POLICY REPORT

IS THERE A WATER CRISIS? —page 6

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Reindustrialization Policy: Atari Mercantilism?

by James C. Miller III

Like many other industrial nations, the U.S. has experienced a period of rampant inflation, intolerably high levels of unemployment, significant dislocation of economic activity, and inadequate growth. Some industries and some areas of the country have been harder hit than others.

Periods of economic stress often produce new ideas, new approaches. During the past year or so we have witnessed a plethora of proposals designed to rekindle the nation's industrial might and return its economy to the high growth track of the 1960s. These proposals vary across the lot. As Robert Kaus recently pointed out,[1] some are intended to preserve industries in decline; others would accelerate the adjustment process and focus the government's aid on so-called industrial winners.

On the whole, debate over "industrial policy," "reindustrialization," or even "reindustrialization policy" is healthy, and I frankly welcome it. Progress is seldom served by turning a deaf ear to new ideas. But today I want to raise certain questions about some of the more seductive proposals one hears and about the predicate on which they are based. Specifically, I want to caution against the simplistic notion that economic salvation lies in governmental intervention to promote high technology on the one hand and erect barriers to competition in basic industries on the other—a policy I call "Atari mercantilism."

Any discussion of industrial policy should begin with a recognition that we already have one. The issue is what type. For example, should the government be more or less involved? Should it be a "planner" or a "catalyst" for market forces? For reasons that will soon become clear, I am skeptical about government programs to achieve industrial growth through special subsidies, protective regulations, and grants of monopoly privilege.

"We will not improve economic progress and maintain our precious freedoms by turning the clock back to defunct mercantilist policies."

The Problems with Industrial Policy

Such proposals bother me for at least three reasons. First, the nation's recent economic troubles are themselves partly the result of ill-conceived government attempts at "guided free enterprise." Second, as Adam Smith and David Hume demonstrated in exposing the fallacies of 18th-century mercantilism, many of the programs now being advanced are bound to fail. Finally, efforts to achieve industrial growth through heightened governmental intervention raise troublesome questions about equity and individual liberty.

In the 1970s, the rate of industrial growth slowed dramatically. One of the founders of productivity studies, Professor John Kendrick, has compared the period from 1960 to 1973 with the post-oil-embargo years of 1973 through 1979. He finds that in the latter period growth in industrial output fell by one-third. And growth in labor productivity fell by nearly two-thirds.[2]

Kendrick attributes part of the slowdown to factors beyond government influence—the oil shock and certain cyclical and demographic factors. But he also concludes that much of the decline was the result of an adverse investment climate, created by accelerating inflation, high taxes, incomes policies, and other regulations. Such policies reduced return on investment and increased risks. According to Kendrick, the decline in the rate of capital accumulation explains over one-third of the slowdown in economic growth. Another 20% is explained by a reduced rate of increase in outlays for research and development. And 15% is attributed directly to increased regulation.[3]

Is there anyone who believes that the decade of the 1970s saw anything but active intervention on the part of our federal government? Can anyone seriously contend that two protracted periods of wage/price restraints—first under President Nixon and then under President Carter—were anything but an exercise in "guided free enterprise"?

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James C. Miller III is chairman of the Federal Trade Commission. This article is based on a speech delivered before the Economic Club of Detroit. The views expressed are those of Chairman Miller and do not necessarily reflect those of the other Commissioners.

EDITORIAL

The Roots of the Debt Crisis

By the end of 1982 the nine largest U.S. banks had lent 222% of their total capital to 40 non-OPEC developing countries. Their exposure in just three countries—Mexico, Brazil, and Argentina—exceeded 100% of their capital. The increasing concern for the stability of the international financial system has produced headlines like "the debt bomb."

The millions of words produced in recent months on the debt issue have rarely illuminated the origins of this crisis. Most attention has been directed at the allegedly dire consequences of worldwide default. Just as Jimmy Carter dismissed 30 years of American involvement in Iran as "ancient history" not relevant to the Iranians' 1979 anger at the U.S., perhaps certain interests would prefer not to discuss how we came to the brink of a banking collapse.

The origins of the crisis are important, however, and they fall into three major categories.

The most important factor is the massive inflation of the last 15 years. In the late 1960s, as Lyndon Johnson spent huge sums on both the Vietnam War and the War on Poverty, the Federal Reserve Board accommodated him by expanding the money supply significantly. In 1968 the federal deficit reached the then-unheard-of level of $25 billion in a year without a world war. In order to accommodate the deficit, monetization of securities by the Fed rose to $6.4 billion. These dollars were then pyramided by the banks into a large credit expansion.

With the Fed pumping more money and credit into the economic system throughout the 1970s, the banks had more money available for loans. This money had to go somewhere, and much of it found its way into the coffers of communist and Third World governments.

Why wasn't it lent in the United States? That leads us to the second element in the debt crisis. From 1966 on, the increasing burden of taxes and regulation began to depress profits, and thus investment opportunities, in the United States. Developing countries—which needed foreign capital and which, being governments or government-backed corporations, didn't face the same limits in paying high interest rates—were glad to pay higher rates than American corporations and individuals could afford. It was easier for the banks to lend $1 billion at a stroke than to find hundreds or thousands of domestic borrowers for that same $1 billion. Finally, restrictions on domestic branch banking made it easier for a New York bank to lend in Calcutta or Caracas than in California.

