicit financial flows by allowing individuals to transfer money undetected. This occurs when individuals and groups establish a company, trust, or foundation so that the “beneficial owner”<sup>14</sup> of the entity is concealed. Companies, trusts, and foundations accomplish this by incorporating subsidiaries in a secrecy jurisdiction or by using nominees in place of the true directors.<sup>15</sup>

### CHANGING DYNAMICS IN SECRECY

In recent years, however, this dynamic has changed. The international community—largely led by the United States—has reformed its attitude toward these laws and norms. Both developed and developing nations have intensified their

scrutiny of secrecy jurisdictions and offered new laws and norms to replace global standards of anonymity.

Arguably, the paradigm between secrecy jurisdictions and the rest of the world began to shift in 2007 when UBS banker Bradley Birkenfeld went to the U.S. Department of Justice (DOJ) to blow the whistle on Swiss banking secrecy. Birkenfeld revealed that Swiss bankers were traveling to the United States, systematically offering wealthy Americans the opportunity to evade taxes, and engaging in an aggressive cover-up to conceal these activities.<sup>16</sup> After an investigation by the Internal Revenue Service, the DOJ pursued both criminal and civil charges against the giant Swiss bank.

Since the infamous UBS case, the DOJ has taken an increasingly aggressive tone with respect to offshore jurisdictions, in particular with Switzerland, which holds an estimated one-third of the \$7 trillion held offshore.<sup>17</sup> The UBS case laid the groundwork for more legal action by the United States against several other Swiss banks—including Credit Suisse, Switzerland’s second largest bank, Wegelin & Co., Switzerland’s oldest private bank, and HSBC, which is based in London but has extensive Swiss operations under its Private Bank.<sup>18</sup> At least eleven Swiss banks have undergone criminal investigation by the Justice Department’s tax division.<sup>19</sup> Beyond Switzerland, DOJ prosecutors have likewise investigated financial institutions in other jurisdictions such as Singapore, Hong Kong, and the United Arab Emirates.

While these actions were reactive, leadership on this issue by the United States (and, more recently, the European Union) has allowed the rest of the world to pursue a proactive role in reducing illicit transfers of wealth between nations. These efforts have resulted in two key trends that show promise to reduce the flow of illicit finances from developing nations. First, much of the world—including the European Union and the Group of Eight (G8)—has committed to implementing a multilateral and bilateral system of automatic tax information exchange. Under such a system, governments would collect data from financial institutions on income, profits, and property paid to non-resident individuals, corporations, and trusts, and then automatically provide those data to the governments where the non-resident entity is located.

In their recent summit in Lough Erne, the G8 committed to “developing a single truly global model for multilateral and bilateral automatic tax information exchange building on existing systems.”<sup>20</sup> The leaders go on to note that it is “important that all jurisdictions, including developing countries, benefit from this new standard in information exchange.”<sup>21</sup> To this end, several developing nations (including Brazil, Russia, Tunisia, and Mexico) have joined the Convention on Mutual Administrative Assistance in Tax Matters, which is open to all countries and provides a legal basis for automatic exchange of information.

The second global trend that promises to upend the dynamic

of illicit financial flows is toward stronger rules on beneficial ownership. In this year's summit, the G8 also specifically addressed this issue, noting, "Shell companies can be misused to facilitate illicit financial flows stemming from corruption, tax evasion and money laundering. Misuse of shell companies can be a severe impediment to sustainable economic growth and sound governance."<sup>22</sup> In recent months, UK Prime Minister David Cameron has led a charge to change worldwide standards on beneficial ownership. Cameron has promised to make information on the beneficial ownership of companies available on public registries, which would not only reduce anonymity but also increase the effectiveness of law enforcement efforts.<sup>23</sup>

These registries, if accepted globally, would boost asset recovery and, through deterrence, may reduce illicit financial flows. The United Nations and a book published by the World Bank, *Stolen Asset Recovery Initiative*, both define a "lack of publicly available registries" as one key barrier to asset recovery. The authors recommend that jurisdictions develop and maintain publicly available centralized company, land, and non-profit registries to enable originating jurisdictions to identify and include the necessary information in requests for seizing or confiscation of assets.<sup>24</sup> A report by John Howell & Co. for Global Witness estimates a public registry of beneficial ownership would save law enforcement officials in the United Kingdom \$47.1 million USD per year.<sup>25</sup>

