POLICY REPORT

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Competition, Antitrust, and the Ready-to-Eat Cereals Case

by D. T. Armentano

The Federal Trade Commission (FTC) antitrust case currently pending against the leading ready-to-eat (RTE) cereals manufacturers presents a timely opportunity to review critically the theory of antitrust policy.[1]

For too long antitrust policy has been relatively immune from the criticism that has devastated other governmental regulations and policies. For example, some economists have argued that government regulation tends to produce results *opposite* to those intended; curiously, however, antitrust policy has rarely been offered as an instance of this well-known phenomenon. And while there have been dozens of revisionist studies demonstrating that business interests historically have supported "regulation" in order to restrict competition, no such revisionist study has yet appeared to unmask the Sherman Antitrust Act.

In short, antitrust policy has more often than not been taken at face value as a policy whose "sole purpose" has been to protect consumers from restricted outputs and higher prices.[2] There are now signs that this essentially naïve perspective no longer commands universal acceptance.

For a number of years, some academic scholars have been severely critical of much of antitrust theory and policy.[3] They have argued that many of the cases brought by the FTC—especially those regarding mergers and tying contracts—have been anticompetitive in their effect and have raised costs and prices. When the courts condemn "economies and efficiencies" as a restraint of trade and a violation of the antitrust laws, even the most ardent antitrust defenders are forced to run for cover.[4]

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"Why has competition been attacked in order to preserve and protect it?"

While this criticism has been important within certain academic circles and in some court decisions, the more fundamental issue yet to be addressed is: *Why* were such antitrust cases brought in the first place? Why did the government believe that it was promoting competition by instituting proceedings against competitive business organizations engaged in essentially competitive conduct and performance? Why has competition been attacked in order to preserve and protect it?

The answer to these questions is at the heart of the antitrust problem. The government and many academic economists have accepted a fundamentally incorrect theory of competition and monopoly power, and this unfortunate theory, in turn, has resulted in absurd antitrust cases. Bad ideas always have (bad) consequences.

Competition and Monopoly Theory

Within the older, classical economic tradition, *competition* was seen (correctly) as a rivalrous process between business organizations for the favor of buyers in the market.[5] Alternatively, *monopoly* was associated with legal barriers to entry that protected existing producers from competition. For classical economists the appropriate public policy to combat monopoly power was obvious: Remove government restrictions and competition would flourish naturally. Even laws preventing business collusion were unwarranted since they could not be executed in a manner "consistent with liberty and justice."[6]

During the 1920s and 1930s classical competition and monopoly theory underwent a major transformation. Competition, formerly understood as a rivalrous disequilibrium process of market adjustment, was transformed into a static, equilibrium condition where resources were routinely allocated as "efficiently" as possible. This metamorphosis was accomplished by focusing attention not on the process of adjustment itself, but on the end-state equilibrium condition that might appear as a *consequence* of the process. Thereafter, competition became associated with many small firms producing homogeneous products, with a total absence of interdependence (formerly the very essence of rivalry) and advertising or marketing of any sort. The problem of accounting for market information (and the process by which plans are corrected) was simply ignored by assuming that information was perfect. "Competitive" firms were now firms that did *not* compete, did not change the nature of the product or its price, did not innovate or market new products, and did not earn economic profits in the long run.

This new theory of competition also

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EDITORIAL

No Quick Fix for Social Security

Millions of American workers received a rude surprise last month: The social security bite out of their paychecks rose from 6.13% to 6.65%. The maximum income subject to the tax increased as well, from $25,900 to $29,700, so that the maximum tax paid by an individual will increase from $1,587 to $1,975. Of course, all these numbers should be doubled because the employer's share of the tax rose along with the employee's share. Economists now recognize that the "employer's share" of the tax is just another cost of labor to the employer and thus is ultimately paid by the employee. Social security, therefore, actually takes 13.3% of most workers' paychecks, up to a maximum of $3,950.

Almost all American workers are subject to this tax increase. The major exception is employees of the federal government, who have wisely exempted themselves from the social security system. They have their own retirement system, with decidedly better benefits than those offered by social security.

This year's rise in the social security tax is the latest in a series of increases mandated by Congress in 1977. That law was called the largest peacetime tax increase in American history.

Yet even that massive tax increase did not make the social security system solvent. By 1980, just three years later, the system's trustees reported that social security would run out of money to pay benefits as early as 1982. The system currently has only enough money in its "trust fund" to pay three months' worth of benefits, down from 13 years' worth in 1950 and one full year as recently as 1970. Even a minor economic dislocation—hardly an unlikely event in a world of double-digit inflation and 8% unemployment—could exhaust the trust fund.

Most observers now recognize that social security is in trouble. Even President Reagan's advisers recommended some changes. But the changes being proposed do not face up to the real problem. They are "quick fix" solutions designed to get us past the next few years. When politicians propose such quick fixes, we may assume they just want to get past the next election. When respected economists offer piecemeal solutions, they may believe that only such answers are politically feasible. Yet if the proposals that are perceived to be politically feasible are in fact not sufficient to solve the problem, it is incumbent on policy analysts to make that fact known. Such insistence on real solutions can help to change what is politically feasible.

What sort of solutions to the social security problem have been proposed?

Some experts recommend raising the retirement age for social security from 65 to 68. This proposal would allow for a small reduction in the payroll tax after it was implemented, but it would not solve the system's basic problems.

Others have suggested that social security benefits be indexed to prices rather than wages. This would have some beneficial effects, but again the system's problems go much deeper than this. Such a reform might delay the collapse a few years, but would not prevent it.

The Reagan transition team recommended forcing new federal employees into the social security system. Such a proposal would seem to accept the "chain letter" nature of social security, suggesting that the only way to pay present recipients is to find new taxpayers. Although it is certainly unfair for the federal government to require the rest of us to participate in a system from which its own employees are exempt, the answer is not to extend the near-bankrupt program but to begin cutting it back.