But why would hard-nosed bankers allow themselves to get in over their heads in international lending? Many of them relied on the notion, as Citibank's Walter Wriston put it, that "Sovereign nations do not go bankrupt." But more than that, as Mark Hulbert demonstrates in a recent Cato Institute study, banks are very sensitive to U.S. government attitudes toward foreign lending. If they believe that foreign debtors will ultimately be backed by the U.S. Treasury, they will have no qualms about increasing overseas exposure. As early as 1962, government was encouraging the banks to engage in extensive foreign lending. A 1975 study by the House Banking Committee reported that "it appears likely that banks have assumed that these loans are in some sense guaranteed—that some form of governmental assistance will be given to a country to prevent a default that might threaten major banks."

Now the banks and the Reagan administration are asking Congress to approve an $8.4 billion increase in U.S. funds for the International Monetary Fund. The administration argues that this money is essential to prevent widespread defaults and possibly the collapse of major U.S. banks.

This money would be a direct wealth transfer from the taxpayers of the United States, not to the people but to the governments of the Third World, and indirectly to the large banks. Despite its reputation for pressing "fiscally austere" programs on governments that accept its aid, in fact the influence of the IMF is largely negative. It strengthens the public sector at the expense of the market in countries where the absence of markets is forcing the people into grinding poverty. It encourages tax increases and protectionism.

The correct response to the administration's IMF request was stated three years ago, the last time Congress was asked for an IMF fund increase:

> Proponents argue that the IMF needs this increase to help prevent economies in the Third World from collapsing under the burden of excessive internal debt . . . . But the IMF does not have a record of success in strengthening unstable economies in the Third World. Indeed, it has been counterproductive.
>
> In a special internal analysis, the IMF has itself admitted that less than one third of its programs have been successful in improving Third World nation's balance of payments positions. But those programs have been very successful in impoverishing less developed countries.
>
> In this time of economic stringency, when federal deficits [then at $50 billion] are placing heavy borrowing requirements on the capital markets of this country, the American public should not be called upon to fork over $5.5 billion to the IMF.

The words are those of Rep. David Stockman. ■

Atari Mercantilism? (Cont. from p. 1)

Surely, such programs, together with escalating taxes and unstable monetary policy, wreaked havoc with business planning.

Over the whole decade of the 1970s, the pre-tax real rate of return on three-month U.S. Treasury obligations was *minus* 0.8%! For the median income family, in the 30% marginal tax bracket, that amounted to a minus 2.7% return on their hard-earned savings.[4] No wonder the savings rate declined, and so did the rate of capital accumulation, one of the important determinants of industrial growth.

For the decade, the U.S. ranked dead last among six major Western industrial nations in both capital formation as a percent of gross domestic product and in productivity growth.[5] By 1981, overall expenditures for pollution control had grown to $60 billion per year[6]—an amount greater than last year's revenues from the corporate income tax.[7]

Another major experiment with guided free enterprise was the energy program—what Herb Stein referred to as

> [a] plan under which low-cost energy [was] taxed and high-cost energy [was] subsidized, thus discouraging production of low-cost energy and encouraging production of high-cost energy.[8]

It is instructive to look at the predicate which guided that experiment. Retired Central Intelligence Agency analyst Donald Jameson recently discussed the study that formed the basis for the government's then apocalyptic view of the energy market. The 1977 CIA report predicted, for example, that by 1985 the Soviet bloc would "require a minimum of 3.5 million barrels of imported oil every day" and that 1983 production by OPEC countries would be over 40 million barrels per day. In sharp contrast, today the Soviets are exporting well over a million barrels a day, and OPEC production is about 13 million barrels daily—one-third the CIA estimate.[9]

The CIA study also projected total free world demand at 55 million barrels per day in 1980 and 70 million by 1985. Actual 1980 daily consumption was about 45 million barrels and, partly due to the worldwide recession, it is running even lower today.[10]

Yet such doomsday forecasts were the basis for preempting the free market. We went barrelling ahead, imposing price controls and excise taxes on fossil fuels, providing special subsidies for the development of exotic new energy sources, and enacting a potpourri of specific measures to restrict industrial and consumer use of energy supplies. At a time when the flexibility of the free market was most needed, the economy was put in a straitjacket from which it is only now beginning to recover.

The intellectual basis for that program holds that managers, workers, and consumers are too shortsighted or uninformed to assess prospective future events. But a recent study by economists George Daly and Thomas Mayor questions that logic.[11] They conclude that automotive consumers were no less rational than the planners themselves. Indeed, they find that

> [c]onsumers [did not] ignore the energy crisis, that they were [not] inherently wasteful in the use of energy, that they were [not] psychologically unable to give up large automobiles, and that such policies as mandatory efficiency standards for appliances and automobiles were [not] the only way to prevent excessive dependence on imported fuel.[12]

Today, the effects of President Reagan's decision to deregulate energy are firmly taking hold. Real as well as nominal prices for gasoline continue to fall. Yet many of the interventionists are now calling for programs to enforce conservation, lest people be deluded into thinking energy prices will fall forever. It seems to me that having seriously underestimated the intelligence of consumers and producers, the prospective planners would do better to keep silent for awhile.

To blame the nation's lagging growth

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Atari Mercantilism? (Cont. from p. 3)

in output and productivity on a lack of industrial policy is, to my mind, simply straining credulity. Again, the question is not *whether* to have industrial policy, but what *kind*. If anything, the decade of the 1970s has taught us what kind *not* to have!

Earlier Mercantilism

Those who would ignore the lessons of the 1970s can scarcely find solace in more ancient history. As Adam Smith and David Hume demonstrated in their scathing attacks on the British and French mercantilists—the central planners of their time—government attempts to pick winners and protect losers were inherently self-defeating. This was not only because such programs allowed special interests to capture the bureaucrats of the day, but in Smith's view it was also because of the tendency of central planners to view individuals mechanically, without regard to their divergent interests. Said Smith of the mercantilist planner:

"Some of Japan's so-called success stories seem to have occurred in spite of, not because of, governmental intervention."

