POLICY REPORT

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VAT: Not Appropriate as a Revenue Raiser

By Ida Walters

In the search for new revenue sources to reduce the deficits, proposals for a value-added tax (VAT) keep cropping up. This indicates that VAT is generally perceived to be some sort of a national retail sales tax that can easily be levied on goods and services at some rate calculated to generate a targeted amount of additional tax revenues.

This perception is far from accurate. Although there is a type of textbook VAT that some economists claim would raise the same amount of revenue as a national retail sales tax (if levied at the same rate) and have the same economic effects, this type of *neutral* VAT is not used in any country. The reason is simple. If the sole purpose is to raise additional tax revenues by taxing consumer goods and services, then a national retail sales tax is just as powerful, and far easier and cheaper to levy and collect.

The type of VAT proposed, and the type most commonly adopted in other countries, is the *consumption* VAT. What is apparently not well understood is that the main purpose of a consumption VAT is to partially or completely replace other taxes in order to achieve a less progressive tax system and, at the same time, provide greater incentives for new capital investment. *The consumption VAT allows business to subtract the amount of its purchases of new plant and equipment from total value added; the VAT rate falls on the remaining value added.* (Unless otherwise noted, subsequent references to VAT refer to the consumption VAT.)

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In 1980, both tax-writing committees of Congress made VAT the centerpiece of major tax restructuring bills. Since any VAT that may eventually be passed in this country is likely to be quite similar to these, they are worth noting. Both bills called for a 10% VAT on most consumer goods and services. A lower VAT of 5% was proposed for basic necessities such as food, medical care, and owner-occupied and rental housing (which together account for about 40% of consumer spending). Farm products, commercial fishing, mass transit, public education, charities, non-profit organizations, and most government organizations would be exempt from VAT.

"Since investments in capital equipment reduce the amount of value added that is subject to VAT, it is likely that purchases of capital equipment will increase relative to other purchases."

Both bills estimated that VAT would collect about $130 billion the first year. In the House bill, this amount would have been offset by a $52 billion (26%) reduction in Social Security taxes; a $47 billion (17%) cut in individual income taxes; a $22 billion (34%) cut in corporate income taxes; and $9 billion in assorted tax incentives to encourage investment. The Senate bill would have substituted VAT for reductions of $88 billion (33%) in individual income taxes; $11 billion (15%) in corporate income taxes; and $31 billion (16%) in payroll taxes.

Before analyzing further the potential promises and pitfalls offered by a restructured tax system featuring VAT, it would be helpful to review the concept of value added, see how VAT would work in practice, and see what its economic effects would be, *assuming* that the restructured tax system raised the same amount of total revenue that the previously existing tax system would have raised.

Value added can be illustrated by a simple example. At the first stage of production, a farmer (labor), plus land, a plow, and seed grain (capital), produce the intermediate good wheat, for example, which the farmer sells to the miller for $10. The miller adds labor and capital to produce flour, which is sold to the baker for $20. The miller's value added is $10 — the difference between the selling price of the flour and the cost of the wheat. At the next production stage, the baker adds labor and capital to the flour and sells bread to the grocer for $30. Since he paid $20 for the flour, his value added must be $10. The grocer adds his costs of labor and capital and sells the bread to the consumer for $40, making the grocer's value added $10 also, since he paid $30 for the bread.

At each of these four stages of production, value added is $10, or a total of $40, which is the same as the retail price of the bread. Since the retail price of any good or service is always 100% value

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EDITORIAL

America's Cities: Crisis or Opportunity?

For two decades Americans have been subjected to an unending stream of demands that we do something about the "urban crisis." As Senator Abraham Ribicoff testified in 1966:

> The crisis of our cities is the crisis of the modern United States. Seventy percent of all Americans now live in or close to cities. The number grows each year. So the fate of the city and the future of our country are one and the same thing.

More money is spent on "the problems of the cities" every year, yet more is demanded. But why care about the cities? Does it matter to us if the cities die?

Nobel laureate F.A. Hayek has written, "Almost all that distinguishes civilized from primitive society is intimately connected with the large agglomerations of population that we call 'cities,' and when we speak of 'urbanity,' 'civility,' or 'politeness,' we refer to the manner of life in cities." Since the late Middle Ages, when people said that "city air is free air," because a serf could gain his freedom by getting to a city, people have sought out cities for freedom and opportunity. Besides great economic opportunity, cities offered tolerance and pluralism and diversity. For those who wanted the finer things in life, cities offered art and theater and culture.

Cities play an important role in the advancement of civilization. It would be a major step backward if we were to let them die — or, that is, if we were to kill them. As dynamic concentrations of thousands or millions of people, cities will adapt to change if we let them; only a truly devastating set of policies could actually cause cities to die.

But cities today do have problems. What can we do about them? The standard response is more of the same. Former New York Mayor John V. Lindsay wrote in the *New York Times* that "the central governments of most of these countries [in which major world cities are located] assume direct responsibility for their cities' well being. Our Federal Government must play the same role — and play it well."

But the problems of the cities are not caused by too little government attention, they are caused by too much. By removing the obstacles that hamper life in the cities, we can save them — without regulating the lives of the residents or confiscating more of the incomes of city-dwellers and other taxpayers.

What obstacles to freedom and prosperity do we need to remove? Perhaps the greatest urban problem is chronic unemployment and the resulting poverty and welfare dependency. Repeal of the minimum wage laws would open up thousands of low-skilled jobs in every city. Employers generally think young men without skills are not worth $3.35 an hour. Since it is illegal to hire them for less, they don't get hired at all. When they don't get a first job, they never learn the skills that would get them a better job.

We should also repeal licensing and other barriers to entry into different occupations. Some 850 occupations are currently restricted by licensing laws, including such low- and semi-skilled occupations as barber, cabdriver, and nurse.