None of these proposals actually faces up to the real problems of social security. These problems stem from a basic contradiction between the two objectives of the program, to provide welfare and to provide insurance. Trying to meet both objectives, it has met neither well. It does not provide adequate benefits for the truly needy, and it does not provide a good return on investment to those who have paid into it all their lives.

It has never been an invested pension fund, as most Americans probably think; rather, it is two separate programs, a tax and a dole, tied together under one name. When any such pay-as-you-go system reaches its mature phase, as social security has, it is no longer able to meet its obligations.

These problems require major reforms. We must begin to look for a system that will provide better retirement benefits at a lower cost. Such a system has been outlined by Peter J. Ferrara in his study *Social Security: The Inherent Contradiction*, published by the Cato Institute. He proposes to fund current social security benefits out of general revenues—as will almost certainly have to be done anyway—and to allow younger workers to invest in private plans *instead* of social security. In a few years the burden on the taxpayers would be relieved, and new retirees would receive better benefits from their private investments.

There may be other proposals as good as Ferrara's. What must clearly be rejected is any piecemeal solution. The problems of social security are too fundamental to allow us the luxury of a quick fix. ■

The RTE Cereals Case (Cont. from p. 1)

produced a far more general approach to monopoly and monopoly power. Legal barriers to entry were now broadened to include any entry difficulty that new business organizations might face in order to compete with established firms. And, importantly, this allowed "industrial organization" theorists to treat product differentiation, scale economies, and advertising not as elements of competition, but as "barriers to entry" that would "foreclose" and "exclude" competition.[7] In short, the concept of business competition was turned around; the essential elements of competition were said to indicate "monopoly" and a "misallocation of resources." That strange antitrust cases would follow this theoretical inversion should come as no surprise.

The RTE Cereals Case

Against the background of this short history of theory, the current FTC action against the leading cereal manufacturers can be clearly understood. The cereals industry conveniently contains all of the ingredients needed in the "modern" approach to monopoly power. The industry is "concentrated," with the four largest firms selling over 80% of the ready-to-eat cereals. Concentration has stayed "persistently" high for many decades. The firms reportedly avoid price competition and almost always follow the leader (Kellogg) when increasing their market prices. The profits of the companies have stayed persistently higher than the normal or competitive return on investment. Finally, and most importantly, the dominant firms maintain their market position by introducing dozens of new cereal types ("brand proliferation"), which has had the effect of restricting new entry into the market and thus restricting "competition" in violation of the law. The remedy sought for such antisocial behavior will be to force the leading companies to license out their trademarked cereal brands to companies currently shut out of the market.[8]

As we have previously argued, this emphasis on product differentiation as a barrier to entry is certainly not accidental. For decades students of economics and antitrust policy have been told by economic theorists such as Joe Bain, Richard Caves, Walter Adams, William Mueller, and William Shepherd that product differentiation (and most often a "frivolous" differentiation) is the most important barrier to competition and is primarily responsible for allocative inefficiency. We should not be surprised, therefore, that such theories have finally been taken seriously by those now responsible for public policy in this area.

Product Differentiation

The argument that product differentiation misallocates resources by deterring entry and competition has been raised in previous antitrust cases, but it has never been the central issue—or, indeed, the *only* issue—as it is in the current cereals case. The FTC argument (actually the argument of Professor Richard Schmalensee) is that brand proliferation by the existing companies so "crowds" the "product space" that there is virtually no room for additional brands by new entrants.[9] New entrants are deterred from entering the market since the risk of failure of a new brand is high and the brand-specific fixed costs (especially advertising) are considerable. Thus continuous brand introductions by the existing companies "exclude" competition and "foreclose" the market to new competition. Even though the leading companies continue to earn "monopoly" profits, entry is effectively barred.

Although this argument may appear plausible, it is riddled with difficulties. Putting aside for the moment the issue of monopoly profits, the actions of the existing companies are completely compatible with intensely competitive market behavior. Indeed, the FTC is not objecting to monopoly, but to the rigors of the competitive process in RTE cereals. For instance, we are told that it costs millions to introduce a new

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In This Issue

POLICY REPORT

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The RTE Cereals Case (Cont. from p. 3)

cereal. We are told that the risk of introducing any single new brand is extremely high. We are told that the established companies introduce new brands (84 between 1952 and 1973) and fill product "holes," or gaps, quickly—so quickly in fact that new business organizations cannot possibly respond.[10] And finally we are told that all of this production—and it *is* production—is ultimately "exclusionary" of competition.

Now if all of this sounds familiar, it should, since it is a variation of Judge Learned Hand's arguments in *Alcoa* (1945).[11] In that case Hand argued that Alcoa "preempted" competition by investing in productive capacity and expanding its outputs of aluminum ingot *before* potential competitors could or would. Alcoa forestalled competition by purchasing water-power sites and developing them, thereby improving its own industrial efficiency. Alcoa anticipated increases in the demand for its products and efficiently filled that increased demand, employing superb management and an "elite" personnel. But all of this was not inevitable, concluded Hand. Alcoa's behavior indicated that it meant to maintain its (near) monopoly position in the market by engaging in these specific "exclusionary" practices.

That these so-called exclusionary practices in *Alcoa* were all efficient practices and productive of economies and benefits for buyers has now been widely admitted. Yet the "exclusions" in the present case do not differ in kind from those in *Alcoa*. After all, the cereal companies were not restricting output and repressing innovation. They were admittedly engaged in activities aimed at holding (or increasing) their market share, and these activities involved introducing and advertising new products (or variations of older products) and expanding the production of those products. That such activity was accomplished *successfully* is the very essence of the FTC complaint and the very heart of the matter. If the firms had misinterpreted consumer demand and not introduced brands, they would have lost market share, and there would have been no FTC case. If the firms had misidentified consumer demand and introduced the wrong brands, they would have lost market share, and there would have been no FTC case. If the firms had failed to advertise and market their products successfully, there would have been, again, no FTC action. Thus it is the success of private planning and production that is at issue in this case, just as it was in *Alcoa*, and no bias against sugar cereals or children-directed TV advertising ought to divert our attention away from this essential issue.

