POLICY REPORT

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Tax Incentives and the Public Sector

by Robert L. Greenfield and Maury Randall

Federal, state, and local governments produce a wide range of goods and services that are also provided by the private sector. Among these are education, transportation, electricity, mail delivery, and refuse collection as well as the use of stadium and convention center facilities, office buildings, and public housing. As a producing entity the government sector is granted a number of tax advantages over privately owned firms. Consequently, it is possible for a government enterprise to be less efficient, yet still offer a lower price for its product than a privately owned competitor. An incentive therefore seems to exist to replace some privately owned firms with less productive government enterprises.

Advantages for State and Local Government Enterprise

The factors aiding state and local government producing units are easily seen by focusing on a particular industry. During the 1970s voters were offered several initiatives that advocated state or local government takeovers of investor-owned electric utilities.[1] Proponents of such takeovers argued that lower prices of electricity would follow conversion to public ownership. Although directed at utilities, their arguments might be applied to other industries as well. A targeted industry might be one with already existing government productive facilities, such as a utility company, or one in which total industry output is currently produced exclusively by privately owned firms.

The transfer of resources to a public power authority might proceed in the following way.[2] Municipal bonds to finance the acquisition of physical assets would be issued. The privately owned utility currently supplying electric power would then sell its plant, equipment, and other assets to the newly created public authority. The proceeds of the sale of these assets would be used to liquidate the corporate debt and equity that the private firm had previously issued.

"For every decline in costs due to the replacement of the private utility, there is a corresponding increase in expenses elsewhere in the economy."

Among the expenses formerly incurred by the privately owned electric utility are financing costs and federal profits taxes, as well as property and other business taxes. Proponents of government takeover of the production of electric power claim that a public enterprise operated as efficiently as a privately owned firm would have fewer expenses than those incurred by a private firm. These cost reductions would then be passed along to consumers of electric power in the form of price reductions. What is the basis of their assertion that public provision of electric power would result in a lower price to consumers?

First, interest rates on debt issued by state and local governments are lower than those on privately issued securities because of the tax-exempt status afforded state and local government bonds. Second, a publicly owned power authority does not have to earn the income required of a privately owned utility. A component of the income earned by a privately owned firm is channeled directly to the federal government in the payment of corporate profit taxes. A portion of the remaining after-tax profit is paid out to shareholders as dividends. Now some of the returns anticipated by stockholders, either in the form of dividend payments or capital gains, represent a return to them for the bearing of risk. These anticipated returns compensate equity owners for living with the possibility of absorbing losses. Because a publicly owned electric utility has no stockholders as such, it is not faced with the necessity of earning income sufficient to compensate owners for risk-bearing. In addition, the price of electric power can be reduced further because land and other productive facilities are transferred from private ownership to public ownership. State and local government agencies pay little or no property taxes or other nonfederal business taxes.[3] A public enterprise need therefore not generate the income required to cover this component of the expenses met by a private firm.

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EDITORIAL

The Battle over the Budget

Those of us who favor lower taxes and free enterprise can only applaud the first few actions of the Reagan administration. While we remain somewhat skeptical that real, lasting economic gains will be made, during its first few weeks the new administration took some positive steps—decontrol of oil prices, abolition of the Council on Wage and Price Stability, a hiring freeze, and slight reductions in government travel, among others.

Budget Director David Stockman has proposed some significant budget cuts, though it must be understood that these so-called cuts will not actually cut the budget; they will only reduce its growth. (Remember the good old days, when a tax cut meant lower taxes and a budget cut meant a reduced budget?) And we should recognize that these cuts are being made from a budget already out of control. If candidate Reagan in 1976 had proposed a 1982 budget of $700 billion, he would have been denounced as a wastrel, yet today we are told that if President Reagan holds the 1982 budget to $700 billion, he will have achieved a mighty saving.

The lesson is that we should not accept the status quo as the starting point for discussion; rather, we should judge the Reagan administration by a sterner standard than the spending plans of the Carter administration. The budget is too high—by tens or hundreds of billions—and it should not just be controlled, it should be *cut*.

Nevertheless, cuts in the proposed Carter budget are necessary, and we can only hope that Stockman will be successful in making them.

The resolution of one of the first disputes that has arisen within the new administration will be a significant guide to what we can expect in the way of budget cuts. In an internal memo that was leaked to the press, Stockman proposed major cuts in foreign aid, cuts that would amount to "the greatest reduction in American foreign aid since World War II." Such a reduction is possible only because the United States is spending more than ever on foreign aid. Stockman's proposed cuts amount to $2.6 billion out of the $8 billion foreign aid budget proposed by President Carter for 1982, leaving $5.4 billion for foreign aid. But Carter's $8 billion figure was a 33% increase over 1981's $6 billion—so Stockman is really proposing about a 10% cut from 1981 to 1982, hardly a drastic move.

Drastic or not, Secretary of State Alexander Haig moved quickly to forestall any cuts. Haig is seeking to make the budget cut issue a test of his control of American foreign policy, thus putting strong pressure on Reagan to side with him. One state department official said, "Foreign aid is not the responsibility of David Stockman. It rests with Secretary Haig."

Haig's reaction can be understood as the traditional, time-honored one of the bureaucrat defending his turf. Power in a bureaucracy is based largely on money and the things money can buy—more staff, more clients, and so on.

But the tradition that Haig is acting in must be broken. After all, if the foreign aid budget is not the responsibility of the budget director but rests entirely with the State Department, will we not hear Health and Human Services Secretary Richard Schweiker proclaiming that entitlements programs are not the responsibility of David Stockman but of his department? Will Housing and Urban Development Secretary Samuel Pierce announce that housing is his responsibility, not the budget director's?