Building codes for both homes and businesses should be abolished or eased. Many states and localities, according to Anthony Downs of the Brookings Institution, require housing standards "far surpassing any required to protect the health and safety of the occupants." In many cases, strict building codes are supported by manufacturers, unions, and construction companies that benefit from the requirements.

Laws that raise the cost of housing or reduce the supply should be repealed. This would include rent control laws, urban renewal projects that displace low-income tenants, restrictive zoning laws, and "tenant protection" laws that make the eviction of destructive occupants almost impossible, hastening the decline of good neighborhoods.

These steps would reduce the incidence of crime in the cities. (This is not to excuse criminal acts as an unavoidable result of poverty, but merely to recognize that people shut out of the economic system can be expected to turn to crime in some cases.) Consequently, fewer middle-class residents would leave. Tax reductions also would dramatically reduce the flight of the middle class and businesses from the city.

Proposals for enterprise zones would accomplish many of these objectives *if* there are substantial tax reductions and repeal of regulations in the zones. Enterprise zones that don't repeal building codes, minimum wage laws, licensing laws, and onerous taxes will have little effect; and it will then be charged that "free enterprise" has failed in the cities.

Cities are vital and dynamic places; a rejection of government intervention and a removal of constraints will revitalize them far more than any "national urban policy." ■

VAT (Cont. from p. 1)

added, it is easy to see that a 10% tax on *total* value added, or a 10% national sales tax on all final goods, would raise exactly the same amount of revenue, or $4 in the case of the bread in the above illustration.

When a 10% consumption VAT is imposed, each seller at each stage of production must add up his purchases of capital equipment and subtract this amount from total value added. The tax rate is applied to the result. To simplify the example, assume that each seller in the above illustration purchased $2 of capital equipment during the accounting period. The VAT rate is applied to $10 minus $2, or $8, creating a VAT liability of 80 cents at each stage of production, or a total VAT liability of $3.20. If the tax can be shifted forward to consumers, the final consumer pays $43.20 for the bread, instead of $40 (see Table 1).

If, as is more likely the case, the higher price reduces the quantity demanded of bread, then VAT cannot be fully shifted forward without losing sales. Since investments in capital equipment reduce the amount of value added that is subject to VAT, it is likely that purchases of capital equipment will increase relative to other purchases (see Table 2).

The above explains value added and demonstrates how the consumption VAT works, but a firm's total VAT liability would not normally be figured on individual bushels of wheat or loaves of bread. The amount of a firm's value added that would be subject to a 10% VAT can be illustrated by a highly simplified schedule (see Table 3) that shows a hypothetical firm's total payments to labor, capital, intermediate goods, and purchases of capital goods during a given accounting period.

From Table 3 it is possible to see more clearly that the base of the consumption VAT — the amount to which the VAT rate is applied — is total sales less purchases of goods from other firms, regardless of whether these purchases are intermediate goods or capital goods. Although income, that is, return to capital, is taxed by VAT, purchases of capital goods can be used to reduce a firm's VAT liability.

Table 3 highlights other aspects of VAT. Unlike payroll and corporate income taxes, VAT taxes total labor compensation, including such items as contributions to employee retirement plans. Any interest paid to bondholders, banks, and other lenders is taxed just like dividends to shareholders.

Also note in Table 3 that the net amount subject to VAT is $50,000, which exactly matches total value added by labor. This means that the hypothetical firm was able to shelter *all* its capital from VAT. What happened is clear; the $30,000 of value added by capital that is subject to VAT is fully offset by the $30,000 of capital purchases, which is subtracted from the amount subject to VAT.

What is the firm's VAT liability in the following year, if there is no new purchases of capital equipment? Assuming that everything else remains the same, except that $5,000 in additional value added by capital is generated by the previous year's purchases of capital equipment, value added by capital is $35,000 ($30,000 + $5,000) and value added by labor is $50,000. The amount subject to VAT is total value added, or $85,000 — quite a large increase from the previous year.

It is very likely, however, that many firms will be able, year after year, to shelter all, or nearly all capital from VAT. They will do this by expanding their purchases of new capital equipment to the point where current VAT savings from additional purchases of equipment are offset by future VAT liabilities that are generated as the equipment adds value to products and services. That is, machines will be purchased in the current period until the last machine purchased reduces the firm's current VAT liability by the same amount that the machine increases the firm's VAT liability in future years. In terms of VAT, this means that the marginal tax rate on capital is zero.

Of course, not all business activities

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can effectively utilize constant and heavy investments in plant and equipment. Even given reductions in other taxes, the relative tax burden of labor-intensive organizations such as consulting firms, is likely to increase under VAT. Because such businesses do not make major outlays for capital equipment, almost all of their value added will be taxable. On the other hand, VAT could lighten the relative tax burden of capital-intensive manufacturing firms, such as steel. The VAT liability of these firms could be less than the reductions in other taxes.

Some other firms may be put in jeopardy by VAT. A firm that shows no profits and thus pays no corporate income tax would still incur a VAT liability on all value added by labor and capital that could not be sheltered by purchases of capital equipment. Many businesses, of course, will find that their VAT liability more or less matches the reductions in other taxes, leaving their total tax burden unchanged.

Although VAT is paid by businesses, it must be borne by either capital (through lower returns to savers), or labor (through lower wages), or consumers (through higher prices). It doesn't matter who actually remits a tax; all that matters — in terms of the effects — is the activity that is taxed. VAT falls on personal consumption, but this does not tell us whether the tax is borne by taxpayers in their role as savers, workers, or consumers.

The cuts in other taxes and the tax preference given to capital relative to labor under VAT are, however, designed to lighten the tax burden of savers. Thus, it is as workers and consumers that taxpayers will bear the major burden of VAT. If VAT succeeds in reducing tax progressively, labor as a group will be better off due to improved real output and income per worker, although lower income groups may be relatively worse off.