> **"The essential elements of competition were said to indicate 'monopoly' and a 'misallocation of resources.'"**

Profits and Resource Allocation

For many economists, and even for some of the critics of antitrust policy, the fact that new entry has been relatively modest and that profits for the leading companies have stayed high presents some major difficulties. Why, they ask—if the industry is indeed competitive—do profit rates stay far above normal for extended periods of time? And is not such performance an indication of monopoly and resource misallocation?

The first point to be made is that even neoclassical competition theory admits that disequilibrium profits need not be "normal." It is only in long-run competitive equilibrium that firms (should) earn a competitive rate of return. And since cereal outputs are expanding and new products are being constantly developed, it is obvious that the industry has not yet reached any final equilibrium. Thus high profits, even from the perspective of the critics, do not unambiguously indicate resource misallocation.

Further, there is no reason to expect any rivalrous process, especially one involving highly differentiated consumer goods, to *ever* reach an equilibrium with normal profits. Although equilibrium is admittedly a useful pedagogical notion, we should not get carried away and expect such theoretical constructs to actually exist in reality. Economists are taking their theoretical models far too seriously and as a consequence are committing grave methodological errors. Unfortunately, these theoretical errors have rather grave policy implications in this case.

Entry

There are several additional points to be made with respect to market entry in the cereals industry. The first is that entry need not be accomplished by totally new firms, but can encompass expansions in capacity by existing firms, too.[12] The FTC insists on using the term in a manner that is not even consistent with neoclassical practice. Since capacity in the cereals industry has increased in response to increases in demand, there certainly has been entry, although it has not been the sort of entry (high-cost, new-firm entry) that the FTC would seem to prefer.

But even admitting that new entry has been limited is admitting too much. For the fact remains that there has been "entry" (even by their definition) into the industry, although that entry has occurred in special product areas, e.g., natural cereals. All of the FTC-alleged "barriers to competition" were not enough, it seems, to prevent successful market entry and competition in natural cereals. Why this competition fails to destroy the entire logic of the FTC case against the cereal companies is not immediately obvious.

Finally, the FTC has argued that the high profits cannot be explained as a return to high risk since the cereals industry, as indicated by the historical stability of its earnings, is hardly a

high-risk industry. Yet earnings are stable despite the high risk associated with brand introductions (consumer taste in cereals being very unpredictable) precisely because the large companies are able to invest in a portfolio of brands and thereby spread the risk of any single brand failure. From the perspective of the potential small entrant, the industry is extremely risky, and entry is, accordingly, deterred. The profit returns would have to be even higher, perhaps far higher, to encourage entry into most of the RTE brand areas. Rather than charge that profits are too high, the FTC should more logically have argued that profits were kept artificially low (given the risk) to discourage entry and competition.

In conclusion, the RTE cereals case is another antitrust disaster in the making. It is both a travesty of justice and an abuse of sound economic principles and reasoning. But all of this is unlikely to deter the FTC persecution and the ultimate examination of these issues in court. By 1985, if we are lucky, we may find out whether selling Cocoa Puffs and Cap'n Crunch at a profit is really in the public interest. ■

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1 The FTC complaint against Kellogg, General Mills, General Foods, and Quaker Oats was Docket No. 8883 and was filed April 26, 1972. (The Quaker Oats Company has since been dropped from the complaint.)

2 Alan Stone, *Economic Regulation and the Public Interest: The Federal Trade Commission in Theory and Practice* (Ithaca, N.Y.: Cornell University Press, 1977), p. 24.

3 Some of the most prominent critics of antitrust (often associated with Chicago and UCLA) would include Yale Brozen, Harold Demsetz, Wesley J. Liebeler, Richard Posner, and Robert Bork (Yale Law School). Two book-length criticisms would be Posner's *Antitrust Law: An Economic Perspective* (Chicago: University of Chicago Press, 1976) and Bork's *The Antitrust Paradox* (New York: Basic Books, 1978). For a more radical criticism of antitrust theory and policy, see my own *The Myths of Antitrust: Economic Theory and Legal Cases* (New Rochelle, N.Y.: Arlington House, 1972).

4 Economies and efficiencies have in fact been explicitly condemned. See, for instance, the argument in *Brown Shoe* v. *U.S.*, 370 U.S. at 294.

5 For an excellent review of classical and neoclassical competition theory, see Paul McNulty, "Economic Theory and the Meaning of Competition," *Quarterly Journal of Economics* 82 (1968).

6 Adam Smith, *The Wealth of Nations* (New York: Modern Library, Random House Edition, 1937), p. 128.

7 See any leading industrial-organization text, or see a new (but still incorrect) treatment, Douglas Greer, *Industrial Organization and Public Policy* (New York: Macmillan, 1980).

8 These assorted findings of "fact" are all contained in the four-volume FTC Staff Report, "Complaint Counsel's Proposed Findings of Fact, Conclusions of Law, Order, and Supporting Argument," September 30, 1980 (available from the FTC for $82.28).

9 Ibid., p. 256–392.

10 Ibid., especially pages 249–50.

11 *U.S.* v. *Aluminum Company of America*, 148 F.2d 416.

12 Yale Brozen, "Competition, Efficiency, and Antitrust," in *The Competitive Economy: Selected Readings*, ed. Yale Brozen (Morristown, N.J.: General Learning Press, 1975), p. 11.

