POLICY REPORT

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Natural Gas: The Case for Immediate Deregulation

By Barry P. Brownstein

In one of those peculiar ironies of government intervention, the largest natural gas-producing states, Louisiana and Texas, will bear the brunt of the next shortage of natural gas in this country.

Louisiana's and Texas's potential natural gas problems, as well as many of the nation's energy problems, stem from the myriad of price control regulations on natural gas. Adding to the regulatory mess is a law which mandates conversion from natural gas by 1990 and another which funds the production of synthetic natural gas. All of these regulations impede the production and development of an energy source which currently supplies 27% of the nation's energy demand and has the potential to supply much more.

A Shortage Policy

One of the simplest laws of economics — yet one which has been continually ignored by politicians for centuries — is that a price set below the market clearing price leads to a shortage. As politicians have discovered, this law plays no favorites — the shortage occurs whether price controls were instituted with the best of intentions or not. On the other hand, a shortage on the free market can exist only very temporarily. A shortage will cause suppliers to increase their asking price, thus increasing the relative price of the good in question. The higher relative price will both reduce the quantity demanded and increase the quantity supplied. It is not by chance that products in short supply, such as energy and credit, are products whose production and/or distribution are subject to price controls.

In 1954 the Supreme Court extended to the Federal Power Commission the power to control the wellhead price of natural gas. The effects of this decision went relatively unnoticed until the 1970s when the price of unregulated intrastate gas rose above the price of regulated interstate gas for the first time. When this occurred new discoveries were left for the intrastate market, or as in the case of a large gas find in Louisiana, not developed at all. By the winter of 1977 shortages were so severe in the Northeast that some factories were forced to shut down.

"It is likely that following gas deregulation oil prices will tend to fall to the natural gas price equivalent."

With the "running out of everything" thesis enjoying popularity within the Carter administration, the Natural Gas Policy Act (NGPA) was passed in 1978. The two major effects of the so-called deregulation bill were to extend permanent price controls to 40-60% of natural gas supplies and to bring under price controls previously unregulated intrastate natural gas.

In typical bureaucratic fashion the NGPA defines 26 different categories of natural gas. Price controls are adjusted each month on the basis of the inflation rate and an escalation clause. For instance, new natural gas, which is arbitrarily defined as gas located at least 2.5 miles from the nearest existing well, has a price ceiling of $3.132 per million BTUs as of July '82. On the other hand, "old" gas dedicated to commerce prior to April '77 has a maximum price of $.813 per million BTUs as of July '82.

Currently, the only deregulated category is gas from wells dug deeper than 15,000 feet, accounting for 4% of production.[1] New natural gas deeper than 5,000 feet is scheduled to be deregulated in 1985, while gas from wells less than 5,000 feet will be deregulated in 1987. Under the NGPA, however, the President has the authority to extend price controls for an additional 18 months.

In spite of the recommendation of a cabinet group last summer and promises to do otherwise, Reagan has decided to postpone the introduction of deregulation legislation until after the fall elections. There is the increasing possibility, however, that such legislation will be judged too politically sensitive to be introduced at all.

Prices and Supplies

Huge natural gas fields, particularly of deep gas (below 15,000 feet), have been found in the United States even with the very modest price incentives provided for by NGPA. This could have been predicted — as early as 1978 the *National Geographic* published potential gas finds likely under higher prices.

Unfortunately, the vast majority of

(Cont. on p. 3)

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EDITORIAL

The Federal Reserve and the Liquidity Crunch

By Joe Stilwell

Do establishment economists understand the liquidity crunch — the growing inability of firms to meet their current liabilities? Liberals claim that inflation is being lowered by raising unemployment. Apparently, they still believe the Phillips Curve hypothesis. That should not surprise anyone — it provides plenty of justification for the interventionist actions which caused the present economic mess.

Administration economists, confusing secondary effects with primary causes, now hope for consumer spending (of illusory tax cuts) to pull us out of the recession. Perhaps they have forgotten their earlier supply-side arguments that the tax cuts were meant to be saved. Reagan, Regan & Co. now believe that interest rate levels are irrational.

Monetarists claim that what the economy needs is lower interest rates. To get them, all the Fed needs to do is promote a stable money supply. Recently, however, the president of the Federal Reserve Bank of Boston said that the Fed is not and will not be able to define money, let alone control it with any precision. So much for the Fed promoting a stable money supply. Basically, establishment economists do not understand, or will not acknowledge, the present economic situation.

Look at the current liquidity crunch. It is best illustrated by the highest unemployment rate, 9.5%, and the highest bankruptcy rate, roughly 50% greater than the previous record, of the past 40 years. Major industries like housing construction and automobile manufacturing are in a depressed state. New housing starts hover near the anemic one-million-per-year-level; GM and Ford lost a billion dollars each in one year. Numerous smaller industries are also depressed.

Tracing the cause of the recession leads to one source: the Fed. Although regulations, subsidies, and other government actions have led to a far less efficient (and less equitable) economy, the Fed deserves full credit for the liquidity crunch. Until October of 1979 the Fed targeted an interest rate level and permitted the interest rates to fluctuate only within narrow ranges. Milton Friedman attacked the policy, quite accurately, as inherently inflationary. Just as significant, the policy also kept the effective rate of interest to borrowers below the market level for extended periods of time. For a few months before the change, the nominal interest rate was actually lower than the rate of price inflation. Since the effective rate was negative, borrowers were being paid to borrow! Then the Fed switched from controlling interest rates to controlling the monetary base. By then, a future spate of bankruptcies had become inevitable.