> [H]e 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 chessboard; he does not consider . . . that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might choose to impress upon it.[13]

It is remarkable that the first test of Smith's thesis—that economic growth is maximized in a free economy—began in the very year his classic treatise was published, 1776. That, of course, was the year of the American Revolution. Subsequently, as Milton and Rose Friedman have observed, from 1800 to 1929, aside from periods of major wars, government expenditures were never more than about 12% of national income. And two-thirds of that amount was at state and local levels.[14] The results of that "test" were unparalleled economic growth and expansions in human freedom.

The Myth of Japan, Inc.

Despite the demonstrable superiority of free markets, there are those who point to the contemporary Japanese economy as illustrating the need for an interventionist industrial policy. Frankly, it is time to shatter a few myths about the Japanese success story. Let me emphasize that I do not condone restrictive Japanese trade policies. I support efforts by the administration to achieve greater access for U.S. firms to their markets. But Japanese industrial policy is not all it's cracked up to be.

First, among major industrial nations, from 1950 to 1973 Japan consistently maintained the *lowest* ratio of government expenditures to national income. In 1973, for example, 29% of Japan's national income was spent by government, versus 40% for the United States.[15]

Second, according to Brookings Senior Fellow Philip Trezise, the Japanese are spending an "almost trivial" amount of public funds on special subsidies for prospective high-growth industries. And he says the same thing is true for their program of tax incentives. Moreover, Trezise finds no evidence that Japanese import policy has singled out "winning" industries. In fact, today such protection is directed to the weakest sectors in the Japanese economy, such as apparel and agriculture.[16]

Third, some of Japan's so-called success stories seem to have occurred in spite of, not because of, governmental intervention. Consider, for example, the auto industry. Neither Toyota nor Nissan were established at the government's initiative. Both were started before the Second World War. Following the war, the Japanese government did impose trade protection and provide for minimal reconstruction loans. But its efforts to keep the industry in the hands of a few producers failed because of intense rivalry among Japanese auto firms.

Finally, there is the myth of the invulnerable Japanese basic industry. In that regard, the U.S. public should know that the value of Japanese merchandise exports actually fell by 8% in the last half of 1982. Excess capacity has hit many of their heavy industries, including autos, steel, aluminum, plywood, and petrochemicals. Recently, I understand, the Japanese steel industry called for an "update" of their government's never-used anti-dumping laws. Japanese petrochemical companies—now operating at an average of 50% of capacity—are claiming that U.S. and Canadian companies are, in effect, "dumping" in the Japanese market. Many Japanese firms are said to require government rescue programs.

"What price increased productivity if purchased through loss of freedom and dignity for the individual?"

Thus, the idea that the industrial leadership of U.S. firms is about to be surpassed *en masse* by Japan is dubious at best. It reminds me of the nationwide concern over high Soviet growth rates in the late 1950s. Diminishing returns inevitably set in. My professor, G. Warren Nutter—a noted scholar of Soviet economic growth—made the point with the following analogy: Each year my younger brother grows older by a greater fraction of his age than I do; of course, he'll never catch me.

And, as Santayana observed, those who would ignore history are condemned to repeat its mistakes. Let's recall our own brief experience with industrial planning during the Great Depression. It included the Smoot-Hawley tariff and the National Recovery Administration. Under the NRA, the federal government relaxed antitrust enforcement, fostered business/government coordination, developed codes of so-called "ethical" business behavior, and otherwise tried to pick "winners." Rather than expand industrial output, the short-lived NRA's major effects were to restrict production and raise prices.

In short, active industrial planning policies did not work in this country in the 1930s. They are not responsible for the Japanese successes of the 1960s and 1970s. And they are not the answer for the United States in the 1980s.

As my good friend Fred Kahn, noted deregulator and President Carter's "inflation czar," observes, we should

> [c]ast a skeptical eye on glib references to the alleged success of government intervention in other countries in picking and supporting industrial winners, arguments that are being used to justify setting up monstrous Reconstruction Finance Corporations to speed the process of industrial revitalization.[17]

The Question of Freedom

Let's now put aside for a moment questions about the efficacy of government planning strategies in raising productivity and increasing industrial output. Let's think of the impact on equity and individual freedom. How many of us liked having the government set and enforce minimum and maximum temperatures in commercial buildings? Or the mileage new automobiles must attain? How many of us would tolerate policies which discouraged small businesses and fostered collusion among their larger competitors? And who wants to subsidize so-called "winner" firms chosen by elite planning boards at the expense of taxpayers, including those who work in the hard-pressed industries?

In our quest for increased economic growth, we must not ignore such questions. What price increased productivity if purchased through loss of freedom and dignity for the individual?

I submit that if we want to foster increased economic growth in a way that will be sustained in the long run and that will enhance, not restrain, individual liberty, we should reduce taxes, restrain the growth of government spending, relieve the economy of excessive regulation, and stabilize monetary aggregates.

220 million individuals are not like so many pieces on a chessboard. We will not improve economic progress and maintain our precious freedoms by turning the clock back to defunct mercantilist policies of a bygone era.

"Among major industrial nations, from 1950 to 1973 Japan consistently maintained the lowest ratio of government expenditure to national income."

Today, we face a critical choice. We can travel the dead-end route of Atari mercantilism. Or, we can follow the course described by my friend Herb Stein:

> We have a system that for two hundred years picked winners successfully. That system is the free market, the free enterprise system, in which people bet their own money on who the winners are going to be . . . .[18] ■

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[1]Robert Kaus, "Can Creeping Socialism Cure Creaking Capitalism?," *Harper's*, February 1983, pp. 17-21.