Regulatory Watch

DEPT. OF HOUSING AND URBAN DEVELOPMENT

Federal regulation of private housing, which began 50 years ago under President Herbert Hoover, has reached such staggering proportions that the nation's basic housing laws now fill over 1,350 pages of small print, an amount that is expanding daily. The authorized housing budget of the Department of Housing and Urban Development (HUD), the agency that administers most of the federal housing programs, will exceed $27 billion in fiscal 1980. Many of the federal housing purchases contain commitments to pay for housing over a long period of time. The federal government presently has $230 billion worth of such commitments.

HUD estimates that the typical American household spends about 19% of its income for housing. This is a larger share of income than for anything else—except taxes.

The Housing Act of 1949 establishes "a decent home and a suitable living environment for every American family," as a national goal. In its attempt to fulfill this goal, the federal government now directly subsidizes the housing of over twelve million households. A Congressional Budget Office study has estimated that the total costs of the direct and the indirect subsidies to public housing tenants will average somewhere between $6,700 to $12,300 a year per unit, depending on the rate of inflation. If this amount were provided directly to the tenants, it would enable them to rent almost any new, privately built apartment.

HUD has approved almost forty thousand construction projects for the upcoming fiscal year. Under the Public Housing Program, local housing authorities are expected to buy projects built by private developers, and the job of the federal government is simply to pay the bill. The planned apartment units will have an average cost of $57,000 per dwelling, not far below the median price of a new home, $63,000.

Under Subsections 221(d)(3) and 236 of HUD's Section 8 (loan management and property disposition), occupants of subsidized housing units are tied to that unit if they wish to retain their subsidy. If the occupant leaves his unit to take a better job, for instance, he loses his subsidy.

HUD has recently been experimenting with a new method of lowering mortgage interest rates: the "local mortgage revenue bond," a device that uses the proceeds of tax-free municipal bonds to finance home mortgages. Although several billion dollars' worth of bonds has been issued, the initial aim of the program, to increase the homeowning opportunities for lower-income families, has not been achieved, because most of the funds have gone to middle- and upper-middle-class buyers.

Rent Control and the Poor

by Charles W. Baird

Rent control is a specific type of price control, and the relationship between price controls and the poor has been well stated by Gary Becker, an economist at the University of Chicago:

> Price controls are almost always rationalized, at least in part, as a desire to help the poor, yet it is remarkable how frequently they harm the poor. The difficulty intelligent laymen have in understanding this is testimony to the insights provided by even simple economic analysis.[1]

To be poor does not mean having to pay high prices. To be poor means having purchasing power (real income) less than some minimum amount. If the market price for some good increases, that merely signifies that something has happened to reduce the availability of that good relative to the ability and willingness of people to pay for it. A price increase informs all market participants of the change in the supply-demand situation and causes them to adapt their plans and actions to that change. Prices that people pay in uncontrolled markets are the terms of participation in the market process, while real incomes that people receive as sellers in the market determine the extent to which they can participate in the market process as buyers. Poverty is not the result of high prices—it is the result of not having much to sell that others are willing to buy.

Attempts to diminish poverty by preventing price increases are self-defeating. The proscription of price movements greatly diminishes the efficiency of all economic activity and, therefore, ultimately must lead to lower incomes for most people. In an economic system of voluntary exchange, people receive incomes primarily by selling the services of the resources they own to others who, in turn, employ the resources in the production of goods and services. Incomes to resource owners are paid out of the revenue producers receive when they sell what they produce to willing and able buyers. Resource owners of all sorts can receive large income payments only if their resources are used to produce those things that buyers really want and are, therefore, willing to pay to get. The pattern and intensities of wants can only be accurately communicated by prices that are allowed to become whatever the market will bear. The price that the market will bear for a good is the only operational measure of the good's value that exists. When sellers attempt to discover such values for all goods, they benefit all of us, because it is only with knowledge of these values that resources can be directed toward uses that generate high incomes for resource owners. The only effective approach to the problem of poverty, therefore, is to allow the price mechanism to work to its full extent in each market. Only then can we be sure that the flow of income payments is as large as it could possibly be.

> **"The only tenants who benefit from rent control are those that stay in one apartment for a long period of time."**

People own unequal quantities and qualities of productive resources. Therefore people will receive unequal income payments as they sell the services of those resources. The market value of a person's labor services, for example, might be low because of a physical handicap or lack of education and training. The value of such a person's labor services is not enhanced by laws restricting price movements. To the contrary. Price restrictions lead to the inefficient use of all resources and, therefore, reduce the earnings it is possible for such a person to realize. The plight of such a person can be relieved only by improving the quantity and quality of the resources he has to sell and by removing all legal impediments (e.g., minimum wage laws and compulsory union membership) to their sale. Where that is not possible, it makes more sense to grant cash subsidies to such a person than to prevent markets from functioning. Malfunctioning markets generate poverty.

Incomes and Rent Control

In New York City, rent control has long been advocated as a measure to help the poor. Indeed, the plight of the poor seems to be the most effective propaganda in the arsenal of New York's rent control advocates. Yet in 1979 rent control in New York City seemed to do at least as much for the rich as for the poor. The mayor of New York, for example, lived in a rent-controlled apartment at $250 a month. The estimated fair-market value of that apartment—what the rent would be in the absence of control—was $400 to $450. The president of the American Stock Exchange paid $660 a month for an apartment with a fair-market value of $850 to $1,200.[2] Many New Yorkers with relatively high incomes inhabit rent-controlled apartments.

The only tenants who benefit from rent control are those that stay in one apartment for a long period of time. This is so even when the rent control ordinance extends to newly vacated apartments. When rents are controlled, it becomes difficult to find a vacant apartment. If one is forced, by a job change or something else, to move, there ensues a long and expensive search for a new apartment. On the average, people with lower incomes move more frequently than those with middle and upper incomes.[3] This means that where rent control ordinances specify decontrol at vacancy, people with lower incomes will face larger rent increases than others; and it also means that the poor face the burden of apartment hunting under rent control much more often than others. When we recall that indirect rationing by price and nonprice rationing devices is often employed under such restrictions, we must at least doubt that rent control helps the poor.