There is an unfortunate tendency in Washington to see foreign policy as free from the same budget constraints as domestic spending. But the money all comes from the same taxpayers, and no taxpayer's money ought to be spent without the closest scrutiny. One federal official, unwilling to speak on the record, told the press, "In a microcosm, in the past there has been about as sensible and rational a debate about foreign aid as there has been about our welfare programs. It needs a long, hard look."

Secretary Haig's response to the proposed budget cuts is just another example of Washington's tendency to "solve" problems by throwing money at them. We have not solved our energy or education problems by spending more money, and it seems at least possible that we will not solve our foreign problems by throwing money overseas. *Policy Report* has commented before (September 1980) about the dubious value of the World Bank, one of the major areas targeted for budget-cutting by Stockman. In this case, Haig argues that American aid can reduce instability and strengthen our alliances with developing countries. Perhaps a long, hard look at our experiences in Vietnam, Iran, and other countries would suggest that American financial assistance does not in fact improve our relations with other countries.

This debate between Stockman and Haig is a precursor of other battles to come. If President Reagan does not sustain Stockman's proposed budget cuts, he will be hard-pressed to make cuts anywhere. Can the President really be taken seriously about balancing the budget and restoring vigor to our economy if he does not flinch at the idea of giving $8 billion in taxpayers' money to foreign nations? ■

Tax Incentives (Cont. from p. 1)

Within this economic environment there is strong incentive for a public organization to replace a privately owned firm, even if the private producer is more efficient than the public enterprise.[4] However, there is more to be considered in assessing the merits of public ownership. Economist and journalist Henry Hazlitt never tires of explaining that "the art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups."[5] Proponents of government takeover of the generation of electric power point to the possible price reductions, the alleged "savings," as establishing the case for public ownership of electric utilities. Can these "savings" be had costlessly? Clearly not.

The case might very well be that the use of tax-exempt state and local government bonds rather than privately issued corporate bonds provides the possibility of lower priced electric power. However, the federal government will collect less tax revenue if a utility is publicly owned because taxes previously had been levied on interest payments made by the private utility. In order to prevent the federal budgetary deficit from growing, the federal government has to raise additional tax revenue. If additional tax revenues are not forthcoming, the increase in the deficit is financed through the creation of money, that is, through an increased rate of price inflation. Milton Friedman has pointed out on numerous occasions that the tax burden is properly measured not by the magnitude of conventionally calculated tax revenues but by the magnitude of government expenditures.[6] If the government spends a dollar, it must raise a dollar—either through conventional taxes, through borrowing, which must be repaid at a later date, or through the creation of money. If government spending remains unchanged, so does the tax burden. The issue here is that the price reductions enjoyed by the consumers of electricity in one geographical area are provided in part by the population of the entire country.

Consumers of electric power generated by a publicly owned utility might also pay lower prices as a result of the utility's not having to earn income sufficient to compensate private owners for risk bearing. Nonetheless, an implicit cost of "self-insurance" exists. Given no stockholders to act as a buffer, the entire risk of future losses falls on the taxpayers of the jurisdiction, regardless of the extent to which they individually consume electricity.[7] Furthermore, the federal government has less corporate income and stockholder dividends to tax, and, if its expenditures are not reduced, revenues must be obtained elsewhere. Again, more taxes must be levied in one way or another.

Prices charged by a public utility may well be lower than those charged by a private utility because the public utility pays little in the way of local taxes. However, the elimination of a major taxpayer places an additional burden on the remaining taxpayers of the area.

Thus Hazlitt's dictum rings true: For every decline in costs due to the replacement of the private utility, there is a corresponding increase in expenses elsewhere in the economy. There truly is no free lunch.

It is conceivable, of course, that in establishing a pricing policy a local government power authority would recognize the social costs of replacing forgone local tax revenues and the "community risk" that arises in lieu of private shareholder risk.[8] One suspects, however, that this would be an unlikely occurrence. But even if these costs were properly imputed, the subsidized cost of capital available to local government still permits reduced prices, and thus it is possible for a public enterprise to drive out a more effi-

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In This Issue

POLICY REPORT

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Tax Incentives (Cont. from p. 3)

cient private competitor.

The Size of the Tax Advantages

Suppose that a state or local government takes over a private investor-owned corporation. Suppose further that the government entity produces any particular level of output as efficiently as its private-sector counterpart. To what extent do the advantages discussed above permit reduced prices as a consequence of the government takeover? Randall and Lackman report that electric power prices charged by the newly established public power authority would be 19% lower than those charged by the average privately owned electric utility; water prices 22% lower; telephonic communication rates 20% lower; and natural gas prices 10% lower.[9] These estimates are based on the assumption that the forgone state and local business tax revenues following on the government takeover are recovered in the price charged by the publicly owned firm. As a result, they represent lower limits of potential price reductions. Of course, failure to recognize such forgone tax revenue provides even greater incentive for government takeover of private industry. Moreover, since these estimates are based upon the questionable assumption that the government authority produces as efficiently as a private firm, they also provide an indication of the extent to which inefficient government production might be combined with reduced prices.

Firms in industries that typically issue large quantities of equity and debt relative to operating expenses appear to be particularly vulnerable to government takeover. In such cases the tax advantages afforded the holders of state and local government debt provide the prospective government enterprise the opportunity to reduce financing expenses substantially. If this reduction in financing expenses is large in relation to the operating expenses incurred by equally efficient public and private firms, there is room for a significant reduction in prices.