Since the Fed's policy had kept effective interest rates below their market levels, businesses and individuals felt free to borrow and spend more at the subsidized rate than they would have otherwise. When interest rate controls were lifted in October, it was only a matter of time until the large debts incurred when interest rates were low became unmanageable. For example, in declaring bankruptcy, Braniff, Wickes, and AM International all cited the high cost of their debt. Other firms that borrowed heavily, like International Harvester at $4.2 billion, will probably soon file as well. Smaller businesses with high leverage have been hit even harder than large firms. Developers found the effective rate of interest on their prime plus loans go from a few percent to over 20%. Consequently, all but the best and the most fortunate developers have declared bankruptcy.

Some economists claim that the Fed is intensifying the liquidity crunch by not expanding the monetary base faster. In other words, they want more money injected into the system to lower the rate of interest. That way, more firms will be able to afford their debt loads. Others claim that the Fed is not being "tight" enough, and as a result, the rate of price inflation will again begin to accelerate. Is the interest rate being kept too high, or is it still being kept below market levels? (With the huge government borrowings, it's quite possible that interest rates should be even higher.) No one can be certain. Only the interplay of market forces, without Fed interference, can determine what the actual rate should be.

How can we maintain an interest rate that accurately reflects the true preferences of borrowers and lenders with the artificially low rates that make an eventual liquidity crunch inevitable and without the monetary overkill that borrowers fear? The monetary system is far too complex to be manipulated from Washington. If we are to avoid even more severe liquidity crunches in the future, the Fed and its establishment economists must stop trying to control the money supply and the economy. The real question is whether that can be done in the current institutional framework, or whether we need fundamental reform or abolition of the Fed. ■

Joe Stilwell is pursuing studies at the Wharton School of Business.

Natural Gas (Cont. from p. 1)

potential gas fields must await deregulation to be discovered. By some estimates, as much as 97% of the potential gas fields in North America have never been discovered. The *Wall Street Journal* estimates that as much as a thousand year's supply of natural gas awaits discovery if prices are decontrolled.[2] Oil price decontrol illustrates the power of incentives — in 1980-81 there was a relatively bigger increase in the drilling of oil wells than natural gas wells.

Much of the confusion over potential natural gas supplies stems from a lack of understanding of what "proven reserves" means. When the Energy Department announces, for example, that the known reserves of natural gas are 15 years, this indicates only the total amount currently available. That amount has very little to do with the total supply of natural gas. It is costly to locate gas, so what is profitable to explore at one price is not necessarily profitable at another. The fact that a supermarket carries only one week's reserve of groceries does not panic us — it would be foolishly expensive to carry a bigger inventory.

Under NGPA, the greatest incentive is to find gas in wells deeper than 15,000 feet on which there are no price controls. Thus, lower-priced gas in the same area remains unrecovered, increasing overall natural gas prices. Relatively cheaper, shallow reserves of old gas are permanently price-controlled, making them impervious to more efficient forms of technology, which could possibly extract more gas out of those existing wells. Gas which has an extraction cost of $1 per million BTUs remains unextracted under a ceiling price of $.813 per million BTUs. But the same gas is cheaper to the consumer than deep gas at $8 per million BTUs. Thus, NGPA's policies effectively increase the overall level of natural gas prices.

The very nature of NGPA leads us to believe that the free-market, decontrolled price could be potentially lower in the long run. Certainly the dire predictions of a doubling or tripling of prices are questionable. Such estimates are usually based on the assumption that gas prices will rise to their oil equivalent. It is much more likely that following gas deregulation, oil prices will tend to fall to the natural gas price equivalent. This is because oil prices are set by a non-free market cartel supported by U.S. government energy policies.

Perhaps all of this seems too good to be true. Why is a sound energy policy not implemented? Many groups are interested in keeping price controls on natural gas. Ironically, among those most interested in retaining controls are the natural gas producers themselves. Since gas from wells deeper than 15,000 feet is deregulated, the producers of the deeper wells are naturally concerned that when deregulation does come, exploration will result in the discovery of less shallow, cheaper fields. Similarly, oil producers are content with natural gas regulation since, as was pointed out, there is the possibility that with decontrol, gas could be profitably produced at less than the price of an equivalent amount of oil.

An energy shortage policy is in the best interests of both the producers of government-subsidized synfuels and nuclear energy. Without the "energy crisis" these industries could not possibly obtain the billions of dollars worth of government subsidies they now receive. Certainly, those academics and intellectuals who dream of a world with more social controls do not desire a free-market energy policy, which can only diminish their influence.

As Julian Simon points out, throughout history we have been assured by experts that we are running out of energy. In the 19th century one of England's great economists, Stanley Jevons, warned that industry would soon run out of coal. Centuries before that there was an energy crisis over charcoal. Yet the long-term trend shows that the relative price of "energy" has been steadily falling. In every instance an increase in the relative scarcity of an energy source has caused the market to come up with a substitute. Simon convincingly argues that this will continue to be the case:

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Natural Gas (Cont. from p. 3)

> I believe that human ingenuity, rather than nature, is limitlessly bountiful. I believe that with knowledge, imagination, and enterprise, we and our descendants can muster from the earth all the mineral raw materials that we need and desire, at prices that grow smaller relative to other prices and to our total income. In short, our cornucopia is the human mind and heart. So it has been in the past, and therefore, I believe, so it is likely to be in the future.[3]

Synfuels and Fuel Uses

Instead of decontrolling the price of natural gas, and allowing the market mechanism to flood us with cheap energy, Congress passed the Energy Security Act of 1980, better known as the Synfuels Bill. Under Reagan the initial Synfuel's appropriation of $19 billion remained intact; $19 billion that the free market would not have spent and that could have been available for other energy sources.