Most people assume, without even pausing to think about it, that landlords affected by rent control are typically richer than their tenants. Actually there is some evidence that this isn't true. The author of an early study of rent control in New York concludes:

> I do not want to argue that the evidence presented indicates that landlords are poorer than tenants. But the data certainly do not indicate the contrary—that landlords have significantly higher incomes than tenants. Thus, if one of the objectives of rent control is to aid low-income people—and I can find no other important objective that rent control does achieve—it does not achieve that objective. Undoubtedly, there are relatively poor tenants renting from relatively rich landlords, but the converse must also exist.[4]

While this particular study was done in 1951, there has never been any presentation of data that suggests the situation has changed.

Middle- and upper-income people are owner-occupiers of their dwelling units to a much greater extent than lower-income people. Since rent control creates a shortage of rental housing, some of the demand for rental housing spills over into the market for owner-occupied units. This results in higher prices in this market than otherwise would exist. This is a clear gain to owner-occupiers who acquired their homes prior to the price increase, but it is not very good news to those who are forced by rent control to seek housing in owner-occupied facilities. Here again, the poor seem not to benefit from rent control as much as others.

Environmentalism and the Poor

Environmentalists and other antidevelopment people have been successful in decreasing the supply of all kinds of housing, both rental and owner-occupied, relative to the demand for housing. In some cases—e.g., Mountain Village in Oakland, California—the actions of the antidevelopment people have changed proposed developments from ones that offer many units with a wide range of prices and rents to ones that offer fewer units on large lots with only very high prices and rents. In some cases—e.g., San Bruno Mountain in San Mateo County, California—antidevelopment forces have been able to get proposed developments completely cancelled.

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Briefs

☐ According to a survey by the Capitol Hill Women's Political Caucus, female legislative assistants in the House earn an average of $3,000 a year less than their male counterparts. Female assistants in the Senate get about $4,000 less than males, while the yearly earnings of Senate female field managers is $9,000 less. Women can do little about this situation because Congress has exempted itself from the Equal Pay Act of 1973 and the antidiscrimination provisions of the National Labor Relations Act.

☐ "Presents are showering on Congress as never before," according to *U.S. News & World Report*, and it's considered neither illegal nor "unethical" as long as the gifts are publicly reported. Show horses, antique firearms, golf equipment, purebred dogs, club memberships, and vacations are only a few of the freebies that have been given to members of Congress. No fewer than 54 congressmen listed gifts of trips (with expenses paid) to resorts or foreign countries to give speeches, attend conferences, or make "fact-finding" tours.

Says Sen. John Tower (R-Tex.), whose $2,000 honorarium and expenses for a five-day speaking trip to Honolulu were paid by the National Consumer Finance Association: "As a member of the Banking, Housing, and Urban Affairs committees, I get invitations to speak to groups that have an interest in the legislation we handle. Obviously, things that happen in a resort are more suspect, but I put in the same amount of work. These groups have a right to representation, a right to ask questions."

☐ The Navy has spent over $150 million during the last 12 years to administer an automated centralized pay system for its military personnel. The system is considered so unreliable that local disbursing officers are forced to calculate pay figures manually in order to check the computer. Each payday, over half of the paychecks must be changed to agree with the correct total.

☐ A top Energy Department official has estimated that it will cost American taxpayers $45 million a year just to keep the DOE's gas-rationing plan on the shelf and ready to go. Most of the money will be needed to run periodic checks on state motor vehicle registration files, on which gas allotments will be based, and to maintain local rationing boards.

☐ The amount of money collected in property taxes has nearly doubled in the last decade despite a growing tax revolt that has led to such measures as California's Proposition 13. In 1969 the cost of property taxes was $32.5 billion; in 1979 it stood at $63 billion. Over the same period of time the gross assessed value of the property subject to taxes rose only 11.8%.

✓ Washington Update

✓ For the first time, the total cost of campaign spending rose to over $1 billion. This figure, which includes $250 million for the presidential campaign, $350 million to elect members of Congress, and some $400 million to choose governors, state legislators, and other officeholders, is nearly twice the 1976 figure of $540 million. The biggest spender in the House was Robert Dornan (R-Calif.), with $1,578,143; the biggest spender in the Senate was Alan Cranston (D-Calif.), with $2,711,192; and the most expensive gubernatorial race was run by John D. Rockefeller IV (D-W.Va.), at a cost of $11,648,091.

✓ The Federal Food and Drug Administration has ruled that manufacturers of infant formulas must submit reports every 90 days confirming the nutritional value of their products. This action was prompted by last year's recall of infant formulas that were deficient in chloride.

✓ A Washington equal-employment-opportunity seminar held by the National Alliance of Business warned employers that "no matter how good their equal-employment record, they are likely to face a discrimination action in the near future." One speaker cautioned that an employer faces a one-in-three chance of being sued over the next three years if he has over a hundred employees.

✓ A General Accounting Office report has revealed that the Pentagon has lost more than a billion dollars in recent years by failing to charge foreign nations for the training and transportation costs associated with the purchase of American military equipment. For instance, the Army Tank Automotive Command billed foreign governments only $1.5 million for several contracts on which a total of $3.1 million was owed.

✓ The Supreme Court has ruled that the Environmental Protection Agency can enforce water-pollution standards regardless of whether a factory can afford the cost of compliance. This ruling rejects the contention of the coal and quarry industry that current cleanup rules should be relaxed for companies that cannot afford the expensive technology needed to clean up their wastes.

✓ Before adjourning, the 96th Congress authorized by a narrow margin a $1.6 billion "superfund" to clean up chemical wastes. Under the measure, the President may choose some one or two thousand abandoned chemical dumps for immediate cleanup. The bill also creates a new agency to keep track of diseases associated with toxic wastes and a $200 million fund to monitor the closed dumps.