If tax revenues collected by VAT are matched by equal reductions in other taxes (as is usually the stated intent when VAT is adopted), and real output is not reduced, it is quite impossible for the general price level to rise, though price indexes that assume a fixed market basket could show a one-time increase. Of course, if the supply of money, or its velocity, increases more rapidly than otherwise, higher inflation will result.

While a restructured tax system featuring VAT entails a gigantic money shuffle, it is not inherently inflationary. Because VAT changes relative tax burdens, however, it will alter relative supply and demand in labor and capital markets and thus affect some relative prices. But for the most part, reductions in other taxes will be shifted to pay VAT.

> "A firm that shows no profits would still incur a VAT liability on all value added that could not be sheltered by purchases of capital equipment."

To the extent that this shift takes place from the business to the household sector, after-tax incomes will increase (due to the reductions in other taxes), but these increases will be partially or entirely wiped out by VAT as incomes are spent on current consumption. To the extent the shift occurs within the corporate sector, before-tax incomes will fall (as firms divert portions of the tax reductions to pay VAT), leaving some incomes and consumer prices the same or lower than they were prior to the introduction of the VAT.

Taxpayers whose average tax burden is raised by VAT may bear the difference as workers (through lower wages) or as consumers (through higher prices). Either way, they are worse off than before. Of course, a more productive economy — should this be the result of a restructured tax system — would benefit everyone. And if monetary policy doesn't fully adjust to the increases in real output, the rate of inflation could even fall.

A tax system that is made progressive, but which at the same time collects the same amount of tax revenues as before, must (in the absence of added economic growth) increase the average tax burden of relatively lower income groups. This is precisely the goal of VAT, and many of the benefits claimed derive from this.

Critics claim that VAT is regressive because lower-income taxpayers spend a larger proportion of their income on current consumption than higher-income taxpayers. And because they pay a smaller portion of their income to taxes than higher-income groups, they will benefit less from the reductions in other taxes. However, this doesn't make VAT regressive, only less progressive. Tax credits, numerous exemptions, varying rates, and other adjustments to maintain existing levels of tax progressively would remove many of VAT's added incentives to work and save.

The claim that VAT would improve the U.S. trade position (chiefly by reducing imports) is heavily stressed by its proponents. The basis of the claim is that international trade rules allow VAT to be slapped on imports and rebated on exports. Since, as we have seen, all domestic prices cannot rise by the amount of the VAT rate, a 10% VAT applied to imports would have the same effect as a tariff. The VAT would make many imports more expensive, relative to domestic substitutes, reducing demand for them. Those who favor the resulting decline in international trade are not acquainted with the well-known and well-documented gains from trade.

France has now had VAT for 25 years, and it has been required of all EEC countries since 1968. Many newly industrializing countries have also adopted VAT, including Korea, Brazil, and Mexico. In nearly all cases, VAT was adopted to replace a variety of already existing indirect business sales taxes that the government found difficult to collect. Only in recent years have a few countries increased their VAT rate to reduce direct taxes, or in lieu of raising them, but only by one or two percentage points at a clip. England is the major exception. It recently decided to reduce income taxes and raise its VAT rate to 15%, from 8% — but the main objective was not to increase the total tax burden on the economy, but to make the tax system less progressive.

Probably the single most important lesson to be learned from the VAT experiences elsewhere is administrative. Countries that began with a number of varying rates, exemptions, tax credits, etc. are moving, albeit slowly, toward a more broad-based, uniform VAT. England has a single rate, but France still has nine VAT rates, ranging from 4% on food to 33% on luxury items. In France, VAT collections account for 45% of total tax revenues, the highest of any country. On average, VAT accounts for about 25% to 30% of total tax revenues among European countries, with VAT rates that now average 16%.

All in all, though, VAT appears to offer more pitfalls than promises. If a more productive economy requires a less progressive tax system, why not directly adjust existing taxes? Just as VAT could be structured to have much the same effects as existing taxes, existing taxes could be restructured to have much the same effect sought by VAT. For example, the accelerated-cost-recovery system (a combination of faster depreciation write-offs and larger investment tax credits passed in 1981) effectively wipes out taxes on returns from *new* capital investment. The so-called safe-harbor leasing provisions, also passed in 1981, make these tax credits and depreciation allowances readily transferable. Companies without large tax liabilities can sell the tax benefits they cannot use to other companies that can use them, allowing them to compete for capital on a more even footing with more profitable companies.

The scheduled cuts in individual tax rates are a worthwhile reform and

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Briefs

☐ The Internal Revenue Service is currently drawing up plans to provide for a continuation of IRS activities in the aftermath of a full-scale nuclear war. The plan was drawn up by Gary Robbins and is entitled "Design of an Emergency Tax System." Robbins admits that the IRS would face serious problems after a nuclear holocaust because "the income tax system is extremely vulnerable to losses of records of transactions." Furthermore, "the necessary information would not be available for preparing of tax returns and determining of tax liability. . . the Internal Revenue Service would find it impossible to verify the necessary figures in audit situations. The plan also acknowledges that "If sufficient damage is done. . . the tax system itself may have to be changed." Federal government officials maintain that the entire plan is meant to be taken seriously.

☐ The 1980 census was so ill-prepared that even the government itself does not plan to use its results. Education Secretary Terrel H. Bell has decided to use 1970 census data in determining how much money each school gets next year under the Title I compensatory education program for children from poor families. Bell defended his decision on the grounds that the law requires him to use "the most satisfactory recent data" for allocative purposes, but also added that "either way I go on this I'm going to be sued."