The synfuels idea goes back to the 1950s. Since then, profit-maximizing firms have consistently rejected synfuels as folly because they cost more than their natural counterparts. Because it takes a significant amount of energy to split shale rock and to convert coal into natural gas, the prospects are that synfuels will cost more for a long time. Further reducing the potential investment appeal of synfuels is that the price of oil is above the free-market level due to non-market forces. Thus synfuels investors are threatened with falling energy prices when these non-market forces are eliminated.

It is evident that synfuels are a waste of scarce resources since they are not profitable without subsidies. In a free market each scarce resource tends toward its highest-valued use. The existence of profits indicates a divergence between where a resource is and where it could be better utilized. Thus, when a firm earns profits it transfers resources from a lower-valued to a higher-valued use, which not only benefits the firm but all consumers. Conversely, when a firm is operating at a loss it transfers resources from higher-valued to lower-valued uses. Therefore, a synfuel project which cannot be operated at a profit on the free market compounds the problem of scarcity. At a time of record-high interest rates and stagflation, these plants are a luxury that we can no longer afford.

In spite of Exxon's withdrawal from the Colony Oil Shale Project, 37 new applications for government supports were filed with the U.S. Synthetic Fuels Corp. in June 1982. These new projects, which include synthetic natural gas proposals, will cost the economy between $6.2 and $14.8 billion in resources, in the form of loan guarantees and price supports. In addition, the environment will be burdened by switching from relatively pollution-free natural gas to synthetic natural gas made from pollution-rich coal. The tremendous amounts of water needed in the production of synfuels will simply aggravate what has already become a severe shortage in some states.

"The long-term trend has been such that the relative price of 'energy' has been falling. Increasing relative scarcity of an energy source has caused the market to come up with a substitute."

With the passage of the Power Plant and Industrial Fuel Use Act, better known as the Fuel Uses Act, in 1978, Congress made the political judgment that natural gas supplies would soon be exhausted. In order to "reduce the importation of petroleum and increase the Nation's capability to use indigenous energy resources," the Fuel Uses Act mandates the conversion of all electric power plants and major fuel-burning installations (defined as using 100 million BTUs per hour or greater) from natural gas by 1990. In addition, new power plants and major fuel-burning installations are prohibited from using natural gas as fuel. Synthetic natural gas is exempted from the provisions of the Act.

Like so many other government regulations, the effect of the Fuel Uses Act is completely different from its stated intention. What it does is reduce demand for natural gas which in turn decreases the price and cuts down on the incentives to find new natural gas. As a result, demand for alternate fuels like OPEC oil is increased. Other high-cost producers, such as those producing synfuels and nuclear energy, find demand for their product has also increased. At present, the Reagan administration has no plans to ask Congress to repeal this legislation.

A Windfall Profits Tax

Although the Reagan administration says it would not support it, the suspicion lingers that the price of deregulation legislation will be a windfall profits tax on gas. The final form such legislation would take is unclear, but any tax on revenues or profits reduces incentives to find more natural gas and transfers resources from higher-valued to lower-valued uses.

These distortions in resource allocations occur because the tax makes the industry seem less profitable than it actually is. This results in resources flowing out of areas where they should be (as judged by the market signals of price and profits) into areas where they should not be.

A windfall profits tax would not be a tax on monopoly profits. No single company in the United States owns more than 9% of proven natural gas revenues.

If a windfall profits tax is passed, a severing of profit incentives to find new gas will partially cancel out the benefits of price deregulation. The worst combination of legislation imaginable would be an unmodified NGPA, with 40-60% of gas under permanent price controls, and a windfall profits tax. Both would serve to distort the price and profit signals in the energy market.

Any distortion of the price and profit mechanism finds a natural constituency in those who favor more government controls. A shortage policy means the government must allocate available supplies. Industrial uses of natural gas are already on a standby basis — their supplies can be cut to meet the needs of residential uses of gas. As in the Fuel Uses Act, this has the effect of cutting down on industrial demand for natural gas.

One of the great strengths of the market system is that the information to coordinate a market need not be in the hands of any single individual. Nobel laureate Friedrich Hayek describes how the market process works when a resource becomes scarce:

> All that the users of tin need to know is that some of the tin they used to consume is now more profitably employed elsewhere and that, in consequence, they must economize tin. There is no need for the great majority of them even to know where the more urgent need has arisen, or in favor of what other needs they ought to husband the supply. If only some of them know directly of the new demand, and switch resources over to it, and if the people who are aware of the new gap thus created in turn fill it from still other sources, the effect will rapidly spread throughout the whole economic system and influence not only all the uses of tin but also those of its substitutes and the substitutes of these substitutes, the supply of all the things made of tin, and their substitutes, and so on. . .[4]

Thus, in a dynamic world planning is not an insurmountable problem. If a new natural-gas user needs a clean-burning energy source, he can outbid other potential users in the marketplace for his

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Briefs

☐ Despite the 10% income tax cut of July 1, almost all households with incomes under $40,000 a year will have their income taxes go up this year, due to bracket creep and increases in Social Security taxes. For instance, a family of four making the median income, $24,300, will get a rate cut of $289 this year but will end up with a net tax increase of $127. Similarly, a family of four making $15,000 will pay an additional $88; the $20,000 family will pay an additional $108; the $30,000 family, $171; and the $40,000 family will pay an extra $318.

☐ In all of the sectors of American agriculture that receive federal subsidies, nearly one-sixth of the gross receipts will come from the U.S. government. Last year, the net cost of farm price support and income support programs and loans ran to about $4 billion, but this figure is expected to leap to at least $10 billion this year. In 1980 the figure was only $2.7 billion. Wheat, corn, cotton, and milk accounted for most of the costs. The federal government will purchase approximately one-sixth of this year's wheat crop, one-quarter of the corn crop, one-fifth of the cotton crop, and one-tenth of all dairy marketings.