✓ In keeping with the Christmas spirit, the last big appropriations bill of the 1980 Congress included such items as: (1) a $2.5 million amendment to build an access road to a Trident submarine base in Washington; (2) $2 million for the Department of Agriculture to destroy the Khapra beetle, a pest that has infected two spice factories in Baltimore; (3) $750,000 to fund a public-affairs teaching chair at Fisk University in Nashville; (4) Senate approval, sponsored by Harry F. Byrd (Ind-Va.), of language banning the use of any federal funds to assist anyone who advocates violent overthrow of the government; (5) approval of about $200 million for 36 construction and repair projects; and (6) $12 million for a courthouse in Redding, California.

✓ Small businesses and individuals who win court cases involving the federal government or a federal regulatory agency may now be reimbursed for attorneys' fees and other court costs. The new law is part of a program designed to encourage challenges to federal regulations.

✓ The Securities and Exchange Commission now has the power to obtain a federal court order to secure a person's bank records if such information is needed to investigate securities fraud. Although the SEC may seize the individual's records without warning, it must then notify the individual of the seizure to allow for a possible legal challenge.

✓ The Department of Agriculture is now planning to give farmers direct loans of up to $200,000 or loan guarantees of up to $300,000 to promote the use of solar energy, methane gas, or alcohol for use on the farm. In the past, such assistance was only available if the farmer used the energy to heat his home. ■

Rent Control (Cont. from p. 7)

This assault on housing is carried out in the name of preserving "natural ecosystems" and open space. In this assault the continued existence of a rare plant in its natural habitat is judged to be more significant than the provision of adequate housing to human beings; and the preservation of panoramic views commanded by people who already have elite homes in attractive locations is judged to be sufficient cause to prevent other people from moving into the area. It seems that backpackers so enjoy hiking through wilderness areas that they feel justified in forcing others to bear the burdens of their packs.

Whether antidevelopment people know it or not, the result of their actions is to raise the prices of all kinds of housing. Not even the Sierra Club can repeal the law of supply and demand. It is the poor, as always, who find price increases most burdensome. It is the

poor who are most hurt by the selfishness of the antidevelopment forces. Antidevelopment people who realize that they are hurting the poor try to shift the blame to speculators, and they recommend that the problem be solved by rent control. But rent control cannot help the poor. There simply is no solution to the problem of housing shortages other than the provision of additional housing.

Antidevelopment groups are typically made up mostly of upper-income elite people who have what they consider to be "the good life" and desire to protect it against any encroachment from "undesirables." For example:

> A recent survey of the Sierra Club membership showed that fully two-thirds of the main wage earners in members' households come from the following occupational groups: lawyers, doctors, dentists, other professionals, college teachers and other teachers, managers and executives, and engineers. More than half the members have had some post-graduate education, with 18 percent having a Ph.D., law, or medical degree, and 21 percent a Master's degree.[5]

Housing developments bring people of less august occupation and income levels, people who tend to lower the "social tone" of a community and who are likely to have children whose entry into the public school systems might increase tax burdens on the elite. Why should the elite have to pay for the education of the children of these outsiders? Their children are in private schools.

Some people whose motives are less socially acceptable than the stated motives of environmentalists use environmental protection as a cover. In Frieden's words:

> In political controversies the new concept of the environment has been able to absorb an earlier and more selfish agenda concerned with preserving the status quo against newcomers. During the suburban buildup of the 1950s, suburbs were already using their land development controls to keep out undesirables. The main fiscal undesirables then were families living in modest homes with young children whose education would use up property tax dollars. Other undesirables were . . . people whose occupation, income level, life-style, religion, or skin color might threaten the prestige levels established by earlier residents. Concern for the environment, as such, was not an important political factor in the 1950s. When this concern emerged later, it reinforced and provided cover for local groups more concerned with fiscal and social undesirables than with protection of wildlife.[6]

"It is the poor who are most hurt by the selfishness of the antidevelopment forces."

Friends of the Earth are not friends of the poor.

Helping the Poor without Rent Control

Much of the housing shortage that causes prices—both in rental housing and owner-occupied housing—to increase so dramatically is caused by regulations such as zoning, subdivision regulation, building codes, and permit delays. Limitation of development in the name of environmental and open-space preservation adds to the problem, and so, too, does the process of inflation. All of these sources of trouble involve direct government action. If the problem that has led to the current outcry for rent control is the effect on the poor of rising prices of housing services, at least a part of the solution would seem to be substantial reduction of the government actions that cause the price increases. Building codes ought to be revised so that they only protect the health and safety of building inhabitants. As it is now, they protect the interests of building trades unions. Zoning laws ought to be revised so that all they do is to separate incompatible land uses. As it is now they preserve the social tone of elite neighborhoods. The permit process ought to be speeded up by eliminating the opportunity for any special interest group to challenge developments and file appeal after appeal when they don't get their way. Environmental regulations ought to be revised so that the interests of humans are put ahead of plants, animals, and open space. It ought to be recognized that potential home buyers and apartment dwellers are people with rights that are just as important as the rights of those who like to backpack in wilderness areas. In short, some sense of balance ought to be introduced into the regulatory process.

Another measure that would be very effective in eliminating the problem that the rent control advocates say they are worried about is tax reform. Specifically, interest and dividend income ought to be exempt from taxation. Saving is the source of funds that investors use to build homes, construct factories, and to acquire machinery, equipment, and tools. More homes mean lower prices of housing services. More plant and equipment construction means more jobs for the poor. Saving is the source of real growth, and real economic growth is the only possible source of improved living standards for all people at the same time. If the economic pie is fixed in size, more for some people must mean less for others. If the pie gets bigger and bigger, it is possible for all to get more at the same time. The enemies of real economic growth are the true enemies of the poor. If the zero-growth advocates get their way, there will be more and more fighting over a pie that at best is fixed in size and probably is even shrinking.