☐ Governor John Evans of Idaho has decided to help erase his state's incipient deficit of $12.1 million by ordering a four-day work week for 5,000 of his state employees. Most state workers have already started receiving Fridays off — thereby saving $1.9 million this year. As part of his belt-tightening program, the governor himself plans on returning $1,072 of his salary to the state and giving his wife's housekeeping help at the governor's mansion the next seven Friday's off.

☐ A recent IRS report has found, not surprisingly, that the government wins more court cases involving taxes than it loses. In 1981, the Tax Court decided 52.1% of its 1,818 cases totally in favor of the government and 35.8% of the cases partly in favor of the government and partly in favor of the taxpayer. The taxpayer was a clear winner only 12.1% of the time. If the Tax Court opinion was challenged in the Court of Appeals, the government won 83.4% of the time.

☐ Recent investigations have uncovered that over the last 18 years GAO has paid for millions of dollars in unauthorized cost overruns on federal construction projects by illegally transferring funds from other projects. Although this practice was apparently carried out routinely without objection or controversy, it violates four federal laws as well as financial control procedures. Investigations noted that the use of this practice permitted cost overruns on federal construction projects to be concealed from Congress, the Treasury Department, and the Office of Management and Budget. Even for projects that are still under construction, the Construction Services Fund received $20.4 million more than it was supposed to spend. ■

VAT (Cont. from p. 5)

should be accelerated. After examining the relevant IRS data, a 1978 study by the economists at W.R. Grace and Co. found that making the highest marginal income tax rate 36% (rather than 50%) would generate only $7.5 billion in lost federal tax revenues. This is not counting additional revenues that such a rate would generate through reduced distortions of economic behavior, and greater incentives to work and save.

Another possibility is to eliminate an existing tax. A 1980 study by the National Bureau of Economic Research found that eliminating the corporate income tax, while adjusting other taxes to hold government tax revenues constant, would "result in an improvement in efficiency worth $6 billion per year. . . ."The study indicates "that this gain would be spread throughout consumer classes in such a way that every class would be better off in the long run."

The corporate income tax is particularly punitive to savings because both the income saved and the income from the resulting investment (dividends, interest, capital gains) are taxed at the firm and individual levels. While VAT gives tax breaks to savers, it does little to alter this. Also, it is well known that corporations act "efficiently" to reduce their taxes, but this may not always inspire the most efficient use of resources, either for the business or the economy.

Why would the U.S. look to VAT rather than give more attention to a number of other alternatives? Most observers believe that it is simply not politically possible to directly lower the taxes of higher-income groups, while directly raising the tax burden of lower-income groups. This is why VAT, the "hidden" tax, is being viewed by many as a more attractive alternative. The risk, of course, is that if there is not enough support in the country to make the tax system less progressive, then VAT, if enacted, would very likely be so complex and so honeycombed with special provisions and rates that we would end up with about the same degree of progressivity that we now have, plus have an additional tax to deal with.

There is a further risk. VAT is an indirect tax that never appears as a separate item on the consumer's sales slip, and it is capable of generating an additional $12 billion in tax revenues when raised a seemingly innocuous one percentage point. It is hard to believe that during the current deficit crisis, VAT (if we had one) would not have been raised a point or two, or more. Thus, the great danger of VAT is that it would probably be used to *feed* government spending during times such as these when government spending most needs to go on a diet. ■

The Economics of Arms Sales

By Tyler Cowen

Many perceptive political and economic analysts have recognized that President Reagan has failed to uphold his pro-market rhetoric in practice. But there are still several areas where Reagan has an undeserved reputation for adhering to free-enterprise principles, most notably in the area of foreign aid. Despite several well-publicized cuts at such multilateral aid agencies as the World Bank, the Reagan administration has asked Congress to *increase* foreign aid by 23% next year. The proposed increases fall almost entirely under the rubric of arms credits and loan guarantees and would expand the foreign military sales program by $1.6 billion over the $4.1 billion already authorized by Congress for fiscal 1983.

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This spending burst is only one part of a carefully orchestrated plan by the Reagan administration to significantly expand America's role as the world's leading arms merchant. Whether arms sales and arms transfers should be increased are questions beyond our scope. We will examine instead administration claims that arms sales will help the American economy by creating jobs, boosting the defense industry, and reducing the expenses of the Pentagon. We will also look at the effects of a large arms sales program on both domestic and international free trade.

In order to implement his aggressive arms transfer plan, President Reagan has made the following changes: 1) abolished the ceiling on the total dollar value of arms transfers allowed each year; 2) eliminated the prohibition on developing a new weapons system simply for export purposes; 3) eliminated rules preventing the sale of weapons systems, which would significantly increase the combat capabilities of a given region; 4) dropped the prohibition against selling arms prior to their deployment with American forces; and, 5) rescinded President Carter's instructions to U.S. overseas officials that they should not promote American arms sales abroad.

The results of Reagan's liberalized arms transfer policy were generated almost immediately. For instance, in his first year in office he pushed the largest single arms sale in the history of the world through Congress — $8.5 billion from Saudi Arabia for AWACS aircraft, Sidewinder missiles, and auxiliary air equipment. Other important arms transfers approved in Reagan's first year include the sale of 24 F-16 fighter aircraft to Venezuela ($615 million) and 40 F-16s to Pakistan ($1.1 billion). In addition, for the first time the sale of lethal military equipment to the People's Republic of China has been approved. The total value of all military sales proposed by Reagan in his first year amounts to $25.3 billion. If private commercial arms sales and grant military aid are taken into account, arms exports for fiscal 1982 are expected to exceed $30 billion — a good deal higher than the previous peak of $17.7 billion in 1975.