[2]John W. Kendrick, "International Comparisons of Recent Productivity Trends," in William Fellner, ed., *Essays in Contemporary Economic Problems* (Washington D.C.: American Enterprise Institute, 1981), pp. 125-70.

[3]Ibid. See also Gregory B. Christainsen and Robert H. Haveman, "Public Regulations and the Slowdown in Productivity Growth," *American Economic Review*, May 1981, pp. 320-5.

[4]See, for example, *Economic Report of The President, 1983* (Washington D.C.: U.S. Government Printing Office, February 1983), p. 87.

[5]Ibid., p. 81.

[6]Gary L. Rutledge and Suzan Lease-Trevathan, "Pollution Abatement and Control Expenditures, 1972-81," *Survey of Current Business*, February 1983, pp. 15-23.

[7]*Economic Report of The President*, p. 257.

[8]Herbert Stein, "Verbal Windfall," *AEI Economist*, September 1979, p. 7.

[9]Donald F. B. Jameson, "CIA Petroleum Prophecy," *Washington Post*, April 6, 1983, p. A-19.

[10]Ibid.

[11]George G. Daly and Thomas H. Mayor, "Reason and Rationality during Energy Crises," *Journal of Political Economy*, 1983, pp. 168-81.

[12]Ibid., p. 180.

[13]Adam Smith, *The Theory of Moral Sentiments* (Indianapolis: Liberty Classics, 1976), pp. 380-1.

[14]Milton and Rose Friedman, *Free to Choose* (New York: Harcourt Brace Jovanovich, 1980), p. 37.

[15]See G. Warren Nutter, *Growth of Government in the West* (Washington D.C.: American Enterprise Institute, 1978), pp. 6 and 58-73.

[16]Philip H. Trezise, "Industrial Policy Is Not the Major Reason for Japan's Success," *The Brookings Review*, Spring 1983, pp. 13-18.

[17]Alfred E. Kahn, "The Relevance of Industrial Organization," in John V. Craven, ed., *Industrial Organization, Antitrust, and Public Policy* (Boston: Kluwer-Nijhoff Publishing, 1983), p. 15.

[18]Herbert Stein, in *Reindustrialization: Boon or Bane?* (Washington D.C.: American Enterprise Institute, 1980), p. 9.

Solving the Water Crisis

Every month the Cato Institute sponsors a Policy Forum at its Washington headquarters, where distinguished analysts present their findings to an audience drawn from government, the public policy community, and the media. A recent Forum featured Terry Anderson, associate professor of economics at Montana State University and author of Water Crisis: Ending the Policy Drought *(Cato Institute and Johns Hopkins University Press, 1983). Commenting on Anderson's talk were two staff members of the National Wildlife Federation, economist David Campbell and lawyer Christopher Meyer.*

Terry Anderson: I'd like to speak briefly about an important new way that resource economists are looking at natural resource issues in general and water in particular. The general approach taken by many economists has been to assume that market failure is going to exist when it comes to many natural resource allocation problems, and that, as a result, some sort of public intervention is needed to improve that allocation. Because of much of the work being done in public choice theory and in law and economics, there is a greater understanding and recognition today of governmental failure as well as market failure. We can no longer state that market failure exists in the allocation of a resource like water and conclude that government can provide a viable alternative. A deeper understanding of governmental failure has forced economists to look more carefully at the market allocation of resources and ask, How bad is the market failure? Why does it exist? Does it exist because of some underlying natural constraints that won't allow us to develop the correct institutions or because there have been collective hurdles thrown in the way of effective market allocation?

Economists are now thinking more carefully about the role that property rights plays in allocating natural resources. They are making efforts to determine just how private property might be defined, enforced, and made transferable so that the market can be used efficiently to distribute resources. As a result, there is a real possibility that a coalition can be built drawing its members from groups that aren't usually allies. The way that economists are now looking at resources provides a basis for a coalition among environmentalists, fiscal conservatives, and classical liberals, that is, those who appreciate the role that personal and economic freedom must play in our lives.

Let me talk briefly about how I tried to apply these general ideas to water and water problems. If you look carefully at the history of water institutions, you see the early evolution of rights and institutions governing water. Markets could and did work quite well in the first attempts to allocate water in the American West. The people who settled the American frontier faced some very different constraints than they confronted in the East. Because of the lack of water and the uses to which it was being put, namely mining and irrigated agriculture, settlers were forced to devise institutions that would allow them first to determine who had the rights to water and then to allocate water to various uses.

A Cato Institute Policy Forum

The system of prior appropriations that evolved in the West during the last half of the 19th century clearly established property rights to water and allowed it to be transferred from one use to another. In my book, I devote a great deal of time to the evolution of water rights, trying to detail how those rights and institutions led to an efficient allocation of the resource and a framework within which water could be developed. One of the things that struck me as I did the research on that section was the degree to which private investment dominated water development during the last half of the 19th century. The figures show that private development took place on a large scale both to store and to deliver water. It wasn't on the scale of Hoover Dam, but in terms of percentages, private development was dominant, primarily because of the kinds of institutions that had evolved.

Near the end of the 19th and early in the 20th century, some important things changed. As a result, there were significant shifts in attitude about the way water should be allocated and the role that the government would play in that allocation. At that time, many people began to observe and document the imperfections of existing water institutions. There were problems with changes in diversion of water, and downstream users were sometimes shortchanged. There were pollution problems caused by increased development on streams. There were capital market problems; not all the development was taking place as regularly as, in restrospect, we think it might have. There was a great deal of concern that when companies owned ditches or storage facilities they would have monopoly power, allowing them to take advantage of farmers who were settling the West.