Meanwhile, as world leaders have intensified their efforts to bring transparency to the international financial system, many secrecy jurisdictions have become more cooperative. After the world learned that Hosni Mubarak and Zine El Abidine Ben Ali held significant offshore accounts in her nation, Swiss foreign minister Micheline Calmy-Rey noted, "Switzerland wants to avoid our financial center being used to hide funds illegally taken from the populations concerned."<sup>26</sup> Switzerland also launched a money laundering investigation into accounts belonging to former Tunisian President Ben Ali and blocked several accounts containing tens of millions of Swiss francs.<sup>27</sup>

These dynamics are not sufficient to stem the tide of illicit wealth transfer, but they remain promising. As the world steps up both its proactive and retroactive scrutiny of overseas transfers of wealth, criminals and corrupt politicians will have to become more creative in their approaches to wealth management in order to continue to store illicit funds abroad. With technological advancements in currency, there are new ways for criminals to do so.

### DIGITAL CURRENCY AND FINANCIAL CRIMES

There are several forms of digital currencies currently in circulation. They range from the more legitimate and mainstream (such as Bitcoin, Litecoin, Namecoin and PPCoin) to the less legitimate (including the now extinct Liberty Reserve, which was seized by the United States Global Illicit Finance Team). Each currency functions differently, and

while all pose a possible risk, this paper will focus on Bitcoin, one of the largest digital currencies and the one that is truly decentralized, endowing it with some unique characteristics that make it difficult to regulate and its transactions difficult to track.

Digital currencies do serve legitimate purposes. They are a form of money, with the inherent economic properties of traditional currencies. That is, they are a store of value, a medium of exchange, and a unit of account.<sup>28</sup> They are an attractive substitute for traditional wire transfer services. Users on opposite sides of the globe can use digital currencies to seamlessly and instantly transfer money using peer-to-peer networks. Unlike wire services like Western Union, Bitcoin does not carry transaction fees for transfer. Traders also exchange these currencies on markets. Bitcoin in particular has become a more attractive, stable investment in recent months, though the currency has displayed consistent volatility over the last three years.<sup>29</sup>

Yet these currencies, and in particular Bitcoin, also have characteristics that lend themselves to illicit activity. Unlike their traditional counterparts, digital currencies are not issued by governments; they are circulated without a third party intermediary (i.e., a bank), and they exist exclusively online. For example, a decentralized, complex computer algorithm on the computers of thousands of users worldwide issues bitcoins, not a centralized network or server.<sup>30</sup>

As with offshore financial centers and tax havens, the characteristic of Bitcoin that lends itself to illicit activity is secrecy. Bitcoin transactions can be anonymous or public, depending on the actions of each individual user.<sup>31</sup> Bitcoin transactions are identified by a Bitcoin address and recorded on a public block chain. The system and its users use public key cryptography to ensure that all computers on the network have up-to-date and verified public records of all transactions.<sup>32</sup> Users do not need to present any form of identification to receive a Bitcoin address—or key—so they are not necessarily tied directly to a person, which makes Bitcoin transactions unidentifiable as long as the user takes care to anonymize his or her IP address.<sup>33</sup>

There are many ways to anonymize a Bitcoin transaction. For example, Bitcoin users can create and use new addresses for each transaction, destroying the old after use, creating additional secrecy.<sup>34</sup> They can route Bitcoin traffic through a laundering service—or "anonymizer"—that takes bitcoins from many users and then shuffles and redistributes them.<sup>35</sup> Finally, users can also use the currency "hawala-style." In a hawala transaction, for example, an Indian could send money to America by finding someone willing to trade bitcoins for rupees. They would anonymously transfer the money and the Indian's counterpart in the United States would trade the bitcoins for dollars.

Fears that these characteristics make digital currencies

susceptible to financial crime are not a future possibility but a present reality. Christin estimates that criminals have used Bitcoin as a medium of exchange for more than \$1.2 million in sales of contraband items per month via the black-market site “Silk Road.”<sup>36</sup> When the U.S. Department of Justice shut down and charged Liberty Reserve (a digital currency) and its founders with conspiracy to commit money laundering, it reported that nearly all of the currency’s five million transactions were illegal. The currency was used to launder more than \$6 billion in proceeds from drug trafficking, Ponzi schemes, child pornography, and many other crimes.<sup>37</sup> While these are relatively small figures in comparison to the magnitude of existing IFFs, digital currencies are quite young compared to traditional banking systems, are growing fast, and their upward potential may be limitless.