☐ The Tax Foundation Inc., a nonpartisan research group located in Washington, D.C., has concluded that state and local governments are resorting more and more to non-tax revenues such as interest collections and user fees. In 1980, 34 cents in non-tax revenues were raised for every tax dollar collected, a 37% increase from 1970. For the first time in history (1980), non-tax revenues exceeded property tax revenues. The former provided $75.8 billion for state and local governments, the latter $70 billion.

☐ At a recent meeting of the New York Financial Writers' Association, Lawrence Kudlow, associate director of the Office of Management and Budget, warned about indirect or "off-budget" federal borrowing, which will rise to approximately $90 billion this year and will reach $96.7 billion in fiscal 1983. Off-budget financing usually consists of borrowing for government-sponsored corporations, such as the Postal Service; off-budget agencies, such as the Farmer's Home Administration; as well as private borrowing guaranteed by the federal government, such as the loans backed by the Government National Mortgage Association.

☐ The Treasury Department's Bureau of Printing and Engraving is currently conducting a study of how the government could continue to print money and stamps in case of a nuclear holocaust. Fifty low-risk cities are now being considered for the location of a satellite printing plant which would be ready to expand its operations after a nuclear war. The federal government is looking for a town which has at least a single large building and can supply 100 to 200 workers, yet still be small enough to be considered safe from nuclear attack.

☐ The heads of nearly all major Wall Street firms believe the compromise congressional budget resolution contains accounting gimmicks and unrealistic assumptions and will not prevent large future budget deficits. As a result, they said, fears of high inflation have continued to keep interest rates high. The executives don't believe Congress will cut the necessary $172 billion from a projected deficit of $250 billion in 1985. They said cuts are needed in Social Security and defense spending. ■

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supply. He can only accomplish this if he expects to earn a profit, that is, use the scarce resources in a higher-valued use. In a centrally planned economy, on the other hand, the planning process usually allocates resources to past users, which thwarts the resource-allocation mechanism of the market.

That our economy can no longer afford the burden of a shortage policy in natural gas is clear. Whether the politicians will listen is not as evident. Nevertheless, as economist Ludwig von Mises pointed out: "It rests with men whether they will make use of the rich treasure with which this [economic] knowledge provides or whether they will leave it unused. But if they fail to take the best advantage of it and disregard its teachings and warnings, they will not annul economics, they will stamp out society and the human race."[5]

Whether or not Reagan continues his attempts to "annul" the economic logic against energy regulation will be one of the lasting legacies of his administration. ■

[1]Thus, the source of Louisiana's and Texas's potential gas supply problems stems from the myriad of natural gas categories. Specifically, the pipeline companies in the producing states do not have large cushions of regulated "old gas" which allow them to bid for the supplies of the deregulated deep gas.

[2]Tom Bethell, "Gas Price Fixers," *Harper's,* June 1979, p. 43.

[3]Julian Simon, "The Scarcity of Raw Materials," *Atlantic Monthly,* June 1981, p. 41.

[4]Friedrich A. Hayek, "The Use of Knowledge in Society," in *Individualism and Economic Order* (Chicago: Henry Regnery Co., 1972), pp. 85-86.

[5]Ludwig von Mises, *Human Action,* 3rd ed. (Chicago: Henry Regnery Co., 1966), p. 885.

"Return With Us Now . . .": The AFL-CIO's Economic Policy

By John B. Egger

For a nostalgic return to the economic policies of the 1960s and 1970s, let us take a look at the AFL-CIO's "alternative to Reaganomics." Conceived within a month of Reagan's inauguration and recently circulated to economists in two pamphlets, the union program redistributes spending power from the rich/savers to the poor/consumers, stimulating demand and reducing inequality in one fell swoop. It satisfies beliefs in both economics and justice — what more could one ask?

High interest rates, we learn, would fade as the union's tax-cut revision and "loophole closing" reduce the deficit by adding even more to tax revenues than to federal spending. Besides, the new Federal Reserve Board of Governors — four new members representing industry, labor, consumers, and agriculture — would use selective credit controls and conduct monetary policy (the Federal Open Market Committee would be eliminated) to assure that "interest-sensitive areas" are not penalized. The AFL-CIO's "interest-sensitive areas" correspond pretty closely to those of the board's new representatives.

The two pamphlets, *The National Economy 1981* and *Reaganomics: The Second Dose,* are reprinted from other AFL-CIO publications. They're attractively and professionally done, packed with information ("Reaganomics" briefly discusses about 75 specific programs), and highly readable. But whether one knows it or not, advocating a program is an exercise in economic theory, and that's where the AFL-CIO economists fall short.

We economists — or those who have been teaching these doctrines over the past 30 or 40 years — see little to stand by in the union documents. As misguided as they appear today to a monetary theorist, the documents reflect an excellent grasp of the conventional economic doctrine of the decades when most of us were college students.

John B. Egger is a doctoral candidate in economics at New York University.

The Union's Theoretical Overview

These pamphlets are not theoretical publications, but the nature of the union's theoretical overview can be inferred from them and from AFL-CIO President Lane Kirkland's May 1982 article, "An Alternative to Reaganomics," in *USA Today.* "The thrust of 'Reaganomics,'" Kirkland writes, "is to turn back to 18th- and 19th-century economic theories." He tells us that Adam Smith "described a perfectly competitive market structure . . . a theoretical model, not an actual economic system, and certainly not the one we face in the 1980s." Kirkland tells us that Reaganomics depends on Say's Law, that this law is adequately stated as "supply creates its own demand," and that it "has been repeatedly exploded by the hard world of experience." He also points to the "fundamentalist economic religion called 'monetarism,' the simple but rigorous faith that all economic elements are determined by the money supply."