Arms Production

Perhaps the most important point in analyzing the economic effects of arms sales is that *the issue of arms sales cannot be separated from the issue of arms production*. Significant arms sales are not possible without a sizable military establishment to produce such arms, while the defense industry as we know it could not maintain its profitability without the existence of the sale of arms in substantial quantities. Therefore, the economic analyst cannot restrict himself to asking what will be the consequences of arms sales while assuming the arms are already produced. He must instead ask: What are the economic consequences of producing and selling the arms? The decision to produce arms and the decision to sell arms are closely related. This linkage is further illustrated by the build-up in arms production that is accompanying Reagan's arms-sales policies.

One of the main causes of America's productivity slowdown in the 1970s and 1980s is the vast amount of military spending after World War II. During the war itself, the U.S. devoted approximately 50% of the gross national product to the war effort. Although the American economy was significantly demilitarized after the war's end, it soon became clear that it was easier to implement new state interventions than to remove old ones. One of the interventions that remained (and grew) was a large-scale government attempt to push capital, skilled manpower, and research and development efforts away from the private sector and into military-related areas.

The burden on our domestic economy manifested itself in at least two distinct ways: in military financing and the relative price and quantity effects of military spending. In President Reagan's case, his military build-up will be financed primarily through borrowing. Although no one really knows how large the upcoming yearly deficits will be, they may easily surpass $160 billion in on-budget items alone. The result of these deficits will be increased federal participation in private loan markets and the crowding out of private investment. Prior to the Reagan deficits the federal government had already been borrowing nearly $1 billion a week — a figure that is currently skyrocketing. Even many of the most stringent hawks, both inside and outside of the government, admit that Reagan's unwillingness to relax defense expenditures is a primary cause of our current huge deficits.

> **"The military budget has been a significant factor behind the bidding up of the price of engineers with approximately one-third of the nation's engineers employed in the defense industry."**

Shift of Capital and Manpower

An increase in arms production also results in a drain of capital and manpower from private concerns into arms production. For instance, the military budget has been a significant factor in the bidding up of the price of engineers. Not only does this shift large numbers of engineers into the public sector, it also permanently increases engineering wages, forcing private industry to decrease their use of engineering services. The defense industry, on the other hand, with its "cost-plus" financing and procurement schemes, need not decrease its use of engineers at all. The quantitative significance of this may be quite important; military procurement expert Lloyd Dumas has estimated that approximately one-third of the nation's engineers are *directly* employed in the defense industry.[1] This "drainage effect" is particularly noticeable with respect to research and development funds. William Magruder in 1972 estimated that "since World War II we have spent $200 billion in research and development in the U.S. alone with 80 percent on defense, space, and the Atomic Energy Commission."[2]

Regarding other assets, Seymour Melman has noted that as of the early 1970s, the net worth of the American military establishment, if appraised at cost, was 38% as much as the assets of all U.S. industry.[3]

The enormous magnitude of these distortions clearly illustrates how the notion that military spending helps the economy is a dangerous myth. Instead, it shifts resources out of market-determined uses and into politically-determined uses. Since military spending tends to be extremely capital-intensive, there is no doubt that it is a significant cause of our current "capital shortage" and productivity crisis. In actuality, the problem is not so much a shortage of aggregate capital but rather a misallocation of specific capital goods away from their most highly valued uses. Any increase in arms sales will require an increase in arms production and will considerably exacerbate these problems.

Another popular economic argument for arms sales is that the Pentagon can partially recoup its research and development expenditures and reduce the per-unit cost of constructing weapons systems by taking advantage of the economies of scale offered by large production runs and overseas sales. There is little reason to think that these savings are quantitatively significant. The usefulness of whatever economies of scale

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Washington Update

President Reagan's foreign aid program was dealt a major setback when the Senate Foreign Relations Committee voted 9 to 8 to transform Reagan's Caribbean Basin Initiative into a multilateral program to be administered by the World Bank. Sen. Chris Dodd (D-Conn.) introduced the critical amendment on the grounds that changing the program from bilateral aid to a multilateral "trust fund" would make other countries more interested in participating. The Reagan plan had previously been presented as a foreign aid package that would send $350 million this year to several Central American countries.

Congress has voted to eliminate the Federal Trade Commission's pending rule that would have required used-car dealers to provide consumers with at least one page of information about any car they sell. Such information would have to tell the consumer about any known major defects of the car and outline any warranty rights the dealer is offering. The bill was vetoed because many Senate members felt it would impose unnecessary paperwork on auto dealers and increase automobile prices. This is the first time that Congress has exercised its two-year-old power to impose legislative vetoes on the FTC.

The Reagan administration has drawn up a detailed proposal to decrease subsidies to the domestic merchant marine industry and allow greatly expanded foreign construction and ownership of U.S. merchant vessels. The proposal would also create a new federally owned cargo fleet for defense purposes. A multitude of regulatory changes and tax breaks are included that would encourage shipping lines to build and repair their vessels in foreign yards and would allow American-flag vessels to be up to 75% foreign-owned. Other measures would exempt the salaries of merchant seamen from income taxes, eliminate federal regulation of freight rates on cargoes carried between domestic ports and tighten the Jones Act, which mandates that cargoes carried between U.S. ports be in U.S.-flag, American-crewed ships. The proposal is still under review within the administration.

President Reagan has decided not to increase the federal excise tax on gasoline for the next year and a half; he has put the proposal on the back burner until October 1, 1983 when he starts preparing the budget for fiscal 1984. The proposal called for an increase of the gasoline tax from 4 cents to 9 cents a gallon in order to raise approximately $5.5 billion. Many of those within the administration who opposed the tax increase felt it would decrease the chances for imposing oil import fees.

Defying a threatened veto, the Senate Appropriations Committee approved a bill which establishes a $1 billion emergency housing program for mortgage aid and wipes out the automatic $75-a-day tax deduction for congressional living expenses while in Washington. The committee also included provisions that would: 1) block the dissolution of the Bureau of Alcohol, Tobacco, and Firearms; 2) appropriate $1.3 billion for guaranteed student loans; 3) provide $2.4 billion for sewage treatment plants and $1 billion for extra food stamp costs; 4) bar the Federal Trade Commission from shutting any of its regional offices; and 5) appropriate $210 million for the older Americans community service program.