As the globe continues to step up scrutiny of offshore accounts and financial institutions and develop more financial transparency in these institutions, digital currencies will become increasingly attractive to tax evaders and criminals in developing nations looking to transmit their hundreds of billions of dollars out of the developing world as illicit financial flows. As the international community makes progress on beneficial ownership and automatic tax information exchange, criminals will seek alternative methods for obscuring the beneficial owners of companies and trusts and new ways to avoid taxes by transmitting funds abroad. An anonymous, mainstream, and instantaneous transaction system can fulfill all of these goals. As Bitcoin gains market share among legitimate users, its attractiveness to criminals will only increase.

### POLICY IMPLICATIONS FOR DEVELOPING NATIONS

In their search for policy solutions to this problem, many developing nations may look to the example of developed countries, but are unlikely to find that tactic profitable. Aware of the problems posed by digital currency, the United States and United Kingdom both recently tried policy and regulatory alternatives. In the United States, the Financial Crimes Enforcement Network (FinCEN) of the U.S. Department of the Treasury and the U.S. Department of Justice has released official statements regarding the regulation of virtual currencies.<sup>38</sup> FinCEN has imposed money laundering controls on Bitcoin usually reserved for traditional wire transfer services like Western Union, which include bookkeeping requirements and mandatory reporting for transactions of more than \$10,000.<sup>39</sup>

Yet pursuing similar alternatives would prove problematic for developing countries. The United States and United Kingdom have significant power and capacity to track illicit activity in digital currencies and regulate transactions, at least when they involve third party intermediaries. Many developing nations, by contrast, do not have similar law enforcement capacity and

are less likely to pursue the regulatory and legal approach that the United States has taken.

A global policy approach, led by developed countries with the resources to execute it, integrates developing nations and would likely be a more productive venture. Yet we are unlikely to see such an outcome. At the recent Financial Innovators Summit at 10 Downing Street, one participant suggested the United Kingdom lead an international approach to regulating digital currency. Tom Robinson, co-founder of the soon-to-be digital currency BitPrice, responded that such a move would be difficult and would take far too long to envision and implement. He suggested the United Kingdom follow in the footsteps of the United States and “make their own decisions.”<sup>40</sup>

The structure of Bitcoin in particular poses another, more specific challenge. With offshore accounts, nations have, albeit shaky, political and legal frameworks by which to negotiate over matters of tax and finance. Secrecy jurisdictions are notoriously uncooperative, but the world has made clear progress in beneficial ownership and automatic tax information exchange in recent years. As the actions by secrecy jurisdictions outlined earlier have shown, given enough international pressure, these nations will begrudgingly change their policies on banking secrecy.

Bitcoin, by contrast, would not respond to international pressure, legal frameworks, or anti-money laundering regulations in the same way that secrecy jurisdictions must eventually respond. If Bitcoin achieves a large enough market share and becomes the preferred medium of exchange for money launderers and tax evaders, the world will not have similar legal and political recourses to negotiate on legal and regulatory frameworks to address the issue. Bitcoin is not under the jurisdiction of a single government, individual, group, or entity. No person or group has the authority to negotiate on behalf of the currency. There is no centralized database from which officials can seize assets. From the perspective of developing nations in particular, this fact will make the currency exceptionally difficult to regulate and oversee.

Without meaningful policy alternatives, digital currency may represent a substantial obstacle to stemming the continued tide of illicit financial flows in the near future. As such, digital currencies could represent a significant impediment to economic growth and development efforts in the developing world.

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# OBAMACARE, NATIONAL SECURITY, AND PARTISANSHIP

## A CONVERSATION WITH CONGRESSWOMAN ELLEN TAUSCHER

INTERVIEW BY SHIRIN PANAHANDEH AND EMILY VAUGHAN



Ellen Tauscher knows government from all angles. Originally an investment banker, she served as the Representative for California's 10th district in the East Bay for more than ten years before President Obama appointed her as Undersecretary for Arms Control and International Security Affairs in 2009. Today, she is a cancer survivor, vice-chair of the Atlantic Council's Scowcroft Center on International Security, and active in board governance, sitting on multiple corporate and nonprofit boards including eHealth, The Alliance for Bangladesh Garment Worker Safety, and Aurora Flight Sciences, a drone company.

PolicyMatters sat down with Congresswoman Tauscher during her weeklong visit to U.C. Berkeley through the Matsui Center on Politics and Public Service to discuss politics, domestic policy, and international affairs. Below are lightly edited excerpts from the discussion.