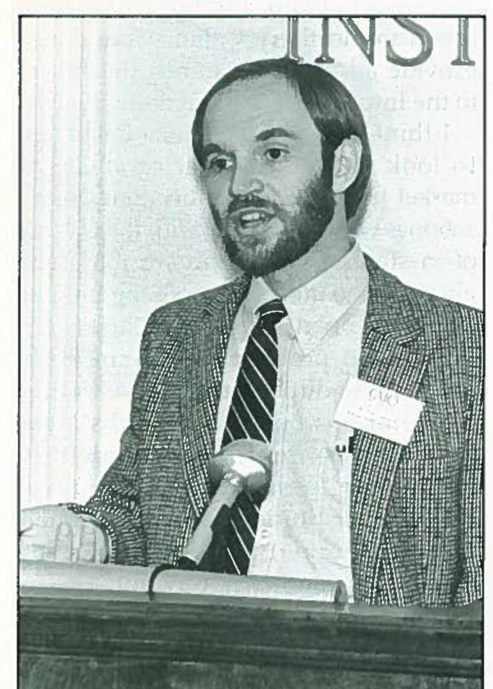
The combination of all these problems and fears led many people to suggest that market or institutional failure existed and that some kind of governmental intervention was necessary. As a result, two things happened.

First, the federal government began to become more involved in water development, storage, and delivery. In almost any Western valley that had much rock to it—dams that store the water and ditches that deliver it—you can see the results of the Newlands Reclamation Act of 1902.

We now suffer some real consequences of the Act in terms of conflicts that exist because water was delivered to parcels that were very different in size from what most would regard as optimal. The Newlands Reclamation Act required that water be delivered to parcels no larger than 160 acres. It also required that the money be paid back from the development, initially specifying that no interest be charged on the payback. Eventually, the Act was interpreted in ways that gave farmers very large subsidies, some ranging higher than 90%. The farmers got very cheap water, and most of them liked that.

The second thing that happened in response to the perceived failure of private water institutions was that the states assumed a greater role in structuring property rights. States began to specify the "beneficial" uses of water and who could and could not hold rights. Many new state regulations came into existence. Today, if you really want to understand Western water institutions, you must study it on a state-by-state basis, since every state does something differently. Perhaps with the exception of New Mexico you can almost be assured that every state has some peculiar institutional or property rights constraints that have changed the definition and enforcement of property rights and have significantly placed barriers on the transfer of those rights.

Our water problems are not simply the result of market failure; they have been caused by the institutional barriers that prevent the markets from working properly.


Terry Anderson: "Economists are thinking more carefully about property rights."


Roger Sedjo of Resources for the Future talks with William Dennis of the Interior Department and Cathy Kinnard of the Council on Environmental Quality.

It is fair to ask: What can we do about it? There are at least three areas where changes can be made.

First, in the case of surface water, many of the impediments to transfers are so severe in most states that water cannot be allocated according to value, at least in a market sense. We need different rules, like those in New Mexico, for example, that allow markets to dictate when and where water can be transferred. Of particular importance is the distinction between consumptive use and diversion use rights. In many places, people have a right to divert water, and those rights are not defined in terms of the right to consume water. Suppose I have a right to divert 100 acre feet of water. I consume 50 acre feet, and 50 acre feet are returned to the stream. That means somebody downstream can claim that 50 acre feet. Suppose they use 25 acre feet and return 25, and so on down the stream. I may decide to sell my right to somebody who will withdraw the 100 acre feet and consume 75, since he will be running it through a coal-fired steam generation plant and most of it will evaporate. That means there will be 25 acre feet less flowing downstream, where users are going to be disadvantaged.

New Mexico has handled the problem by defining surface water rights in terms of a right to consume, not a right to divert. Under this system, I don't have the right to sell 100 acre feet, but only the 50 acre feet I use. New Mexico is far ahead of most other Western states in defining rights in this way and providing an opportunity for markets to work more effectively.

With respect to groundwater, the problem is like a soda with two straws stuck into it and each person trying to drink the most before the other person does. In my book, I propose some ways that rights to both the stocks and the flows of groundwater might be defined to eliminate some, though not all, of the common pool problems. The Tehachapi Basin in California provides a good example of an agency's effort to set up a system of rights that lets the markets play a greater role in groundwater allocation.

Finally, there is the issue of in-stream flows. Until I started doing research for my book, I hadn't really thought about how the problems associated with in-stream flows could be solved with a market. I thought this would be the one case where there was no good market

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solution. But I began to look into some of the ways that other countries, particularly England, have handled the problem. They have clearly defined in-stream flow rights, and people in England can and *do* own such rights. They can leave the water in the river and use it for fish habitat, enjoy it as scenery, or use it for whatever other purpose they desire. The crucial thing is that they *own* the right.

As a result, there have been some important and interesting pollution cases in England that have arisen because the person who owns the right protests when somebody dumps toxic chemicals into the water killing off their fish. If you own those fish—whether you belong to a fishing club or if you own a hotel with six miles of stream open to paying guests—you get upset when your stream is polluted.

One association in England has examined over 700 cases of pollution and won almost all of them, managing to get people to either stop polluting or pay damages for the pollution done. I did first-hand research by looking at some of these trout streams. Research like that may not be conclusive, but it certainly is fun. I think there is a real opportunity for us to reconsider the way we treat in-stream flows in the U.S.

As I looked into the problem more, I found that in many states it is illegal to own water for in-stream purposes. In Utah, for example, I cannot leave water in a stream just for fish to swim in. By law, providing fish habitat is not a beneficial use, and nonbeneficial uses are wasteful.