Federal Government Production Activities

The advantages granted state and local government enterprise may be available to the productive activities of the federal government as well. Generally, little if any property taxes are paid on federally owned buildings and installations.[10] An agency of the federal government does not have to earn income to cover the payment of stockholder dividends or to cover the payment of federal and state taxes on profits. In addition, no risk premium need be paid on Treasury securities issued to finance risky projects. If a project is financed with debt issued by the U.S. Treasury, poor management and subsequent losses such as those that have been associated with the operations of the U.S. Postal Service and Amtrak are simply absorbed by the taxpayers.

> **"The price reductions enjoyed by the consumers of electricity in one geographical area are provided in part by the population of the entire country."**

These advantages over the private sector accrue to all levels of government. However, a consideration that provides government activity with an advantage over private-sector activity may, in turn, provide the activity of one level of government with an advantage over the activity of another level of government.

These differential effects on the activities of various levels of government may be of some significance in determining where within the public sector one might expect a particular productive activity to be undertaken. For example, the differential effect of reduced financing expenses reduces the likelihood of federal government involvement. Municipal government debt and federal government debt differ in that municipal government debt offers greater tax advantages to its holders than does federal government debt. Federal government interest payments are exempt from state and local government taxes but not from federal income taxes. Municipal government interest payments are exempt from both. Thus, while Treasury securities offer lower yields than do privately issued corporate securities, yields on Treasury securities are higher than those on municipal government debt. This, of course, is a cost disadvantage suffered by federal government activity.

Forgone nonfederal tax revenues, on the other hand, enhance the probability that the federal government rather than a lower level government unit will undertake a particular productive activity. Relinquished local property taxes and regional business taxes are probably of less concern to the federal government than they are to lower government units. In determining costs, establishing a pricing policy, and evaluating the performance of its operations, an agency at the federal level may afford little if any consideration to lost tax revenues of state and local governments, which provides an incentive for the federal government to become involved in productive activities.

Capital Budgeting and Renting Decisions within Government

The impact of tax laws extends beyond subsidizing government production of goods and services used by consumers and business firms. Operational decisions throughout the public sector are affected as well. All divisions of federal, state, and local governments require some combination of office space, equipment, and other forms of physical capital whether or not public agencies are involved in activities competitive with the private sector.

Should a new government building be constructed, or should space be rented in a privately owned structure? Should a computer be purchased or leased? Or might a private firm be hired to provide the required computing facilities? In such situations the tax laws provide incentives for the government agency to purchase the structure or equipment. Even if the government is less efficient than the private sector in maintaining the capital under consideration, ownership of the capital may be viewed by the public agency as the appropriate course of action.

A clear illustration is provided by considering the way that a public agency is likely to obtain required office space: The space can be acquired either through the rental of space in a privately owned building or through ownership of a building. If the rental market provides private owners with only a market rate of return, the public agency can implicitly earn a greater than market rate of return through ownership. The agency imputes to the building it owns a flow of rental revenue equal to that generated by a privately owned building, yet the financing and tax expenses incurred by the public agency are less than those faced by a private owner. Of course, a state or local government may benefit more than a federal government agency as a result of reduced financing expenses, while advantages due to reduced tax expenses accrue in larger amount to the federal government agency. However, each level of government is encouraged to own a building rather than to rent space from a private agent.

Possible Reform Measures

Reform measures that might reduce the advantages government agencies hold over private firms suggest themselves immediately. First, the tax differential that currently accrues to holders of government bonds might be eliminated. If service on publicly issued debt is tax exempt, interest payments on bonds issued by the private sector should be treated in an equivalent manner. A second measure involves the elimination of subsidies implicitly provided municipal, state, and federal government enterprises as a result of exemption of these enterprises from numerous taxes levied on privately owned firms. These include a variety of regional and federal business taxes as well as local property taxes.

Adoption of these measures would result in the prices of goods and services produced by publicly owned firms more accurately reflecting the true costs incurred in their production. The incentives promoting the creation of new, relatively inefficient government enterprises would be reduced. Some existing inefficient government-owned productive entities might be converted to better-managed private

Regulatory Watch

FEDERAL COMMUNICATIONS COMMISSION

By a 6-to-1 margin the Federal Communications Commission voted to deregulate major portions of the nation's radio broadcast industry. Radio stations now have the freedom to broadcast as many commercials an hour as they want, and the FCC has eliminated specific time requirements for public affairs programming, ended rules requiring stations to survey the needs of their community, and lifted complex rules forcing them to log all their programs. Previously, advertising had been limited to 18 minutes per hour of air time, and stations were expected to fill 6% to 8% of airtime with either news or information shows. The FCC's decision to deregulate was immediately challenged in court by the Media Access Project on behalf of the United Church of Christ.

Although the FCC has declared that it will consider new applications for UHF channels, any such potential channel located within 250 miles of the Canadian border or 200 miles of the Mexican border stands no chance of approval because the FCC has no mechanism for coordinating UHF broadcasting with the Canadian or Mexican governments. Any applications filed from within the 200-250 mile range are simply returned to the applicant.

When the FCC wanted to skirt the Sunshine Act of 1977 and hold a closed meeting on personnel problems last December, it took the easy way out—it didn't announce the meeting until December 9.

Dale G. Davis of Holmes County, Ohio, has recently filed a petition to start a local FM broadcasting station. After Davis's petition was challenged by WWST, a larger regional FM station, on the grounds that WWST was already supplying programming directed specifically at Holmes County residents, Davis was forced to submit another petition in order to secure his claim. The FCC required that this petition contain an economic and demographic study of Holmes County, showing that the county's economy is based on dairy and poultry farming and that WWST had failed to produce programming of interest to the farming community. Before Davis can be assigned the channel, however, he must still obtain approval from the Canadian government because of his proximity to the Canadian border.