*Ellen Tauscher was a Democratic member of the United States House of Representatives for over ten years, representing California's 10th district in the East Bay. Appointed by President Obama, she served as Undersecretary for Arms Control and International Security Affairs from 2009 to 2012. She is currently the vice-chair of the Atlantic Council's Scowcroft Center on International Security and sits on multiple corporate and non-profit boards, including eHealth, The Alliance for Bangladesh Garment Worker Safety, and Aurora Flight Sciences, a drone company.*

**PolicyMatters Journal (PMJ):** *Since the passage of the Affordable Care Act (ACA), health care costs are matching historical lows. Can this be attributed to the law, or is something else at play?*

**Ellen Tauscher:** I [had] just left the Congress, so as I was transitioning and getting confirmed by the Senate, [the bill was coming up]. I was going back to the Hill to see my friends, and I said, "Hey you know that healthcare stuff you're doing, it's not healthcare reform, its health insurance reform." They kind of just looked at me. In every business and every community people use shorthand, so we have been talking about healthcare reform, and we were using the shorthand for that to talk about a specific element of it because, generally, people believed—just like Mitt Romney

believed when he was governor of Massachusetts—that you can't reform healthcare in the totality unless you have everybody insured. The variables and the unpredictability of having some people use emergency rooms with virtually no continuity of care just creates havoc when it comes to predictably dealing with cost. Health insurance reform became the obvious rallying point.

**PMJ:** *What about the rollout glitches?*

**Tauscher:** Clearly, there have been some glitches. I came from the private sector into government when I was elected in 1996. There are things that the government is good at and there are things that the private sector is good at. There are often too many people in the public sector that are suspicious of the private sector. There just isn't an understanding of who has core capabilities and who has the means to do what. I'm on the board of a company called eHealth, which is a public company and has been selling insurance online for 15 years. Twenty million people have gone through our site. So I'm not suggesting they should just have gone to eHealth, but eHealth knows more about this and has forgotten more about it than anyone else. Our site doesn't crash. There is more of a need for a public-private partnership. When the government decides they want cell phones they go to the

private sector to get them; they don't build a telephone company. The idea that they had to build a very complicated, very networked software system to connect all of these different things and that they could pull it off very quickly was just a bridge too far.

We never got our strategic narrative about why we were doing healthcare reform and why we were doing health insurance reform...And then there were all of these predictions: "You're not going to lose your health coverage." Well, people are, because they've got lousy coverage that's expensive. Losing your coverage isn't the worst thing in the world if it can easily be replaced with something that is more comprehensive and less expensive, but they never finished the strategic narrative to give people a sense of what the promise of this was. In the short term, I'm hoping that people will give it a try even though it's had a few false starts. In spite of the bad PR and the bad rollout, there's still no alternative.

**PMJ:** *What about the pilot programs in the ACA aimed at bending the cost curve: Do you think they will be effective and scalable?*

**Tauscher:** I think that the answer is yes, but a lot of this is going to be about getting some experience and getting the data. A part of this is having some ability to hold people accountable and responsible...The concern is that people will find it less prudent to be part of these things because they're going to expect that their experience with the website will be replicated in different parts. There's going to have to be much more of a phased roll out of things. We're going to have to earn back some trust. We're going to have to prove that the government actually can stand up and fly right and create a sense of optimism about the program.

**PMJ:** *Technology is a huge part of healthcare, but is impacting all policies, programs, and problems. What kind of impact has technology had on national security issues?*

**Tauscher:** We've really been the leader internationally in the world on national security technology since the dawn on the nuclear weapons program. A lot of California technology has been the reason that we've been able to make the world smaller and more interconnected, whether it's cell phone technology or all the stuff Apple's done or the whole Wi-Fi, Bluetooth boom. But there's a lot of new technology including drone technology that has gotten a very bad name. I sit on the board of a drone company. Most drone technology is benign. It creates the ability to either take pictures or movies or listen for a long time. Certainly drones

are used for lethal means, unfortunately a lot of the times it's in Pakistan to go after bad guys finding safe harbor there, but there's a lot about drones that are really helpful. Right now we use signage along highways for Amber Alerts and you can use helicopters. But if you have to go a long way, and you have to be persistent, it's a lot safer to use a drone to hover and be doing surveillance over either a car or a house. Obviously, I know a lot about missile defense technology. We have a lot of different platforms that are meant to keep us safe, provide deterrence, and keep us from having to put our precious fighting men and women at risk.