Skipping a lot of quotable Kirklandisms, we learn, in conclusion:

> It is time to forget the "unseen hand" of Adam Smith and take our economic life into our own hands by dealing directly with our many concrete, visible problems and sectoral and structural needs. It is time for the U.S. to formulate a national industrial policy and abandon the irrational attachment to policies that threaten to bring about the wholesale condemnation of entire industries and regions.

Most of this has been taught as gospel for years. We find historicism or institutionalism, the belief that there is no general economic theory, merely a bagful of situation-specific theories; Reagan apparently got confused and picked the wrong one out of the bag. We are told that Adam Smith's *The Wealth of Nations* is relevant only in "perfect competition" — a doubly damning reflection on economists in that neither Adam Smith nor the nature of competition as an active process has apparently been taught properly. Kirkland offers not only the simplistic Keynesian misinterpretation of Say's Law but even the expression of it — "supply creates its own demand" — which originated with Keynes. His call for national planning brings to mind the Humphrey-Javits bill of 1975, endorsed by most Nobel economists. (I have a little trouble criticizing Kirkland's explicit comments on "monetarism"; although its policy prescriptions are generally good, it lacks a theoretical foundation because its proponents have largely focused on monetary statistics.)

Kirkland implies that the monetary theories of the last century were shallow, which again shows he (or his economists) learned the Keynesian lesson well; Keynes, to highlight his own importance, had dismissed nearly all earlier writers as naive, and his charge was widely and readily accepted. As amazing as it may seem to one acquainted with the richness, depth, and diversity of Thornton, Wicksell, and a dozen other 19th-century monetary theorists, I once studied under a young Ph.D. in monetary theory during the 1960s who, when asked what economists did before Keynes, replied, "Well, I don't know — value theory, I guess."

So the AFL-CIO pamphlets revive what should be — and, increasingly, is — an embarrassing episode in the development of economics, a period which has been called "the Keynesian episode" (by W.H. Hutt) and "the Keynesian diversion" (by L.B. Yeager). Let's take a closer look at the union's major specific proposals.

Fiscal Policy: Restore Social Programs and Soak the Rich

It's hard to know how much President Reagan really believed that we're on the upper part of the Laffer curve — that a cut in tax rates would raise tax receipts — and how much his cuts were ideologically based on the belief that earners, even if they're already relatively well-off, deserve to keep more of what they earn. Either way, the AFL-CIO would reverse the cuts and impose an assortment of new taxes.

> **"The essential economic problem of democracy is that the benefits of intervention are often concentrated, while their costs are frequently diffuse and hidden."**

By limiting or repealing Reagan's tax cuts, the AFL-CIO's 1983 plan could raise $31 billion. Its "loophole closings" would bring in $47 billion, and the proposed $33 billion increase in defense spending is included as a source of revenue because it will either be cut or financed by new taxes on the wealthy and business.

Apparently unable to tolerate negative numbers, even compared to OMB estimates for 1983, the union proposes to raise up to OMB levels every single spending account for which administration projections are lower. As is well-known, these are mostly social programs; this restoration would add $41 billion to administration projections. Since some spending accounts (e.g., national defense) show administration projections exceeding the OMB's, and the union doesn't feel obliged to "restore" these, the change advocated by the union converts a $21 billion cut (compared to OMB 1983 figures) to a $20 billion addition.

But that's not enough. The union also wants to spend $23 billion in "necessary outlays" to "create jobs" — divided almost equally among five programs: public works, training, low-income housing, RFC-style grants and loans to ailing sectors, and extended unemployment benefits.

If we add up the numbers ($111 billion in new revenues, $64 billion in new spending), we find that the administration's $92 billion deficit estimate could be reduced to $45 billion. As desirable as might be a reduction in the deficit, the union proposal adopts the government philosophy Reagan explicitly has opposed: "fiscal responsibility" through higher and higher taxes, never lower spending.

The AFL-CIO proposal tilts taxes toward "business and the wealthy," and spending toward lower- and middle-income groups and certain special interests (like the "interest-sensitive areas" mentioned above). It argues that under the Reagan cuts "hundreds of billions of dollars that should be creating jobs, rebuilding industry and meeting the essential public needs will be siphoned off by the rich and the corporations."

Every time I've "siphoned off" something — like gasoline (from one of my own cars, of course) — it's been for some purpose. The AFL-CIO doesn't tell us what "the rich and the corporations" use their new after-tax largess for, probably because it knows: Most of the saving and investment is done by the wealthy and, in the form of retained earnings, by businesses.

Underlying the union approach is the Keynesian theory of the "accelerator": an increase in consumer spending causes businesses to want to expand, and brings jobs and prosperity. As plausible as this sounds, it requires two conditions: unemployed resources of all types (so that

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Washington Update

The Reagan administration has unveiled a 44-page statement of new merger guidelines, which are expected to signal the beginning of a more permissive era for corporate mergers. Working closely together, the Justice Department and the FTC have each issued a set of rules. Assistant Attorney General William Baxter has stated that the underlying philosophy behind the shift is that "mergers are a very, very healthy phenomena of the capital markets and should not be interfered with except under exceptional circumstances." One of the most important changes is the introduction of the Herfindahl Index, a mathematical formula designed to measure the degree of concentration in an industry. This index will replace the "sliding scale" system previously used by the Justice Department.

The "Truth in Securities Act" of 1933 has recently been amended by new SEC rules which lighten the information disclosure burden for companies that frequently market securities. These corporations are now allowed to use a technique called "shelf registration" which permits them to register a very large total of securities at one time. The detailed facts are filed only when the securities may either be sold immediately or kept "on the shelf" for future sale. One important difference in this procedure is that corporations are now free to sell the securities in parcels through underwriters, broker-dealers, or directly to large investors, bypassing investment bankers. These rules will be in effect until December 10, 1982, when the SEC will review them.