If interest and dividend income were exempted from taxation, people would have more incentive to save than they do now. Current income tax laws bias the choices of people away from saving and toward consumption. To see why, consider the following example: In the absence of any income tax at all, it would take $1.00 of income to purchase a $1.00 consumption good, and it would also take $1.00 of income to buy a $1.00 investment good. If the rate of interest is 10%, the $1.00 investment good would generate an interest income of 10 cents per year. Suppose now that a 20% income tax is imposed, and that interest income is taxed along with other income. In order to buy a $1.00 consumption good, it would be necessary to earn $1.25 of income before tax. In order to have 10 cents interest income after tax, it would be necessary to have 12.5 cents interest income before tax. It would be necessary to earn $1.56 of income before tax in order to have $1.25 after tax to use to purchase an investment good that yields a before-tax interest income of 12.5 cents. With the tax the price of a $1.00 consumption good is $1.25, but the price of a net interest income of 10 cents is $1.56. The cost of saving has risen relative to the cost of consumption, so less saving will be done relative to consumption.

If interest income were exempted from the tax, one would have to earn $1.25 of income before tax to purchase a $1.00 consumption good, and one would have to earn $1.25 of income before tax to be able to purchase a $1.00 investment good that would yield an interest income of 10 cents. The price of saving would be unchanged relative to the price of consumption; therefore, the tax would not reduce saving relative to consumption.

Deregulation and this type of tax reform have one overwhelming advantage over either rent vouchers or a cash subsidy plan: They do not involve taking income earned by one person and transferring it to another person. On the contrary, they let all people keep more of what they earn for their own uses. To the extent that such reform also produces sufficient economic growth to increase the purchasing power of the poor as much as subsidy plans would, it is unquestionably superior to either subsidy plan. Even if it doesn't increase the purchasing power of the poor as much as subsidy plans would, it has a lot to recommend it. Deregulation and the exemption of interest income, if implemented, would reduce the need for direct subsidies. These measures offer a clear opportunity to reduce the extent of coercion in the society while at the same time addressing the perennial question, What about the poor?

Conclusion

A rent control advocate is like Adam Smith's man of system who

> is apt to be very wise in his own conceit, and is often so enamored with the supposed beauty of his own ideal plan of government, that he cannot suffer the smallest deviation from any part of it. . . . He seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board; he does not consider that the pieces upon the chess-board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different

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 prices. All figures are expressed as annual rates of change, unless otherwise indicated.

	1980 Third Quarter	1980 Second Quarter	1980 First Quarter	Average for Last Four Quarters
MONETARY SECTOR				
Monetary Base	6.9	5.2	7.6	7.3
M1-A	11.0	−3.9	4.8	4.1
M2	15.4	5.5	7.2	8.8
M3	12.6	5.7	7.8	8.8
Discount Rate (average)	10.9	12.4	12.5	11.9
Prime Rate (average)	11.6	16.3	16.4	14.8
PRICE CHANGES				
Consumer Price Index	13.8	4.9	21.6	13.7
All-Finished-Goods Price Index	12.2	6.0	19.3	12.7
Intermediate-Materials Price Index	6.4	5.2	24.0	13.2
Capital-Equipment Price Index	8.5	11.3	13.4	10.8
INDUSTRIAL PRODUCTION INDICES				
Consumer Goods	142.9	143.3	148.3	146.1
Producers Goods	147.2	146.8	159.4	153.3
Raw Materials	139.0	145.0	156.3	149.2
Ratio of Capital Goods Production to Consumer Goods Production (1967 = 1.00)	1.03	1.02	1.07	1.05

SOURCE *Federal Reserve Bulletin*

> from that which the legislature might choose to impress upon it.[7]

If rent control advocates were really interested in the welfare of the poor rather than increasing the extent to which everybody (except them) is treated as a piece on a chessboard, they would be seeking ways of lowering the market prices of housing. Instead they seem to be aligned with the environmentalists and other zero-growth advocates in a battle against the economic system of private property and voluntary exchange. In spite of all the evidence that government is the problem, they advocate still more government action; and, sadly, it seems they always will. ■

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[1] Gary S. Becker, *Economic Theory* (New York: Alfred A. Knopf, 1971), p. 108.

[2] Eric K. Hemel, "What Does Rent Control Control?" *Taxes and Spending* (San Francisco: Institute for Contemporary Studies), Fall 1979, p. 85.

[3] Ibid., p. 84.

[4] D. Gale Johnson, "Rent Control and the Distribution of Income," *American Economic Review*, May 1951, p. 582. Quoted by Edgar O. Olsen in "An Econometric Analysis of Rent Control," *Journal of Political Economy*, November-December 1972, p. 1099.

[5] Bernard J. Frieden, *The Environmental Protection Hustle* (Cambridge, Mass.: The MIT Press, 1979), p. 130.

[6] Ibid., p. 129.

[7] Adam Smith, *The Theory of Moral Sentiments* (1979), (Indianapolis: Liberty Classics, 1977), pp. 380–81.

PR Reviews

***Cutting Back City Hall* by Robert Poole, Jr. Universe Books, 1980. $12.50.**

One of the most popular arguments against such tax-cutting measures as California's Proposition 13 is that state and local governments will be forced to cut back on "essential" services if their tax receipts are drastically reduced. Robert Poole's latest book, *Cutting Back City Hall*, convincingly refutes this myth by showing how many of these public services can actually be more efficiently provided by the private sector. Hence, not only are tax cuts desirable because they decrease the taxpayers' burden, but also because they provide a powerful impetus for privatization.

A persuasive example of Poole's thesis is his analysis and description of private fire protection. The largest of the agencies that fight fires for profit is the Rural/Metro Fire Department of Arizona. Rural/Metro, which has been in operation for over 30 years, now has more than 55,000 subscribers. While the average national household pays $103 a year in taxes for fire protection, the average Rural/Metro customer pays only $23 a year (less than one-fourth of the national average) and receives a higher quality of protection.