**PMJ:** *You worked a lot with Russia on the New START Treaty to reduce nuclear weapons stockpiles. How has the relationship changed since you were undersecretary?*

**Tauscher:** The Snowden circumstance exacerbated an already chilly relationship since President Putin came into office. That's unfortunate because I think the United States and Russia are pretty indispensable to the world. When we work together cooperatively we get a lot done, and when we don't it's like when mom and dad aren't talking. Right now we're in a chillier part of the phase than when I was there, but this too shall pass. But we're working very

“There are things that the government is good at and there are things that the private sector is good at. There are often too many people in the public sector that are suspicious of the private sector.”

cooperatively right now on Syria. Things are not improving at the presidential level yet. I don't think that our president and their president are as cooperative, mostly because of Mr. Putin, as we need them to be. But I'm hoping that the Russians will agree to move to further arms control talks off the New START treaty. Right now New START manages strategic and deployed. We need to move to strategic, deployed, non-strategic, and un-deployed so we have a big agenda on our side. The good news is that while the Putin-Obama relationship is far from healthy, our talks...are still very operational. We just need to get back to a place where were less aggrieved about something somebody said or something somebody did.

**PMJ:** *How important are presidential relationships to getting work done? If there's a chilly relationship at the top, how much impact can you have beneath?*

**Tauscher:** It depends on the relationship. When I was



undersecretary, we were in trouble trying to get the New START treaty negotiated in Geneva in 2010 and I went over to try and break the stalemate we had. We had three technical issues and three political issues that we just couldn't quite get past and I needed the president to talk to President Medvedev and on a couple of different occasions. When that happened things started to resolve themselves, and we started to get clarity. It's an enormously helpful thing. Now you don't want them to do the heavy lifting of the negotiating, but very often there are times when you need to kick it upstairs. You have to be strategic when you ask these questions. You have to make sure you have good information and you have to be effective. So you can't be using Secretaries and Presidents willy-nilly.

**PMJ:** *You accomplished a lot getting the New START Treaty ratified in the same month Don't Ask, Don't Tell was repealed. Are those things possible given the current composition of Congress?*

**Tauscher:** The horrible state of affairs in Congress, in the House specifically, is due to partisan redistricting. Gerrymandering. There are too many places in the country where governors who control redistricting want to run the table for their party. The Congress, which can't look very different than the state assembly and the state senate, is done with the same partisan attitude. That's basically achieved a situation where, in most districts, all you have to do is win the primary. People from other parties, whether they're democrats, republicans, or independents, cannot hold you responsible in the general election because they cannot defeat you. So all you have to do is win a primary which means all you have to do is be as crazy as possible. And guess what? The crazy person wins the primary and the crazy person goes to Congress. The majority party in the House has been colonized by nihilists called "tea partiers." They're

anti-government. This is like people that don't eat pizza going to Italy. You have people who don't care about the government shutdown. That's fine with them; they're not for the government. Too many people going to Congress don't have the temperament for compromise and aren't interested in it. The only way we can change that is to have national nonpartisan redistricting. We have it in California. We can be smug about that, except that we're chained to the other forty-nine states. We don't have 218 votes in California; we only have fifty-three. So when people from other parts of the country that aren't interested in doing what's right, and are happy to shut the government down, and are happy to act in a partisan and rancorous way, we can't get what we need. We should be pushing for national nonpartisan redistricting now. Not in 2020. We can't afford to wait that long.

**PMJ:** *How does that new level of partisanship impact foreign policy and the types of arms control and international security issues you worked on?*

**Tauscher:** I don't believe we could get the START Treaty out to a vote right now. The kind of thing that happened by voice vote in the past, that was part of the what's called comity, the kind of nonpartisan, "let's try to do the right thing, let's try to be statesmen" air of responsibility that you used to see—now it is devoid of the body. Crazy things are happening that are very damaging and very disrupting.

**PMJ:** *What is the biggest crisis or most impending future problem that we're not paying enough attention to right now?*

**Tauscher:** The thing that worries me more than anything [is the] dysfunction of the Congress to do anything—to pass the budget, to do what used to be a voice vote on passing the debt ceiling. What worries me is that sometime in the near future we will have some national or international crisis of huge proportion where the president will need the political will of the American people. The way you get the political will of the American people is to have the support of the Congress. And if you went to the Congress and said, "I need you to give me the American people's political capital and support to do something", what do you think would happen? I'm afraid about what would happen. It worries me that we have become incapable of doing what is important. When it comes to things like standing up with allies if there should be some kind of national security emergency, I'm very afraid that some of these people would be willing to be irresponsible to make the point that they're priority is to delegitimize the President. I know there'll be something that will happen—there's always something that's happening—that causes us to have to stand up and do things. I'm very worried that there are too many people who are unfortunately in office right now that cannot be statesmen. They're more interested in petty, political, partisan agendas, and they don't care who they hurt.