Unless Congress acts now in its behalf, the U.S. Fire Administration will die with the onset of President Reagan's fiscal 1983 budget. The Fire Administration was created in 1974 to help improve state and local fire-fighting efforts, but it is being discontinued because the Reagan administration feels that its task has been accomplished. If Congress does not restore the Fire Administration funding, approximately half of its $8.5 million budget will be cut and the other half transferred to the National Bureau of Standards Center for Fire Research.

The Department of Transportation has sent a legislative proposal to Congress that would allow the Coast Guard to charge private boaters an annual fee to pay for such services as navigation aids, port safety and security, recreational boating safety programs, and commercial vessel safety documentation. The fee, based on the size of the vessel, would be designed to collect $440 million — approximately 30% of the Coast Guard budget. For recreational boaters, fees would run up to $200 a year.

The Reagan administration has imposed sugar import quotas for the first time since 1974 in order to spare the federal government the expense of buying and storing thousands of tons of this year's domestic sugar crop. Without such quotas, domestic sugar prices may have fallen — at a time when federal price supports commit the government to buying sugar at 16.75 cents a pound. Administration sources have said they fear that this commitment will create a budget exposure this year of $200 million. It is estimated that the quotas will cost consumers up to $1 billion a year.

Reagan insiders hint that the administration is considering a proposal to repeal the private express statutes and allow private companies to carry mail in competition with the post office. With the recent departure of a number of free-market proponents from the White House, however, the proposal is not likely to make it through the administration's review process. ■

Arms Sales (Cont. from p. 7)

exist has yet to be demonstrated, and even the Department of Defense has admitted that "there is only a loose relationship between production readiness and cost economies on the one hand, and the total dollar volume of transfers on the other."[4] Besides, even if these savings are real, there is no reason to believe they will ever be returned to the taxpayer.

However, an even more fundamental criticism of this argument is possible. If we assume that the current level of arms production is a "given" then it may be true that the most cost-efficient manner of financing these arms may be to sell off some of the surplus production. But once arms sales and arms production are considered part and parcel of the same package this reason no longer holds. The optimal level of arms sales is not independent of the optimal level of arms production. Only if we assume that we are currently at (or near) the optimal level of arms production could we even begin to construct a "per-unit cost" argument for selling arms. Sales may be needed to sustain arms production but whether so much production is desirable should also be considered. Also, it is only because of the possibility of selling a weapons system that many items are produced at all. Selling these sorts of systems does not really "recoup" any research and development money since no outlay would have been necessary at all if the potential sale was not previously envisioned.

The Employment Argument

The most influential economic argument used in favor of arms sales asserts that it helps the American economy by increasing domestic employment. A study by the Bureau of Labor Statistics of the U.S. Department of Labor estimated that foreign military sales provided 277,000 jobs in 1975.[5] Even though this was less than a third of 1% of domestic employment in 1975, it is still argued that arms sales are an important contributing factor to the health of our economy. Since the production of arms tends to be concentrated in a few

(Cont. on p. 10)

Regulatory Watch

DEPARTMENT OF ENERGY

Fulfilling a campaign promise, President Reagan has finally sent Congress a bill that would abolish the Department of Energy. The bill, which would shift most of the DOE's functions over to the Department of Commerce, is the product of months of negotiations between the Reagan administration and Senate leaders. White House counselor Edwin Meese claims that this reorganization will save $2 billion over the next four years.

The Energy Information Administration, a branch of DOE, has recently published for the Federal Energy Regulatory Commission (FERC) its computed ceiling prices for natural gas and the high-cost gas incremental pricing threshold. These ceilings are based primarily on the prices of alternative fuels and are required under the Natural Gas Policy Act of 1978. In general, this act states that interstate natural gas pipeline companies cannot charge their industrial customers more than the cost of any alternative fuel oil.

FERC has extended another year interim rules defining and implementing reporting procedures for shortages of electric energy. Under these rules, any eligible public utility now serving firm power wholesale customers must submit reports to the Commission, the utility's customers, and appropriate state authorities concerning any shortage of electric energy or capacity anticipated within the next year. In addition, public utilities must report any modifications of their plans for accommodating these shortages.

In accordance with a statutory requirement, the Office of Conservation and Renewable Energy has issued a final rule for the Residential Efficiency Program, a financial assistance program designed to demonstrate the feasibility of capturing wasted energy through retrofit of existing residential buildings. The final fuling made official DOE's decision not to continue funding the program. The program was meant to be a cooperative venture among the private sector, utilities, and state and local governments but quickly ran into difficulties because it was found to be "unnecessary or unlikely to be workable or fair."

The Department of Energy is currently engaged in a bitter fight with the General Accounting Office, consumer groups, and several members of Congress over whether federally mandated energy efficiency standards are necessary for home appliances. In 1978 DOE had set standards for 13 major appliances but withdrew them after a storm of protest. Since then, DOE has been adamantly opposed to mandatory federal standards. Under current law, if new standards are not forthcoming from the federal level, then all previous state and local standards will be wiped out.

FERC has issued a Notice of Inquiry to investigate what it feels may be serious economic distortions evolving in the nation's natural gas markets. Phenomena such as higher natural gas prices resulting from partial deregulation, especially for gas produced from depths below 15,000 feet, have been cited as examples of distortions. After a staff analysis of the problem, the Commission is expected to eventually readjust some of its price ceilings. ■

Arms Sales (Cont. from p. 9)

areas (i.e., Seattle, Houston) many claim that the above figures understate the true importance of the arms industry.