The same sort of thing exists in Montana. A rancher in the Madison River valley, which contains a beautiful trout stream, had some water that was no longer being used for irrigation. Often, if you don't use the water, you lose it, so he decided to grant an easement to a conservation foundation on the condition that they agree to leave the water there for in-stream purposes. Their attorney looked into it and said, "We'd love to have it, but it would not be a legal claim. We can't take the water and leave it in the stream." Again, we have an impediment to a market solution to this significant amenity or environmental problem. What appears to be market failure problems is really an institutional failure, where the possibility of markets working at all is precluded.

Part of the audience for Terry Anderson's lecture.

By looking at water issues in this way I am convinced that there is a real possibility for some new ideas to come forth that would allow markets to play a greater role in improving the efficiency of water allocation and in contributing to environmental and amenity values. I am impressed with some of the projects that are going on at the Conservation Foundation, where they are looking at the possibilities for and the impediments to water transfers. That seems to fit with the idea I expressed earlier that there is a possibility for a coalition forming among environmental groups and the new free market environmentalists. The days of structural solutions to water problems are over, and it is time to look elsewhere. I firmly believe that there is a possibility for markets to play a greater role.

David Campbell: Chris Meyer and I were the wrong people to invite here if you wished to develop an argument today. I wish you good luck with your book. I think it would be to the country's benefit if people in the government read it.

I can give you one example of how the environmental community is using competitive markets to achieve its goals. The Environmental Defense Fund has recently suggested a partial solution to southern California's water shortages. Their proposal is quasi-market based. EDF proposes that the Metropolitan Water District of Southern California (MWDSC) pay to reline the canals where water is being lost in the Imperial Valley Project in southeastern California. In return MWDSC would receive the water it saves. EDF feels the MWDSC would gain more water than they could obtain through costly projects from northern California and also provide additional water in the future to the Imperial Valley irrigation district.

I think you've given us a challenge: to look more closely at problems of market failure. For instance, our organization is very concerned with the defense of in-stream flows, and we may have given up too quickly on looking for market and property rights solutions.

Pollution problems are going to be much more difficult to solve with market solutions because the substances and sources are difficult to identify. Again, environmentalists have taken the social institution or the government regulation route, perhaps too readily, as the short and easy way out.

I first really became aware of the property rights issue when reading Alan Randall's 1975 article in the *Natural Resources Journal* that described and compared two systems that are used to allocate

resources. One primarily uses property rights and the other relies on social institutions. I argue that both systems are on a continuum where resources are allocated by different mixes of property rights and social institutions.

Institutional arrangements whereby resources are owned in common have been given a bum rap by the "tragedy of the commons" argument. The establishment of private property rights and greater reliance on the market are given as the solutions to the "commons" problem. But the cause of resource misallocation is *non-ownership* of certain resources. Establishment of common property rights could also be a workable solution to *res nullius* externalities.

For example, there are one and a half million acres of commons still left in England and Wales. These commons have survived because the owners of those commons really are owners. They have property rights that are exercised under rules that have worked well for centuries. Terry's book mentions how the early miners in California established the first forms of appropriate water rights. These miners' agreements utilized social institutions as well as property rights. They can work. It helps if the participants in these institutions do have an idea of how the market works and how it would help to allocate their resources.

I believe that appropriate social institutions, with property rights, can be developed to solve many of the water resources problems described in Dr. Anderson's book.

Christopher Meyer: You should have asked a real lawyer to come here instead of one tainted with training in economics. The fact is that I do share your enthusiasm for free market solutions. I certainly prefer the simplicity and symmetry of economic thinking to the obscurity and irrelevance of much debate in the arena of law and politics. The free market presents a very attractive alternative to the seeming hodgepodge of decisions under the collection of laws and regulations which now control the allocation of water in the West. Environmentalists are coming slowly to catch on to the importance of using market solutions to achieve environmentalist goals.

Christopher Meyer talks with Richard L. Stroup of the Interior Department.

On the other hand, there is a danger of being blinded by the beauty and simplicity of the market solution. In order to make this proposed coalition work it is tremendously important for us not to be overly enthusiastic so that we fail to recognize the limitations of markets. Granted, these limitations have been acknowledged by Terry and by others who've worked in the field, but they have at times been underrated.

I would like to mention two problems in particular. The first is that in-stream flows are of necessity a public good. Complicating this problem is the fact that the market does not give full weight to the preferences of future generations, who are represented in the market only by the proxy of their forebearers who ordinarily discount the value they may place on preserving environmental quality. These are problems that have been much discussed in the literature, and I think it's important to underscore the deep concern of environmentalists that such externalities not be overlooked.

Aside from the problem of externalities, privatization of environmental goals faces a practical problem: timing. There is a dangerous tendency among persons who advocate policy reform to take anything they can get. When they recognize the reality that they can't have every component of their reform policy, there is a great temptation to say "Well, we'll take whatever reform is politically practicable at this point, and we'll worry about getting the rest later." In the area of water resources that is a particularly dangerous tendency.

This is a problem which I think has some applicability in the area of water resources. I would be very cautious about moving away from some of the admittedly less perfect systems of allocating our water resources—such as federal protection of in-stream flows—

(Cont. on p. 11)

Can the Income Tax Be Reformed?

Policy Report Reviews

Low Tax, Simple Tax, Flat Tax, *by Robert E. Hall and Alvin Rabushka. McGraw-Hill Book Co., New York, 1983. 136 pp. $9.95.*

In 128 pages Hall and Rabushka explain their well-known 19% flat-rate income tax proposal. Why the reform is needed, how it would work, how to get it adopted, what the economic consequences would be, and how flat taxes have succeeded historically are all dealt with in a manner fitting to the Hall-Rabushka flat-tax forms themselves: single, one-sided postcards. And all of it is there to convince the reader that "by 1990, every income group will be unambiguously better off from the economic benefits of tax reform."