Poole's book is also chock-full of figures and facts on such issues as parks, libraries, garbage collection, police protection, and public education. The only flaw in his arguments is that he often suggests such arrangements as "user-fees" as ends in themselves, rather than as steps toward the ultimate goal of a completely free market. Only the abolition of all government monopolies can lead to the justice and prosperity of a free market.

***The Full Employment Alternative* by Andrew Levinson. Coward, McCann & Geoghegan, 1980. $10.95.**

The thesis of *The Full Employment Alternative* is that the traditional approaches of liberals and conservatives to the unemployment problem have failed. The liberal attempts have failed because they accept the Phillips curve unemployment-vs.-inflation trade-off; the conservative proposals are bankrupt because they are "committed to a hopelessly outmoded laissez-faire philosophy." Levinson ridicules the economic theories (i.e., neoclassical economics) behind that philosophy because the theories are based on such unrealistic assumptions as perfect foresight for all economic actors. Such ideologies have resulted in the growth of a permanent class of unemployed citizens and in governmental reluctance to formulate policies to deal with unemployment. The author's suggestion for our problems is "a uniquely American coalition of business, labor, and government with a genuine commitment to full employment."

Unfortunately, Levinson does not discuss free-market solutions to the unemployment problem that do not rest upon neoclassical economic theory: The abolition of the minimum wage and the elimination of occupational licensure, for example, are given short shrift. Not only could the removal of such interventions solve many of the problems in our labor markets, but it is also consistent with individual freedom. The same cannot be said for Levinson's approach.

***The Fleecing of America* by Sen. William Proxmire. Houghton Mifflin, 1980. $10.95.**

Senator Proxmire's latest book tells the story of the "Golden Fleece of the Month" award, an institution he established in 1975 to expose outrageous uses of taxpayers' money. The book, replete with examples, is a valuable survey of the waste and extravagance that have come to characterize the federal government. One particularly amusing example is a $97,000 grant given by the National Institute of Mental Health to study Peruvian brothels. The researcher, a Doctor Van den Berghe, defended the study by explaining its methodology: "Twenty-one prostitutes were formally interviewed and many more were interviewed informally. . . . By visiting the brothel at various times, it was possible to get a good idea of its everyday functioning."

The Fleecing of America contains chapters on such topics as New York City's fiscal problems and the Chrysler bailout. Proxmire argues that the poor are the primary victims of government handouts. Taxpayers with incomes of over $50,000 (only 1.5% of the population) actually get the benefits of over 75% of government-supported programs. ■

"To be governed . . ."

Balancing the budget

[Reagan's] administration-in-waiting, sprawling through nine floors of federal office space at 1726 M St. NW, has so many employees that no one can produce a definite count (estimates range from 588 to 1,200); . . . and it has spent so much money that a 50 percent cost overrun is predicted. . . .

As for the budget overrun, [transition financial controller Verne] Orr says he never expected to carry out the transfer of power for the $2 million Congress appropriated.

—*Washington Post*, Dec. 15, 1980

Rising above principle

Transportation Secretary-designate Drew Lewis yesterday promised less government involvement in transportation industries, but indicated there will be exceptions such as the ailing automobile industry. . . .

He said while the Reagan administration is committed philosophically to letting the free enterprise system work without government interference, it cannot let a major auto company go bankrupt "if there is a reasonable solution to it."

—*San Francisco Chronicle*, Jan. 8, 1981

Reflect on this

The public relations firm [of Deaver & Hannaford] is claiming the bounty of its close association with the president-elect—a stable of well-paying conservative clients who have made it one of the fastest-growing firms in the country. . . .

Among the firm's other large corporate clients are 3M Co. and Rockwell International. 3M has been trying to convince state officials in California for four years to adopt a proposal requiring use of reflective material in auto license plates. Such a law could mean $500,000 a year in revenues to 3M, but so far the idea has not been persuasive, despite the efforts of Deaver & Hannaford.

—*Washington Post*, Dec. 18, 1980

What a way to mismanage

The Air Force renegotiated a missile contract, raising it from 286 million dollars to 430 million, following what the appropriations panel called "gross mismanagement" by the contractor.

—*U.S. News & World Report*, Dec. 8, 1980

Room for one more?

In New Jersey, it's called the Politicians' Full Employment Act. In truth, it is a state law, passed earlier in 1980, that allows public financing of gubernatorial primaries. . . . A candidate needs just $50,000 to start drawing the state's matching funds, which is not especially hard. Hence the rush to become Governor is on; 18 people have already declared that they will run in next June's primary. Others will soon join them.

—*New York Times*, Dec. 30, 1980

Our new ZIP code

What this boils down to is a system that will require an individual to call a ten-digit number to get the correct nine-digit number that must be placed on the letter to replace the five-digit number. However, if people can't remember the ten-digit number that must be called, they can always dial a three-digit number, 411, to find out how to get the ten-digit number so they can call to get the nine-digit number to replace the five-digit number.

—Sen. Roger Jepsen (R-Iowa), before the Subcommittee on Energy, Nuclear Proliferation, and Federal Services, Nov. 25, 1980

A new twist for imports

Maryland, the District and West Virginia yesterday accused Mid-Atlantic Toyota Distributors Inc. of Glen Burnie and approximately three dozen regional Toyota dealers with conspiring to artificially *inflate* the price of cars by an estimated $500 each since late 1979.

—*Washington Post*, Dec. 19, 1980

We could have told you that—in fact we did!

Antonio Cabral, a provincial director of agriculture, has come to Moamba, Mozambique, to deliver a stunning message. Central planning, the soul of a socialist economy such as Mozambique's, "hasn't functioned at all" on the farm, he says.

—*Wall Street Journal*, Dec. 30, 1980

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