The FCC has set aside 50 channels in the 800 megahertz land mobile frequency bands for the use of local government agencies. Although local governments have not yet finished filing their petitions, the FCC has granted them the channels out of fear that all remaining available frequencies on this strip would be petitioned for by private claimants.

organizations. Clearly, elimination of the tax advantages that government enterprises enjoy would improve economic productivity. ■

[1]See Lucien Smart, "1979: A Year for Public Power?" *Public Utilities Fortnightly,* 7 January 1979, and "Rising Electricity Rates Prompt States, Cities to Consider Utility Takeovers," *The Wall Street Journal,* 23 October 1974, p. 38.

[2]In 1978 approximately 10.2% of electric generating capacity was controlled by state and municipal entities. The federal government and cooperatives controlled 11.4% and private firms owned 78.4%. Data are from *Moody's Public Utility Manual, 1979.*

[3]The extent to which government property is untaxed is described by Alfred Balk, *The Free List: Property Without Taxes,* Russell Sage Foundation, 1971.

[4]DeAlessi reports that electric utilities owned by local governments have higher operating costs and adopt cost-reducing innovations less readily than privately owned electric utilities. See Louis DeAlessi, "An Economic Analysis of Government Ownership and Regulation: Theory and Evidence from the Electric Power Industry," *Public Choice,* Fall 1974. For an indication of the extent to which privately owned electric utilities are operated more efficiently than municipally owned utilities in the Los Angeles area, see Robert O'Brian, "Public Policy Toward Electric Utilities: Overtax and Underprice," *Public Utilities Fortnightly,* 21 July 1972.

[5]Henry Hazlitt, *Economics in One Lesson,* rev. ed. (New Rochelle: Arlington House, 1979), p. 17.

[6]See, for example, Milton Friedman, *Tax Limitations, Inflation and the Role of Government* (Dallas: The Fisher Institute, 1973), p. 19.

[7]Government pooling of risk does not lower the social cost of capital, which is indicated by the return on privately issued securities. See Eli Schwartz, "The Cost of Capital and Investment Criteria in the Public Sector," *Journal of Finance,* March 1970.

[8]There is a second reason why risk costs might be underestimated. Those most willing to invest in a private firm own shares in the company. In a publicly financed organization each taxpayer must assume part of the risk in the government entity, even if there is no desire to do so. Thus, the rate of return needed to compensate a random group of taxpayers would tend to be higher than the required return for voluntary stockholders in a private firm.

[9]See Maury Randall and Conway Lackman, "Tax Incentives Encouraging Government Entry into Electric Utility and Other Industries," working paper, Bureau of Economic Research, Rutgers University, New Brunswick, N.J., 1980.

[10]See Balk, *The Free List.*

Some Economic Perspectives on Government Drug Policy

by William Orzechowski

Among the most popular government interventions in the economy have been those laws designed to protect an individual "from himself"—laws governing everything from seatbelt buzzers to saccharin, from labels to Laetrile. Drug control is one of the most conspicuous examples of this sort of intervention. Indeed, a broad consensus of public opinion seems to support the state's prohibition of the possession and consumption of a wide range of drugs.

The traditional economic approach to the drug problem focuses on the consequences of trade in black markets. Although this approach is useful, another complementary economic analysis is also possible. This approach analyzes the effect of government regulations on the choice of drugs and indicates that individual patterns of drug use are determined by the relative prices of legal and illegal drugs. If the sale of a particular drug is prohibited, significant substitution effects occur as individuals shift to lower-priced alternatives. Such substitutions play an important role in an individual's health. As will be shown later, current government policy gives individuals an artificial incentive to specialize in a single drug. Such concentrated use of a drug may, in fact, be the most harmful form of drug use.

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From this perspective, the nineteenth-century drug policy that allowed individuals to choose a set of drugs on the basis of their own calculations may have led to a healthier populace than our current restrictive laws. By increasing the range of drugs available, a laissez-faire policy decreases the likelihood that any one particular drug will be chronically abused and increases the opportunity for individuals to choose a combination of drugs that will minimize physiological and psychological damage.

Effects of Black Markets

The conventional economic analysis of the drug problem concentrates on the implications of trade in the black market. The conclusions are well known and tend to indicate that drug regulation, like other regulation, often creates unfortunate and unforeseen secondary consequences.

To begin with, illegal markets make it extremely difficult for people to get information about the quality of drugs. Many common business procedures such as advertising and the use of brand names are, for obvious reasons, not practiced in illegal markets. As a consequence, drug seekers encounter great difficulty in purchasing drugs of desired quality and are thus more likely to incur harm. In addition, some forms of addiction and the formation of more harmful habits may occur because illegal markets may encourage the sale of concentrated drugs. For example, the decline of opium smoking and the concurrent rise in the use of concentrated opiates (heroin and morphine) are often attributed to the Harrison Act of 1914, a federal law that banned the sale of opium and brought an end to the open drug policy of the nineteenth century. One commentator on drug laws notes that

> a smoker would have to smoke 300 or 400 grains of opium to get a dose equivalent to the intravenous injection ("mainlining") of one grain of heroin. Even heavy opium smokers actually smoke less than this daily. . . . Surely the nineteenth-century enemies of opium smoking did not and could not foresee that the new laws were starting this country down the dismal road from that relatively innocent "vice" to the intravenous injection of heroin.[1]

When a given quantity of drugs becomes hard to get, drug users will tend to prefer single-dose, concentrated drugs rather than milder drugs that may be taken more often because of the high cost of obtaining larger quantities of milder drugs relative to the cost of obtaining a single dose of a harder drug.