There are two tax forms, both of which try to keep to the principle that all income should be taxed only once and as close to the sources as possible. The Individual Compensation tax on income paid by employers to workers (those on wages, salaries, and pensions fill this out); and the business tax on owners' income produced by their business. All types of income are appropriate for one of these two tax forms, because all net income above a minimum (personal allowance) level is taxed at 19%. (This personal allowance makes the flat tax mildly progressive: The further you are above the personal allowance, the closer you are to paying 19% of your total net income.)

The 19% rate (replacing marginal rates as high as 70% today) will ostensibly be successful in collecting revenue because the tax proposal does not allow big profit earners to wriggle out of paying their taxes. So extensive are these loopholes that, on average, final taxable income is about half of personal income, and it is the big earners who benefit most from these loopholes. Deductions now possible for payments to a retirement plan, alimony, interest paid on borrowed money (the single biggest shelter), charitable contributions, and medical expenses would all be eliminated.

The flat-tax plan would have numerous effects on the economy. Most obvious, the accounting industry and the IRS bureaucracy would be shaken by the simple, postcard-sized forms, but there are more important results. Incentives for growth would be greatly increased as people would always be facing a marginal 19% tax rate. In 1979, married taxpayers had marginal rates of 17% if their income was less than $7600, and from there the rates grow to stifling magnitudes. A constant rate of 19% would certainly make new investment more attractive. The authors feel that after seven years the improved incentives will increase real incomes by 9%.

Another important result of the flat tax would be the immediate fall in interest rates. Since the simple tax permits no deduction for interest paid and puts no tax on interest received, both supply and demand in the loanable funds markets will happily agree on a lower rate. The authors feel that the decline would be by at least one-fifth.

Serious repercussions may occur in the housing market, as mortgage payments would no longer be deductible. If the tax reform produced no other economic effects, mortgage holders would be hit hard, housing prices would drop, and the leaden pace of new housing construction would slow further. The predicted fall in interest rates, however, would offset the blow to mortgagers (most mortgage agreements now index payments to future interest rates). "The total effect of reform depends on the relative strengths of the contending forces—the value of the lost interest deduction against the value of lower interest."

The benefits the authors expect from the adoption of the flat tax are probably reasonable. But they hardly mention one further advantage: The government would have limited control over the system and would encounter great difficulty in any attempt to raise taxes. With the fixed rate, bracket creep would be eliminated, and to raise taxes the government would have to openly raise the flat rate, which would cause an uproar.

Unfortunately, the benefits from the reform may well be too dispersed to counter the special interest groups that prefer the present system.

Public Finance: Revenues and Expenditures in a Democratic Society, *by Richard E. Wagner. Little, Brown and Co., Boston, 1983. 490 pp. $22.95.*

Public-choice economics, the systematic analysis of the determinants of government action, has revolutionized the study of public finance. But as is usual in such revolutions, it takes decades for the results to filter into the textbooks used in college courses. The publication of Richard Wagner's well-written and comprehensive textbook is a hopeful sign that that process is underway.

Orthodox public-finance theory, at least in the United States, had concentrated for decades on the identification of theoretically deduced "market failures" and the examination and comparison of various coercive governmental remedies. The state itself was considered a *deus ex machina* whose purpose was the maximization of social welfare. Human nature was bifurcated: Market activities were shortsighted and private, while political activities were farsighted and public. Government was the firm that would miraculously internalize externalities, provide public goods, and maximize social benefit. The absurdity of this approach has been challenged by a growing body of literature, including much by Richard Wagner, that critically examines the actual incentives faced by governmental decision-makers. The results of these investigations have serious implications for the theory of government, as well as spillover effects in the theory of markets and property rights. Not only has a theory of "government failure" emerged, but also market failures have been revealed as the result of a *lack* of enforceable and freely transferable property rights (not their presence). Government is increasingly seen as a mechanism by which individuals can *generate* externalities, securing private benefits at the expense of others.

Public Finance assumes that readers have at least an introductory background in microeconomic theory and is designed for use in upper-division courses in public finance. In addition to providing a superior textbook for class use, the work provides a useful and balanced guide to contemporary public-finance theory. The volume begins with the theoretical foundations of public finance and proceeds to examine taxation and expenditures, the principles of "collective choice," the divergent outcomes of different decision-making regimes, economic calculation, and the various activities of modern American government. Perhaps the most original and interesting chapter is "The Protective State," where war, foreign policy, military procurement, and military policy are examined in light of the principles developed earlier in the text.

Public Finance, like any textbook designed for general classroom use, recognizes the trade-offs between imparting orthodox thought and introducing new ideas. The former dominates most of the text, while the latter are generally raised in the form of challenging questions for the student and useful suggestions for further reading.

Wagner's work is highly recommended as an introductory text in public finance. It is a useful addition to the growing literature of the new political economy, something that has been seriously lacking since the decline of classical economics (with the only surviving system of classical political economy being Marxism). As Wagner writes, "It is increasingly recognized that the workings of governmental institutions should command a central place in the study of public economics, for the study of public economics must properly be an exercise in political economy."

Economic Effects of Social Security, *by Henry J. Aaron. Brookings Institution, Washington, D.C., 1982, 84 pp. $12.95.*

Of all the federal budget programs that experienced budget crises over the last few years, the Social Security problem is usually considered the most serious. Social Security, which has been an important feature of the American economy since the New Deal, is now the largest nondefense government program in the United States. Its cash payments accounted for nearly 7% of 1981 GNP, and the present discounted value of future payments due now runs to several trillion dollars (exact figures depend upon the specific estimate).