A Justice Department ruling has sharply curbed the federal government's claim to scarce water supplies in the West, reversing a Carter administration policy that had upset Western state officials. The new policy says that the federal government cannot preempt state water rights without express authorization from Congress. Federal rights to water for Indian reservations, national forests, and defense installations are preserved, but the government must now obtain state approval to use water for wildlife preservation, livestock watering, or recreation. Western state officials have said that this ruling will mean more water will be available for developers, municipalities, miners, and farmers.

Recent reorganizations at the Department of Interior have beefed up the agency's mineral development activities at the expense of conservation and other public land uses. The shuffle, which was directed by Interior Secretary Watt, involved transferring about 700 employees to the new Minerals Management Service. The four-month-old MMS is now responsible for managing federal tracts, both on and off shore, after they are leased, as well as for awarding leases for the Outer Continental Shelf.

The Federal Trade Commission may eliminate rules requiring food manufacturers to disclose additional information in advertisements about the contents of their products — specifically, the number of calories, the amount of the cholesterol, and the "precise nature" of natural foods. Although these food advertising rules were tentatively approved two years ago, many members of the commission have argued that there is no problem and that the rules are not merited. Many of the commission's staff members see the attempt to abandon these rules as the beginning of a drive to cancel any major new regulatory efforts.

Several leading House Republicans and Democrats have introduced a bill that would ban oil and gas leasing in wilderness regions permanently. Besides banning leases on the 24 million acres of wilderness lands, the measure would also give Congress the power to place millions more acres under wilderness protection. This bill is expected to pass the House easily but may run into trouble in the Senate.

The United States Court of International Trade, in rejecting a suit filed by the U.S. Cane Sugar Refiners Association, has upheld President Reagan's quotas on sugar imports. The quotas are an attempt to keep sugar prices high in order to spare the federal government the expense of running its sugar price support program, but they have encountered serious opposition from consumer groups and free-trade advocates. The independent sugar refiners, who use large quantities of imported sugar, contend that the President had no authority to institute quotas on top of the present price support program. They are expected to appeal this ruling.

The Reagan administration has once again requested that the Senate Finance Committee increase the federal debt ceiling, this time from $1.079 trillion to $1.275 trillion through September 30, 1983. In addition, the Treasury has asked for a fluctuating interest rate on government savings bonds that automatically increases or decreases with market movements. This latter proposal is intended to stem the tide of investors who are cashing in their savings bonds because of their low rate of return.

The Small Business Administration has published an advance notice of proposed rulemaking that would redefine the term "small business." The new rules would lower the maximum number of employees allowed from 1,500 to 500, effectively cutting in half the number of businesses eligible for the SBA's $10 billion in loans. Although the agency proposed a similar change two years ago, it was dropped after vehement opposition from the business community. ■

AFL-CIO's Policy (Cont. from p. 7)

we can get real expansion everywhere at once, without one industry's expansion requiring contraction elsewhere), and financial resources to pay for all the newly-employed resources. Despite a 9% unemployment rate, the want-ads Reagan is fond of citing show that unemployment is not universal; young engineers, for example, have many attractive offers. As for the financing, it obviously can't come from the savings of those from whom income was redistributed; it has to come from either an increase in the velocity of circulation (which can't be relied upon) or in the supply of money. The union's program for stimulating consumer demand will reduce saving and thwart the production and employment expansion it seeks — unless it also involves old-fashioned inflationism in the form of unanticipated money creation.

Monetary Policy: Inflationism and Controls

The AFL-CIO argues that "the Reagan program will have little effect on inflation." That's because the union adopts a non-monetary view of inflation (oil cartels, crop failures) in which tight money actually raises inflation by raising interest costs.

Since the Fed began to focus semi-seriously on monetary aggregates rather than interest rates in October 1979, interest rates have risen and monetary growth, while highly variable, has generally declined. (I say "semi-serious" because the board's economists and governors clearly have not fully abandoned nominal interest rates as an indicator of policy.) Rather than attributing inflation's decline to this comparative monetary restraint (using rough quantity-theory reasoning), the AFL-CIO talks only of high interest rates — which may actually be declining as of this (late May) writing.

The union tragically misunderstands the economic function of market prices in its effort to protect "interest-sensitive areas such as agriculture, housing, auto production, and high-priority basic industrial production." When the rise in a resource's market price renders a business unprofitable by raising its costs, it's because the public has better uses for the resources. The demise of that business is a sign that the market is working — allocating the valuable resources elsewhere, where they're valued more.

Columnist Art Pine of the *Wall Street Journal* noted that the harsh realities of recession and tight money are forcing — as nothing else could — modernization of the steel and auto industries, and that "the housing industry has ended its unsustainable mid-1970s binge."[1] Pine cites

(Cont. on p. 10)

Regulatory Watch

FEDERAL AVIATION ADMINISTRATION

The Federal Aviation Administration has proposed a new airworthiness directive that will require a modification of many airline seats with new track-lock fittings. If finalized, this action would enable airline seat attachment structures to meet Technical Standard Order regulations. These regulations are designed to prevent the airplane seats from becoming detached after a crash landing.

Several notices have been issued by the FAA that would set aside "transition areas" at different airports across the country. These transition areas are designed to provide controlled airspace protection for aircraft executing new Runway Standard Instrument Approach Procedures. Among the states involved are Connecticut, Alaska, and California.