Second, black markets increase the purchase price of drugs as entrepreneurs require compensation for the risks associated with supplying illegal commodities. For example, on the black market heroin sells for more than 20 times its legal pharmaceutical price. As a result, many illegal drug users resort to crime in order to finance their habits. Lower prices would mean less crime. A former police commander cogently states: "When prices increase, addicts simply steal more."[2]

Third, it is often alleged that illegal markets stimulate the development of organized crime because economies of scale exist in terms of taking risks in black markets. Consequently, criminal syndicates tend to grow and thrive. An expert comments: "Fines that would ruin a small operator can be absorbed by a larger organization since spreading the risk decreases the probability of ruin, . . . encouraging a high degree of organizing even to the point of making the market a natural monopoly."[3]

The supposed purpose of government drug policy is to improve public health by discouraging the consumption of certain drugs. Given the exorbitant price of illicit drugs, there can be little doubt that this purpose has been achieved. However, the effect of drug prohibition on the pattern and intensity of overall drug consumption is another matter.

Many people relieve anxiety, depression, and tension and attempt to achieve various states of euphoria by taking drugs. If current policy merely

"Some forms of addiction and the formation of more harmful habits may occur because illegal markets may encourage the sale of concentrated drugs."

causes individuals to seek lower-priced alternatives, then its major effect is to create a new pattern of drug use. There is no assurance that the new, policy-induced pattern will necessarily improve public health. Not only will people compensate by consuming greater quantities of legal drugs, but they may consume a blend or "portfolio" of drugs that is more harmful than the drugs they would take if they could choose freely in an open marketplace.

The Substitution Principle

Important to the issues raised above is scientific medical opinion concerning the nature of the relationship between licit and illicit drugs: The weight of opinion holds that the relationship is one of substitution. Medical journals are replete with cases describing individuals who have shifted from one drug to another in response to a policy-induced change in relative prices. For example, alcohol has been used as a substitute for a great many other drugs. One researcher has stated that "it is useless to prohibit other drugs, even heroin, so long as alcohol remains freely available. . . . Banning other drugs accomplishes little of value; it simply increases the number of those who turn to alcohol (or increases the amount they drink)."[4] The possibility of substituting alcohol for heroin has been known for almost a century. Nineteenth-century physicians became aware of it when they saw the results of the increasing government regulations on opium. An experienced medical doctor wrote in 1902, "Unless care be taken, a drunkard results. The shore of the post–poppy land is strewn with wrecks of those who after escape from narcotics peril have taken to rum."[5]

In a more recent study of ex-addicts, researchers uncovered the same pattern: "The most striking finding in [this study] concerned the very close relationship between alcoholism and abstinence from narcotics. In about half the cases studied—the 'ex-addicts' merely changed their status from that of drug addicts to alcohol addicts. Many of these were alcoholic before they began the use of narcotics, and have merely returned to their first love."[6]

Similarly, alcoholism has been treated by substituting heroin for alcohol, a popular therapy in the nineteenth century. A former Assistant Surgeon General reports that "drunkards are likely to be benefited in their social relations by becoming heroin addicts. When they give up alcohol and start using opium they are able to secure the effects for which they are striving without being drunk or violent. . . . Among 33 heavy drinkers who converted to morphine only one continued to drink and his drinking was moderate."[7]

Many other comparisons with supposedly "softer" drugs reveal similar substitution effects. In fact, alcohol may be a substitute for drugs ranging from heroin to caffeine. These effects were quite visible during Prohibition, when individuals substituted a variety of other drugs for alcohol. Brecher reports that "marijuana, a drug previously little used in the United States, was first popularized during the

(Cont. on p. 8)

✓Washington Update

✓The Interstate Commerce Commission has unanimously issued a proposal to eliminate the common carrier obligation that has been imposed on truckers since 1935. Such a change would end the requirement that the nation's truckers carry all goods tendered to them and serve all locations included in their licenses. Such licenses are considered highly restrictive because they often allow a trucker to carry only a small variety of commodities to a small number of locations. The licenses are so difficult to obtain that in some cases they have been sold for millions of dollars.

✓Alan Greenspan, an important economic adviser to the Reagan administration, has recommended that Reagan delay his planned cut in personal income taxes until midsummer. Greenspan mentioned the problems associated with changing tax liabilities once a tax year has begun as one reason for his suggestion. A delay in the tax cut would also decrease the drain on fiscal 1982 federal revenues by more than $35 billion.

✓President Reagan's plans to hold fiscal 1981 spending to $620 billion will be much more difficult to implement than previously thought because of the Carter administration's revised estimates of this year's spending. Even with sharp cuts in social programs in fiscal 1980, federal spending is approaching $665 billion, with a deficit of $60 billion. Reagan's figure of $620 billion must also be able to handle his projected increase in defense spending as well as a tax cut.

✓President Carter's Transportation Secretary Neil Goldschmidt chaired a panel that recently produced a report on the health of the American auto industry. The study recommended import restrictions over the next five years and predicted that American companies will be unable to remain competitive unless they increase productivity by at least 5% a year.

Shortly afterward, the chairman and ranking Democrat on the Senate Trade Subcommittee introduced legislation to restrict Japanese auto imports. Chairman John Danforth (R-Mo.) and Sen. Lloyd Bentsen (D-Tex.) said their bill would set a three-year quota of 1.6 million Japanese cars annually, or 300,000 fewer than American consumers bought in 1980.

✓Two dozen congressmen from the East and Midwest have asked the Supreme Court to limit the ability of western states to tax coal that is strip mined within their borders. The congressmen are trying to strike down Montana's 30% coal severance tax by contending that it is unconstitutional because it imposes an unreasonable burden on interstate commerce.

✓A coalition of 60 environmental and civic groups have urged the government to "stabilize" the growth of America's population in light of dwindling resources. The joint statement was issued in response to Global 2000, a study sponsored by 21 federal agencies that also urged governments to control population growth and the depletion of the earth's resources.