It is true that either a cessation or a sharp cutback in arms sales would throw many thousands out of work in the short run but it is by no means clear that this would damage the long-run prospects for economic growth. As noted previously, the military-induced drain of skilled labor is one of the main causes of our current supply-side malaise. After a period of readjustment, most of the workers in question would resume their employment — this time in the civilian sector — producing goods that have been demanded by the market. There would be a tendency for these labor services to be efficiently allocated — a tendency which exists to a far lesser degree in the relatively noncompetitive defense industry.

If one feels that the readjustment period would be either too slow or intolerably painful, the burden could be eased by granting a multi-year tax exemption to those thrown out of work. Not only would this relieve some of the strain attending unemployment but the lure of tax-free income would also provide a strong incentive to find a new job as quickly as possible. Many of those affected would be highly skilled and trained individuals, such as scientists or engineers. There is no doubt that many of them would accept lower wages in the private sector but such an adjustment is necessary as soon as possible in order to prevent a continuation of the chronic oversupply of defense-related engineers and scientists that military spending has created. Other transition problems would be eased by the stimulative effect that a cutback in military spending would have on the economy.

In short, the effects on employment of a reduction in arms sales are an argument *in favor* of such a reduction. Personnel (and resources) will be shifted away from state control and into market-determined channels of employment. Reagan's plan to increase the production and sale of arms is inherently inconsistent with his free-market rhetoric. If all goes as planned, the 1985 defense budget will be larger (even in real terms) than the entire 1975 federal budget. While this will generate a tremendous amount of public-sector employment, such employment is actually a sectoral misallocation of resources and is inconsistent with a free and healthy economy.

Another problem with the Reagan arms sales program is its direct violation of the principle of free trade. It has long been a time-honored principle of such consistent free-traders as classical liberal Richard Cobden that the government should do nothing to subsidize or artificially encourage the export of any commodity, whether it be steel, wheat, or arms. Yet commercial arms sales ($2.1 billion) comprised less than a quarter of the arms sold for cash in fiscal year 1981. Not only did U.S. government cash sales alone total $7.6 billion in 1981, but the federal government has a panoply of additional arms transfer programs involving loans and grants. Reagan has proposed that the loans and grants be funded at $4.7 billion for fiscal 1982 — fourfold increase over the 1981 figure of $1.1 billion. After congressional pressure reduced Reagan's 1982 request to $4.1 billion, Reagon soon decided to ask for $5.7 billion in loans and grants for 1983. In addition, the United States has waived payment on military loans to a country other than Israel for the first time — $200 million for Egypt and $50 million for Sudan. Five nations — Egypt, Greece, Somalia, Sudan and Turkey — have been granted special repayment terms on other military loans, getting a 10-year grace period followed by a 20-year repayment period. Reagan's 1983 proposal is even more extravagant; it includes $3.9 billion in guaranteed loans for arms purchases to 31 nations, $789 million in very low interest loans, and a waiver of payment on an additional $950 million in military-related debt.

Whether or not one is an advocate of private arms sales, it should be recognized that *government* arms sales, loans, and grants are inconsistent with international free trade and free markets at home. The artificial encouragement given to arms transfers skews normal trade patterns among nations and results in an additional diversion of resources from the private sector of both the supplier and the recipient. At a time when taxpayers are required to "bite the bullet," we can expect increasing resentment at being forced to subsidize foreign military establishments.

This resentment has been exacerbated by the notorious inefficiency of the weapons sales and weapons procurement policy of the Defense Department. Like most bureaucracies, DOD is plagued with waste and mismanagement. When weapons are being produced and sold on such a large scale, these problems tend to reach epidemic proportions. For instance, the Reagan budget cuts for his first year in office were completely neutralized by the cost overruns for 47 weapons systems in *one quarter only* ($47.6 billion). The Pentagon's record on arms sales is no better. The Center for Defense Information has noted: "the General Accounting Office in particular has repeatedly criticized the Pentagon for financial mismanagement and for accounting and cost recovery problems in the [foreign military sales] program. The GAO has charged the Pentagon with failure to bill fully or in a timely fashion, for improper computation of termination costs in trust funds, for underpricing military goods and services, for untimely and inaccurate delivery reporting, among other things . . . At least hundreds of millions of dollars are involved, maybe billions."[6] In the last five years alone the Pentagon has underbilled arms buyers by $1 billion.

Although the most important aspect of arms sales should be their political and ethical implications, the economic issues deserve a closer look than they have usually been given. As we have seen, the popular contention that Reagan's arms sales policy will help the economy is not solidly based in either theory or fact. In truth, it represents yet another deviation from the free-market rhetoric of the Reagan campaign. ■

[1]Lloyd J. Dumas, "Taxes and Militarism," *Cato Journal* 1 (Spring 1981) 285.

[2]William Magruder, "Technology and the Professional Societies," *Mechanical Engineering*, September 1972.

[3]Seymour Melman, *The Permanent War Economy* (New York: Simon and Schuster, 1974), p.23.

[4]Senate Committee on Foreign Relations, *Arms Transfer Policy*, 95th Congress, lst session, July 1977, Appendix 3, p.94.

[5]Department of Labor, Bureau of Labor Statistics, *Foreign Defense Sales and Grants, Fiscal 1973-1975: Labor and Material Requirements*, July 1977, p.17.

[6]"U.S. Weapons Exports Headed for Record Level," *The Defense Monitor*, vol. XI, no. 3, pp.10-11.

GOVERNMENT RECEIPTS MONITOR

A quarterly feature of *Policy Report*, the "Government Receipts Monitor" summarizes the latest levels and sources of the federal government's income.