A special federal aviation regulation has been issued which outlines the procedures for temporary allocation of the arrival slots previously held by Braniff Airways. This directive, which had been in the works since Braniff suspended all service in early May, provides for a random drawing to determine priority order for the allocation of the Braniff slots.

Recent FAA amendments have added a new airworthiness directive for certain kinds of British aircraft models. These amendments require the installation or replacement of a fuse for the auxiliary power unit start cable. Some of these British models have no fuse while others have a fuse of insufficient amperage. The new fuses are designed to protect the busbar on the seatlock in the event of a fault in the starting cable.

Final rules describing several Alaskan High Altitude Routes have been amended to cover certain corrections in the routes which the agency's Airspace Regulations and Obstructions Branch suggested. This action also establishes a high-altitude reporting point for area aircraft.

The FAA has extended the U.S. Navy's jurisdiction over several restricted flight areas in Maryland so that the Navy may continue to flight test the F-18 aircraft beyond the previous expiration date of July 1, 1982. Under the new ruling, the Navy is given another six months, during which time all unauthorized flight operations are prohibited over the restricted area. ■

AFL-CIO's Policy (Cont. from p. 9)

economist Carol Kenney, who says, "The on-going adaptations of American business to this current tight-money, slow-growth environment may pay big dividends through productivity improvements and lower inflation in the decade of the 1980s." Pine and Kenney bring to mind the accurate (if old and often ridiculed) theory of the monetary malinvestment trade-cycle theorists, that depression is a necessary and desirable purge of the wasteful and mistaken expansions of the preceding boom.

The late-1960s guns-and-butter deception created demands on credit markets which would have driven rates up had it not been accompanied by monetary expansion. By keeping rates relatively low, however, the government encouraged the over-expansion of such industries as housing (tax and inflation-hedge motives enter, too) and agriculture. (The problems of high-flying, debt-financing farmers were recounted by Pine.[2]) The AFL-CIO seems to consider these industries to be interest-sensitive by nature, without recognizing the stimulation that inflation provided for each. With land prices seemingly rising forever, and crop price supports encouraging capital investment for production, heavy-debt farmers looked good for years; now it's the low-debt traditionalists who are landing on their feet, on their own land.

The union would lock in the distortions of the '60s and '70s because of its hatred and misunderstanding of market adjustments. With representatives of such "interest-sensitive" bloated industries determining monetary policy, as the AFL-CIO would have it, we should all drag out the collected works of Harry Browne and Howard Ruff, and head for the hills.

Can Any Democracy Control Inflation?

The essential economic problem of democracy is that the benefits of intervention in the market are often obvious and concentrated, while their costs are frequently diffuse, hidden, and delayed. It takes knowledge and maturity to understand this, and while many writers from the gloom-and-doom popularizers on up have warned us not to expect it in our general citizenry, the public's apparent willingness to give monetary restraint more time is encouraging.

Unless Congress and the President can agree to deficit-reducing budgets, or major monetary reform like open-currency competition or a gold standard, I think it's politically unlikely that monetary restraint will continue — so permanent inflation control is still far from being achieved. It should be clear, though, that the AFL-CIO pamphlets, like Senator Kennedy's similar "Democratic Response to the Reagan Administration's Programs" (*USA Today*, May 1982), will throw off all but the slimmest pretense of controlling inflation. Both appeal to special-interest shortsightedness and are products of outmoded economic theories we'd all better hope remain in the past. ■

[1]Art Pine, "Today May Appear Bleak, But 1990 Looks Great," *Wall Street Journal*, May 24, 1982.

[2]Ibid.

INFLATION MONITOR

A quarterly feature of *Policy Report*, the "Inflation Monitor" shows the distorting effects on relative prices throughout the economy of government fiscal and monetary measures. All figures are expressed as annual rates of change unless otherwise indicated.

	1982 1st Quarter	1982 2nd Quarter	1981 3rd Quarter	Average for Last Year
MONETARY SECTOR				
Monetary Base	6.4	3.9	5.8	5.5
M1	6.6	5.7	.3	5.5
M2	9.2	8.8	8.4	8.4
M3	8.7	9.2	10.1	9.5
Discount Rate (average)	12.0	13.4	14.0	13.3
Prime Rate (average)	16.3	15.8	20.3	17.8
PRICE CHANGES				
Consumer Price Index	1.0	5.3	13.5	6.8
All-Finished-Goods P.I.	.6	5.4	2.8	3.7
Intermediate-Materials P.I.	−1.5	3.5	4.3	4.1
Capital-Equipment P.I.	2.1	9.4	5.7	6.3
INDUSTRIAL PRODUCTION INDICES (1967 = 100)				
Consumer Goods	141.0	144.3	149.5	146.2
Producer Goods	145.7	150.2	154.7	151.1
Raw Materials	138.4	144.1	154.4	147.7
Ratio of Capital Goods Production to Consumer Goods Production	1.03	1.04	1.03	1.03

SOURCE: *Federal Reserve Bulletin.*

PR Reviews

Economic Education: Investing in the Future, edited by William H. Peterson. University of Tennessee Press, Knoxville, 1982. 93 pp. $9.95 cloth, $4.95 paper.

The Burkett Miller Memorial Lectures on Economic Education, sponsored by the Center for Economic Education, have been compiled in this attractive little volume by William Peterson, holder of a Free Enterprise Chair at the University of Tennessee. In his introduction, Peterson points out that a recent survey of 15,000 junior high school students indicated that only 23% could correctly identify a simple description of a capitalist economy, and only 50% could differentiate the American and Soviet economies. The lectures attempt to examine the causes of this problem and to suggest some possible solutions. As noted on the back cover, "The relative absence of a basic economic literacy among the American people prohibits realistic and intelligent debate about economic issues."