✓President Ronald Reagan has named Murray Weidenbaum, a professor at Washington University and an expert on business regulation, as the chairman of the Council of Economic Advisers. Weidenbaum, who had served as one of Reagan's economic advisers during the campaign, is well known for his cost-benefit approach toward government regulations.

✓Wyoming senators have voted 18–12 to raise the state's highway speed limit to 65 miles per hour despite last-minute warnings from the federal government that the state may lose $60 million in highway aid. The future of the bill in the Wyoming State House is uncertain.

✓Among the new tax cuts that the Reagan administration is considering are proposals to:

1. Ease the "marriage penalty" by giving working couples a tax break.
2. Scale down the top tax rate on dividends and interest from 70% to 50%.
3. Allow charitable deductions on nonitemized returns.
4. Grant tuition tax credits for private schools.
5. End double taxation of dividends.
6. Index all tax brackets to inflation.

Drug Policy (Cont. from p. 7)

period of alcohol prohibition and ether was also imbibed. The use of other drugs increased too; coffee consumption, for example, soared from 9.9 pounds per capita to 12.9 pounds in 1920. The list is long and could be lengthened—but we need not belabor the obvious."[8]

Data from more recent studies indicate the same relationship between alcohol and marijuana: "Fifty-four percent of regular (weekly) marijuana users decreased their alcohol consumption after taking up marijuana, while only 2 percent increased their alcohol use. With respect to daily users the difference was even more striking. Here 89 percent of the users had decreased their alcohol consumption."[9]

Corroboration of these substitution effects, along with their uncertain influence on the public health, may be seen in India's experience with prohibitive opium and marijuana laws:

> As a signatory to various international treaties on narcotic drugs, India gradually banned the sale of opium. . . . Similarly the sale of cannabis products were [sic] greatly reduced. It is ironical that India has banned cannabis, a traditional drug with wide social acceptance and with questionable health risk while it has, in effect, promoted alcohol, the harmful effects of which are too well known. . . . Perhaps this is the price of "modernization."[10]

The substitution phenomenon exists between most other combinations of drugs as well. An important example is the use of marijuana and heroin in Vietnam. Acting on the assumption that marijuana use leads to heroin use, military officials instituted a policy prohibiting marijuana use. However, in accordance with the principle of substitution, GIs responded to the policy by taking more heroin—the relatively cheaper alternative. A member of the Drug Abuse Council commented on the aftermath of the army's antimarijuana campaign: "The Army is universally credited with causing the swing to heroin through its own blunder: the campaign against marijuana. . . . Human ingenuity being what it is many soldiers simply switched to [heroin]."[11]

"Operation Intercept," a government program designed to block the flow of marijuana from Mexico to the United States and Canada, is often pointed to as a policy that triggered drug substitution effects. Canada's Le Dain Commission reported on the increase in demand for LSD as a consequence of higher prices for marijuana: "We have been told repeatedly that LSD use increased rapidly during periods when cannabis was in short supply. The effectiveness of Operation Intercept in the U.S. in reducing the supply of marijuana available in Canada was a major cause of the increase in the demand for 'acid.'"[12]

In San Francisco the rise in the demand for amphetamines was attributed by many analysts to public policy against marijuana and LSD: "The conversion to speed was facilitated, moreover, by the anti-marijuana and anti-LSD campaigns being waged at the time."[13]

One of the most notable cases involving drug substitutions concerned Dr. William Halstead, one of the greatest of American surgeons and a founder of the Johns Hopkins Medical School. Halstead in his earlier years had become addicted to cocaine, and in order to break the habit he went into isolation. When he returned, a brilliant medical career followed. Halstead's success was popularly ascribed to his magnificent strength of will, but it was discovered many years later that he had cured his cocaine addiction by becoming a morphine addict.

"By increasing the range of drugs available, a laissez-faire policy decreases the likelihood that any one particular drug will be chronically abused."

The bulk of the relevant historical data substantiates the substitution hypothesis. Yet popular opinion uncritically accepts the "additive hypothesis," the theory that drugs are complements in consumption. A common myth is that those addicted to heroin started with marijuana and that therefore marijuana leads to heroin addiction. In fact, heroin addicts are most commonly former users of alcohol, not marijuana. Second, the use of heroin tends to reduce the use of alcohol. A new habit is not simply added to the previous habit. More important, those who become chronic abusers of any hard drug are in most cases responding to fairly serious psychological problems. The fact that they may have used marijuana is hardly more relevant than their previous consumption of milk. And we have seen that a lower price for marijuana leads to a reduced demand for other drugs, including heroin.

Public Health Effects

Given the documented pervasiveness of the substitution effect, there is little assurance that regulations have beneficially altered the total consumption of harmful substances. Instead, the pattern of drug use has changed. It then becomes important to ask if drug laws have contributed any more to the public health than the much less restrictive policy of the nineteenth century. For three reasons the answer appears to be "no."

First, there is a substantial body of medical evidence indicating that the two most common legal drugs, alcohol and nicotine, rank as the most dangerous drugs for human consumption. Alcohol is associated with major neurological and physiological damage: "Alcohol addiction, unlike morphine addiction, is utterly destructive to the human mind. Among 70,000 first admissions of males to state mental hospitals in 1964, for example, more than 15,000 (22 percent) were given a diagnosis of alcoholism. . . . Alcohol is similarly destructive of the human body."[14]

Second, alcohol is responsible for irreversible liver and brain damage. Those countries that consume the most alcohol per capita (France and Italy) lead the world in the number of cases of cirrhosis of the liver.