Not only do many analysts charge that the system is nearing financial bankruptcy, but many economists (notably Martin Feldstein) have produced studies claiming that the Social Security system has negative incentive effects on both savings and labor supply. Along with these protests have come suggestions for reforms, both major and minor.

Rather than trying to revamp Social Security, however, Henry Aaron argues that the program has been a success. Not only have the financial difficulties of the system been exaggerated, but it also has not interfered with savings or labor force supply. Thus, the book is an important statement of the current liberal analysis of Social Security.

Most of Aaron's brief book consists of an examination of some of the relevant economic models behind analyses of the Social Security system and a look at some empirical data. Chapter two examines the life-cycle, multigeneration, and short-horizon models of saving and working behavior. Subsequent chapters provide "tests" of these models, concluding that Social Security does not adversely affect the American economy in any significant way. Its main effect has been to reduce the retirement age. What is the critical reader to think of this?

If one thing should be clear by now, it is that there is a mass of empirical evidence on both sides of the Social Security debate. On the whole, the aggregate mass of data is ambiguous. Rather than simply slinging numbers back and forth for another few years, another approach is called for: common sense. There is simply no doubt that massive payroll taxes such as Social Security are bound to affect a worker's savings. In addition, nearly all economists agree that the employer's share of the tax ultimately falls on the worker in the form of lower wages. Thus, with substantially less income per se for the consumer to allocate as he wishes (either spending or saving) both savings and consumer welfare *must* be decreased. Furthermore, the savings *rate* on the remaining income is bound to be adversely affected—not only because of lower incomes but also because many people believe their old age is at least partially taken care of.

We must stop hiding behind econometric results from selectively chosen models with selectively chosen data. More often than not, such models simply reflect the economist's own pre-formed policy biases. Whatever Aaron may claim, there is no denying that Social Security is a real problem and that the status quo needs a drastic overhauling. ■

Policy Forum (Cont. from p. 9)

until we are really quite confident that we have in place the underpinnings of a free market solution. That is going to provide more efficient allocation.

But with those two caveats—attention to externalities and to timing—I think it's fair to say that most environmentalists share your desire to get rid of the baggage of brute force regulation, and to move forward toward the cautious implementation of more efficient market-based solutions to environmental protection problems. ■

"To be governed . . ."

We still have a headache from last year

In his address [to the National Association of Home Builders], Reagan attacked the House Democratic Study Group for what he said is its list of "serious alternatives" for raising taxes . . . .

"If you'd enjoy [tax increases] you'd love to be hit on the head with a two-by-four," Reagan ad-libbed.

—*Washington Post*, May 17, 1983

Trust the people, but not too much

Missouri Sen. Jack Danforth commenting on his colleagues in light of their recent vote on the modified Kasten amendment (delaying for four years implementation of tax withholding from dividend and interest income): "Mr. President, what we have in this country is a Congress of the United States listening too attentively to the voice of the public."

—*Washington Times*, April 27, 1983

Otherwise, they're off to a good start

When the federally chartered National Consumer Cooperative Bank opened its doors here three years ago, it was expected to nurture the growth and development of thousands of non-profit, consumer-owned business collectives across the United States—ranging from grocery cooperatives to co-op apartment buildings . . . .

Only about 40 percent of the bank's money—about $90 million—has been disbursed to borrowers, and much of it has been criticized as risky. Federal bank examiners last year found that 54 percent of the bank's loans then were credit risks, and 25 percent were not even earning interest.

While the bank has lent to some inner-city co-ops and backed some small rural businesses, the bulk of its money has gone to fund housing co-ops, many with upper-middle-class owners . . . .

Much of the money is invested because the bank consistently has failed to meet its loan projections. The bank's former president has said she could find only 16 credit-worthy co-ops outside the housing field . . . .

More than $1.4 million has gone to outside law firms in the last 15 months. This includes $660,000 to Wald, Harkrader & Ross, which recently hired Richard A. Gross, who had been the bank's general counsel . . . .

About $200,000 went for a consulting contract—and legal fees to negotiate it—for the bank's former president, Carol S. Greenwald. She left last fall after the critical federal bank examiner's report . . . .

The contract also provides Greenwald with some employe benefits, use of a secretary, free office space in the bank building and a $25,000 lump-sum payment, officials said. Thus, she will be making about $95,000 this year, compared with the $75,000 in salary and deferred compensation she earned from the bank in 1982.

—*Washington Post*, May 6, 1983

Art for the people

The Smithsonian Institution has set up a committee to find out why so few blacks, Hispanics and Asians are among the 20 million Americans who visit the museums on the Mall each year.

"It's evident the Smithsonian appeals to the traditional audience—WASP, white, educated," said committee cochairman Edward F. Rivinus, a senior editor at the Smithsonian Press. "Nonetheless, there are plenty of black educated and Hispanic educated (people)—I'm not talking about the ghetto—in a position to enjoy what we have to offer."

—*Washington Post*, May 17, 1983

Coursework in American free enterprise

A group of kids and a teacher who started a bank at school were learning a lot about high finance when the state decided to teach them a lesson about the law—by shutting them down.

"The law is the law," said Robert Ledbetter, a state deputy banking commissioner, whose examiners closed the bank at Easton Middle School for operating without a charter, which would cost $200,000, charging too much interest, collecting loans without a license and using the word "bank" in the title of a business without state authorization.

—*Washington Times*, May 5, 1983

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