Contributors include Peterson, George Leland Bach, W. Lee Hansen, Marilyn Kourilsky, Mary Ellen Oliverio, and Walter E. Williams. Williams' essay entitled "Economic Education and Minorities," is outstanding. He argues that one of the main flaws of economic educators is that they fail to point out (or even perceive themselves) that "good intentions alone often produce the opposite effects." The minimum wage and occupational licensing are among the interventions examined which actually hurt the interests of the minority groups they are supposed to protect.

Though some of the speakers occasionally confuse the issue of free enterprise with the interests of big business, this book is recommended for anyone interested in the problems of economic education. ■

The following charts were inadvertently omitted from Ida Walters' article, *VAT: Not Appropriate as a Revenue Raiser,* in last month's *Policy Report.*

Table 1

A 10% Consumption VAT being shifted forward to the final consumer

Stages of Production for Bread	Total Value Added	Purchases of Capital Goods	Taxable Value Added	Total Value Added Plus 10% VAT on Taxable Value Added	Payments for Intermediate Goods	Selling Price
Farmer	$10.00	$(2.00)	$ 8.00	$10.00 + $0.80	—	$10.00
Miller	10.00	(2.00)	8.00	10.00 + 0.80	$10.80	21.60
Baker	10.00	(2.00)	8.00	10.00 + 0.80	21.60	32.40
Grocer	10.00	(2.00)	8.00	10.00 + 0.80	32.40	43.20
			$32.00	$40.00 + $3.20		

Table 2

A 10% Consumption VAT absorbed by labor and capital at each stage of production

Stages of Production for Bread	Total Value Added	Purchases of Capital Goods	Taxable Value Added	Total Value Added Plus 10% VAT on Taxable Value Added	Payments for Intermediate Goods	Selling Price
Farmer	$9.28	$(2.08)	$ 7.20	$ 9.28 + $0.72	—	$10.00
Miller	9.28	(2.08)	7.20	9.28 + .72	$10.00	20.00
Baker	9.28	(2.08)	7.20	9.28 + .72	20.00	30.00
Grocer	9.28	(2.08)	7.20	9.28 + .72	30.00	40.00
			$28.80	$37.12 + $2.88		

Table 3

VAT Liability

Payments for:	Amount	Subject to VAT
Labor, including fringe benefits	$ 50,000	$50,000
Capital (interest, dividends, retained earnings, rents)	30,000	30,000
Intermediate goods	20,000	
Total Sales	$100,000	
Purchases of new capital goods	30,000	(30,000)
		$50,000

"To be governed . . ."

Did we miss something?

A reporter asked [White House Drug Abuse Policy Office Director Carlton] Turner why the government should attempt to prevent adults from smoking marijuana, especially given Reagan's oft-stated view that government too often tells people how to run their lives.

In answering, Turner mentioned instead another drug:

"My idea is that this society we live in today has a responsibility and, when you have a situation where we have 26,000 people killed on the highway each year because of alcohol, that should give you an answer."

—*Washington Post,* June 25, 1982

It is?

Lockheed Corp. and the Department of Defense are engaged in a large, joint lobbying effort to convince the House of Representatives to buy 50 more C5 air transports, according to a detailed computer printout obtained from Lockheed.

The printout shows that Lockheed and the Pentagon mapped out an elaborate plan to try to enlist at least 40 of Lockheed's subcontractors as well as various government officials — from high-ranking military officers to the president — to contact more than 260 members. . . .

Air Force Lt. Gen. Kelly H. Burke, who is responsible for the proposed C5 program, said yesterday: "You're just wrong if you think this is a highly unusual happening. . . .

"All you're seeing is democracy in action. This is the way the system is supposed to work."

—*Washington Post,* June 22, 1982

The burdens of office

Between November and April, [House Ways and Means Committee Chairman Dan] Rostenkowski spent at least 45 days as a guest of various corporations, trade associations and individuals at such resorts as Florida's Doral Country Club, Boca Raton Hotel and Club, Turnberry Isles Yacht and Country Club, Hawaii's Kannapoli resort and the Canyon Hotel Racquet and Golf Resort in Palm Springs. . . .

In addition, Rostenkowski, who is a member of the Professional Golfers Association Advisory Committee, has received hundreds of dollars worth of merchandise, including a watch, a radio, golf bags, a putter, a jacket, pants, luggage, a jewel case, plates and glasses. . . .

"These charity events are part of the business of being a public figure," said John Sherman, Rostenkowski's press secretary. "They are in the range of duties a member of Congress has. . . . All politicians suffer these duties and these obligations."

—*Washington Post,* June 6, 1982

His constituents thought he was a Chicagoan

Rostenkowski said he was aware the NCAA basketball semifinals were to be played that weekend [when two staff members received a trip to New Orleans paid for by lobbyists]. "I don't think I'd be a Washingtonian if I said I didn't recognize that Georgetown was playing basketball."

—*Washington Post,* June 7, 1982

Call the exterminator

Insects captivate Capitol Hill. With groups of House members already labeled "boll weevils," "gypsy moths" and "yellow jackets," Richard Conlon of the Democratic Study Group sees new possibilities: "ladybugs" (female members) and "horseflies" (rural members or committee chairmen).

—*Wall Street Journal,* June 4, 1982

They can vote with their feet

Cubans and Haitians whose welfare payments are running out in Florida are receiving notices from the state listing 10 states where they would be eligible for additional payments — were they to move.

—*U.S. News & World Report,* June 14, 1982

Fiscal responsibility

Key bureaucrats in many federal agencies are being warned to stay on the job in August and September — favorite vacation months for many. Reason: They'll be needed to make sure their agencies spend all their allotted money before the government's fiscal year ends on September 30.

—*U.S. News & World Report,* June 28, 1982

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