Third, alcohol is a socially disruptive drug. It is by far the biggest law enforcement problem in America. In 1965 it was found that "at least 40% of *all* arrests are for being drunk or being under the influence while driving."[15]

The effects of tobacco use are also well known. Cigarette smoking is associated with both lung disorders and ailments of the cardiovascular system. One researcher reports that "cigarette smoking is by far the most important cause of lung cancer and is also a major factor in deaths from coronary heart disease, chronic bronchitis, emphysema and other diseases."[16] In addition, research reveals that nicotine is an extremely addictive drug. In one study an analyst reported that "more than 80% of those who had successfully stopped smoking were smoking again."[17]

In contrast to the damages reported above, the medical research on several illicit drugs, notably the opiates and marijuana, reports damages to the mind and body that are mild by comparison: "As the great Joseph Lister observed, opium soothes while alcohol maddens. In the turn of the century America, while their fellows were being incapacitated in even larger numbers by drink, drug users, able to maintain their supplies without difficulty and at modest expense, generally pursued normal callings and posed no problems for society."[18]

Lister's observation was confirmed by subsequent research: "The classical study on the physiological effects of prolonged opiate use found other than those effects attributable to the addict life style, long term opiate use was not characterized by either physical deterioration or impairment of physical fitness. Even microscopic examination of body tissues fails to show evidence of organic damage."[19]

A former director of President Nixon's special action office for drug abuse prevention summed up recent findings as follows: "The addict who is able to obtain an adequate supply of drugs through legal channels and has adequate funds usually dresses properly, maintains his nutrition and is able to discharge his social and occupational obligations with reasonable efficiency. He usually remains in good health, suffers little inconvenience, and is, in general, difficult to distinguish from other persons."[20]

The damage done by marijuana is even less evident than the damage done by stronger opiates. Most studies indicate that marijuana is mild relative to alcohol and cigarettes in terms of mental and physiological damage. In addition, marijuana is reportedly not addictive. If the most common drugs are ranked in order of danger, marijuana is listed as the least harmful. The ranking in descending order of danger is glue (sniffing), methamphetamine (speed), alcohol, tobacco, barbiturates and hypnotics, heroin and related narcotics, LSD and other hallucinogens, and marijuana.[21]

The application of restrictive drug policy has encouraged relatively greater use of concentrated substances within drug classes and to some extent across drug classes. This kind of substitution is known as a "luxury effect." It occurs when a sizable tax or levy is added to the price of both normal and luxury commodities. Since the tax is the same in both cases, the relative price of the luxury item falls. The effect takes place within illegal drug classes since the penalties are not commensurate with the concentration of the drug. For example, the price of a kilo of heroin (an opium concentrate) under legal conditions may be 10 times the price of raw opium. However, in an illegal market the penalty for distribution may be a five-year prison sentence in either case; therefore the illegal price of a kilo of heroin may be only twice the price of raw opium, making opium smoking relatively more expensive.

This phenomenon explains the virtual disappearance of opium smoking and the rise of heroin "mainlining" techniques. Harsh methods of consumption replace mild ones. For example, nineteenth-century Chinese immigrants were heavy opium consumers, but they consumed the bulk of their opium by smoking it. Problems associated with concentrated drugs, such as overdose, were uncommon. The Chinese during this time were considered to be an extremely able and hard-working people.

The luxury effect can also occur across drug classes as long as penalties are not proportional to the "hardness" of the drug. For example, in many states penalties for possession of marijuana and heroin are similar: "Most state marijuana laws specified that marijuana penalties should be the same as heroin penalties. Thus, as heroin penalties were escalated through the decades, marijuana penalties rose automatically. Nineteen states, moreover, made no distinction between mere possession of one marijuana cigarette and the sale of large quantities of heroin."[22] As a consequence, individuals who choose illegal drugs will have an additional incentive to consume the "harder" varieties.

Twentieth-century drug policy has been proalcohol and protobacco. The relative prices of these drugs have fallen since the nineteenth century as increasing penalties have been placed on other drugs, which has had the effect of causing a serious imbalance in consumption. Important in this regard is the concept of optimal deterioration, which suggests that the least damaging way to consume harmful substances is to spread damage across bodily organs. By limiting the legal range of drugs to alcohol and tobacco, the laws encourage the use of large quantities that can inflict permanent and irreversible damage on particular parts of the body, especially the brain, cardiovascular system, lungs, and liver. As one authority has stated: "The amount of harm done to the human body by nicotine and alcohol vastly exceeds the physical harm done by all of the other psychoactive drugs put together."[23]

"Medical journals are replete with cases describing individuals who have shifted from one drug to another in response to a policy-induced change in relative prices."

Serious bodily and mental damage is the consequence of heavy use of a particular drug. For example, limited use of alcohol is actually considered healthy by some medical authorities, but marginal damage to the body accelerates as the consumption of alcohol increases. By choosing from a larger range of drugs, individuals could moderate their use of each particular drug, thereby deflecting the damage to particular organs and minimizing the total damage done to the body. This is especially true with drugs such as marijuana, where medical science has failed to show any kind of serious bodily or mental damage resulting from moderate use.

Current drug policy limits the ability of people to adjust their drug consumption in accordance with their own body's characteristics. Because of a particular body chemistry or psychological predispositions, a person may have a high level of tolerance for one drug, yet react adversely to another drug. Expanding the range of legal alternatives may improve public health by enabling individuals to choose a set of drugs consonant with their particular medical characteristics.

Billions of dollars have been spent in administering and enforcing twentieth-century drug laws. Moreover, these policies have caused serious health problems by implicitly encouraging individuals to consume large quantities of a small set of drugs (especially alcohol and tobacco) that cause permanent damage to particular bodily organs. A much less costly and more healthful policy would be similar to nineteenth-century drug policy. This policy, by increasing the range of legal drugs, would cause greater moderation in the use of a particular drug and therefore deflect the irreversible damage that is the consequence of the intensive use of a single drug. ■

GOVERNMENT SPENDING MONITOR

A quarterly feature of *Policy Report*, the "Government Spending Monitor" summarizes the latest expenditures by the federal government.