	RECEIPTS (annual rates in millions of $ unless otherwise stated)			
	1982 1st Quarter	1981 4th Quarter	1981 3rd Quarter	Average for Last Year
Total Receipts	569,596	588,764	626,848	604,829
Surplus or Deficit	−25,658	−207,148	−58,780	−56,656
Total Individual Income Taxes	343,800	286,104	320,272	346,254
Gross Corporate Income Taxes	58,808	63,592	60,632	74,962
Employment Taxes and Contributions	179,476	165,712	167,200	175,174
Social Insurance Taxes and Contributions	188,936	183,224	191,648	196,505
Unemployment Trust Fund	9,872	8,892	16,528	15,518
Excise Taxes	36,708	41,808	46,580	43,205
Highway Trust Fund	6,484	6,816	6,788	6,563
Estate and Gift Taxes	9,072	7,532	7,432	7,672
Customs Duties	8,608	9,344	9,296	8,883
Miscellaneous	15,396	17,536	16,224	15,679
Holding of Public Debt Securities (current total)	1,061,299	1,028,729	997,855	1,014,764
Holding of Agency Securities (c.t.)	5,094	5,987	6,086	5,836
Federal Securities Held by Public (c.t.)	862,809	830,055	794,434	815,818

SOURCE: Monthly Treasury Statement of Receipts and Outlays of the United States Government.

PR Reviews

Tomorrow, Capitalism, by Henri Lepage. Open Court Press, 1982, $14.95.

With the publication in French of just two books, *Tomorrow, Capitalism* and *Tomorrow, Liberalism*, economic journalist Henri Lepage has rapidly become one of the best known advocates of the free market in Europe. Both books have become best-sellers in France. *Tomorrow, Capitalism* is now available in English.

The main theme of *Tomorrow, Capitalism* is that statist economics is dying rapidly and that a new brand of free-market economics is rising to take its place. Not only are the older forms of statist economics unsound on theoretical grounds, but they have been falsified by the repeated failures of central planning and government manipulation of monetary and fiscal policy. Lepage's rather broad view of the neophyte free-market economists includes the supply-siders, the Chicago school, the Austrians, the "public choice" school, and the followers of Gary Becker and the UCLA school.

Tomorrow, Capitalism should prove to be one of the most important books of the 1980s. Lepage's book falls short of being perfect, however. There are two points deserving of criticism. The first is Lepage's attachment to "positivist" methodology, which emphasizes the "testing" of economic theories by their power to predict. It is far more likely that a truly sound version of free-market economics can only be built on a deductive approach, à la Mises and Hayek. The second point is the identification of free-market economics as "right-wing" economics. Such terminology is bound to result in the sort of confusion between true capitalism and state-monopoly capitalism that Lepage himself protests.

"To be governed . . ."

We suspected that

Jabbing a finger at the House floor, where members were winding their tortuous course through three dozen pending amendments, [House Appropriations Committee Chairman Jamie] Whitten said, "They're dealing with figures that are based on speculation, assumption, and hallucination — and making people think they are real."

—*Washington Post,* May 27, 1982

Defenders of free enterprise

Longtime political workers maintain that anyone with serious designs on the Mayor's office here [in Los Angeles] has, by tradition, found it necessary to gain the backing of the business establishment. Right now that establishment wants a candidate who will help advance downtown redevelopment, push for a rapid transit system and work toward improving the city's aging convention and sports facilities.

—*New York Times,* May 31, 1982

Did Bolger send his letter express mail?

Federal Express television commercials are absolutely, positively noted for humor. They feature incompetent relatives rising to the top, high-speed executives telling Peter that Pittsburgh is Perfect and senile chief executive officers who can't remember the word federal. But a new one, prepared by the New York ad agency of Ally & Gargano, features two rude, lazy postal workers chewing the fat while a customer all but dies of old age at the window. The U.S. Postal Service and the American Postal Workers Unions are not amused.

"I cannot believe," Postmaster General William F. Bolger wrote to Federal Express President Fred Smith, "you condone a commercial that insults the integrity of some 670,000 postal employees, the overwhelming majority of whom are diligent, courteous and efficient." Moe Biller, general president of the postal workers union, has written the networks complaining about the commercials. "It is unfair, malicious and belittles every person who labors as a postal worker," Biller said.

This cycle for which this particular commercial was made was scheduled to end Sunday, a Federal Express spokesman said, but it could appear again in the future. "I don't think any company wants to hurt an individual," he said, "The intention was to point at the institution."

—*Washington Post,* May 21, 1982

Who's fooling whom?

And, finally, this jewel. Robert Leider, an Alexandria publisher who keeps an eye on federal grants, spotted a $26,000 contract being offered by the Department of Housing and Urban Development that seemed a bit strange. Entitled "Training Program on Fraud, Waste and Mismanagement," the offer said "prospective contractors must have the necessary experience to develop and present a training program in fraud, waste and mismanagement for HUD employees. . ." Is HUD searching for ways to create malfeasance? Leider wonders. He also pointed out that the notice was, appropriately, printed April 1. HUD officials weren't amused. The advertisement was directed at companies that can help HUD employees reduce waste, they said.

—*Washington Post,* April 28, 1982

Good enough for government work

Ronald H. Lewis, [New Jersey] Gov. Thomas H. Kean's choice for state education commissioner, copied verbatim and without attribution from other sources about half his doctoral thesis, the Star-Ledger reported today.

The newspaper said the copied material appeared on at least 66 of the 121 pages of Lewis' study. An almost uninterrupted 48-page passage in Lewis' paper came directly from three books, the newspaper said.

—*Washington Post,* May 10, 1982

No wonder they're asking for more money

A report by congressional investigators has renewed demands on Capitol Hill to crack down on use of outside experts by federal agencies. What triggered the uproar was discovery that the Pentagon had hired 23 private engineers at an average salary of $94,500 each — far above the $69,630 pay of cabinet secretaries.

—*U.S. News & World Report,* May 3, 1982

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