EXPENDITURES(annual rate in billions of $)

	1980 Fourth Quarter	1980 Third Quarter	1980 Second Quarter	Average for Last Year
Federal Government	642.4	626.8	592.4	607.2
Defense	149.2	76.6	72	91.4
Labor	31.2	38.8	30	32.1
Education	14.4	13.2	13	13.5
Health and Human Services	220.4	210.8	191.4	207.5
HUD	14.4	9.9	13.6	12.4
Energy	9.6	8.3	7.6	7.6
Transportation	22	20.8	18	19.5
Federal Aid to State and Local Gov'ts	88.9	87.7	87.2	87.3
Federal Interest Paid	86	67.2	89.2	76.6
Federal Transfer Payments	268.1	265.3	236	249.6
Federal Surplus or Deficit	−134	−129.6	32.8	−84.8
Reported Federal Debt	917.4	894.3	875.3	885.6
Total Government Employment, All Levels (millions)	16	16.3	16.2	16.2

Sources: All data are derived from *Treasury Bulletin*, the *Monthly Treasury Statement of Receipts and Outlays of the United States Government*, and the National Bureau of Economic Research Databank.

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[8] Brecher, p. 266.

[9] Ibid., p. 432.

[10] World Health Organization, *International Collaboration* (Toronto: Alcoholism and Drug Addiction Research Foundation, 1977), p. 75.

[11] Norman Zinberg, *New York Times Magazine*, 5 December 1971.

[12] Interim Report of the Canadian Government's Le Dain Commission, 1970, p. 139.

[13] Brecher, p. 291.

[14] Ibid., p. 261

[15] Thomas F. A. Plaut, *Task Force Report: Drunkenness* (Washington, D.C.: President's Commission on Law Enforcement and Administration of Justice, U.S. Government Printing Office, 1967), pp. 120–31.

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[18] Richard Ashley, *Heroin Myths and Facts* (New York: St. Martin's Press, 1972), p. 115.

[19] Ibid., p. 112.

[20] Jerome H. Jaffe in *The Pharmacological Basis of Therapeutics*, eds. Goodman and Gilman, 4th ed. (New York: Macmillan Co., 1970), p. 286.

[21] Ashley, pp. 112–13.

[22] Brecher, p. 419.

[23] Ibid., p. 475.

"To be governed . . ."

Oh

VV: How about paying for all the defense, with the tax cut and balancing the budget. How's Reagan going to answer that?

David Stockman: At the rhetorical level, you've got to defend it artfully. At the policy level it doesn't matter.

—*Village Voice*, Nov. 26, 1980

Protecting the consumer

A city ordinance is being drafted that would require locksmiths and key duplicators to be licensed by the police department, but some businessmen already are saying the measure doesn't have enough teeth. . . .

"If they set up a standard where each locksmith company had to have a master locksmith on the payroll, then they would cut down on the fly-by-night dealers," [Fred] Peifer [president of AAA Safe & Lock Co.] said. . . .

Tim Conroy, vice president of Allstate Safe & Lock Co., said he is against the proposal as is because the fees for licenses and permits are not high enough.

—*Memphis Commercial Appeal*, Dec. 28, 1980

Another oil company ripoff

Sources said their studies indicated a $10 billion increase in the nation's energy bill under decontrol. The sources said the federal government would get $7 billion in increased revenue under the Windfall Profits Tax; the oil companies would retain $2 billion, and state and local governments would share $1 billion.

—*San Francisco Chronicle*, Jan. 29, 1981

No vacancy

The General Services Administration spent more than $2.5 million for space at a Washington office building while it remained vacant for more than two years, federal auditors have found.

The money was spent while several agencies fought bitterly over who was going to move into several floors of empty space from another downtown building just three blocks away.

—*Washington Star*, Jan. 27, 1981

Computermania

At the top of the [econometrics] trade is the Wharton model designed by Lawrence Klein, who just received a Nobel prize for it. This computer program uses 669 mathematical equations to process vast amounts of inaccurate statistics into a prediction of where the economy is heading, or how many electric toothbrushes will be sold.

—*The Press*, February 1981

Business as usual

In April 1979, the District of Columbia Investment Co., a federally subsidized agency established to assist small, disadvantaged minority businesses, awarded $450,000 in financial backing to a wine-importing firm partially owned by the head of the D.C. Democratic Party, Robert B. Washington Jr., who is the agency's lawyer.

The $450,000 cash infusion—nine times the size of the average loan made by the agency—violated no laws, even though Washington, a politically well-connected lawyer, is wealthy.

—*Washington Post*, Jan. 30, 1981

Chrysler II?

Ronald Reagan's new energy secretary, James Edwards, has made no secret of his enthusiasm for nuclear power. What's not so well known, though, is his enthusiasm for a bailout of a nuclear processing plant in his home state of South Carolina. The tab to the taxpayers could amount to $2 billion.

Knowledgeable insiders have described the operation in question as nothing less than a boondoggle. It is such a risky venture, in fact, that the nuclear power industry wanted nothing to do with it unless Uncle Sam would put up the money.

—Jack Anderson, Jan. 30, 1981

Better never than late

. . . most of the regulations just now published [by the federal government] were long overdue—some of them by as much as six years. Delays this long can impose substantial costs on states, localities and companies that must operate under uncertain and shifting interior guidelines.

—*Washington Post*, Jan. 22, 1981

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