POLICY REPORT

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RESCUING THE AMERICAN ECONOMY

by Yale Brozen

The American economy is in obvious difficulties. Inflation rates in the past decade have reached unprecedented levels with unprecedented duration. Productivity is declining. Real wage rates are falling. The proportion of national income taxed by government in the United States has reached heights never before seen in this country even in time of war.[1] And the unemployment rate has risen to an altitude that now persists above 7½%.

Inflation is not a totally new experience in the United States, but two back-to-back years of double-digit inflation (1979 and 1980) is new in this century's record. Productivity drops have occurred before, but usually for two or three quarters in a year followed by an upward surge, which makes up for lost ground. Three years of declining non-farm business productivity in normal times, however, is a new experience. Real wage rates have declined in the past, but four years of declining earnings is unheard of.

The first challenge we face, then, is to end the current inflation. Second, we must reverse the direction productivity has been taking. Third, we must reduce the burden of government. We must reduce our tax burden and we must eliminate those intrusions of government that restrict our freedom and dampen the creativity of private enterprise without sufficient benefit to justify costs.

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Eliminating Inflation Without Recession

From 1972 to 1980, the price level doubled, and the reason is clear. The amount of money doubled in those eight years. A primary reason for the doubling in the quantity of money is the assistance the Federal Reserve gave to the federal government in financing its deficits, which averaged over $50 billion a year (including off-budget activities) during that period. The Federal Reserve banks created the money used to help finance those deficits, so we got too much money chasing too few goods.

"If we want to create jobs and turn our productivity around, what is required is a larger supply of capital."

To eliminate inflation, we must slow the rapid growth of our money supply. To do that, we must reduce federal deficits and take the pressure off the Federal Reserve to assist in the financing of those deficits. But then we confront the problem of avoiding a slide into recession, which always before has followed a persistently declining rate of money growth. The reason we slide into a recession *after* a *year* of slowing money growth is that money wage rates continue to rise at the same old pace. That occurs because people do not readjust their expectations about future price levels. Both employers and employees expect prices to continue to rise at the pace they have seen in the past. Expectations are recursive. The result is that labor and goods are priced out of the market because prices and wage rates outrun the demand for goods and labor.[2]

To illustrate the point, in the 1974 recession, the demand for goods increased by 6%. If wage rates had increased by less than 6%, employment would have increased. But that increase in demand was more than soaked up by a 10% rise in wage rates. As a result, employment dropped and unemployment rose. The rate of wage increase did not slow until the following year, and only then did employment again begin increasing.

To avoid increasing unemployment as we slow our inflation by slowing the growth in the amount of money, money wage rate increases must be cut from their current 10% rate to 2%. If we do that, along with the current slowing in money growth, workers will be pleasantly surprised as real wage rates rise and unemployment decreases.

The rapid rise in money wage rates in the past four years has not preserved the purchasing power of an hour of labor.[3] A less rapid rise in money wage rates with present money growth rates will actually increase the purchasing power of workers and reverse the trend.

Restoring Productivity Growth

That brings us to the second challenge — to reverse the decline in productivity growth. The purchasing power of hourly earnings has declined in the past three years because of declining productivity.

Output per worker hour in the United States grew at a 3.2% annual rate from

(Cont. on p. 3)

EDITORIAL

What Does It Mean to Abolish an Agency?

Many advocates of the free market are skeptical that any President will ever really "get the government off our backs." The more federal agencies are reorganized, the less anything seems to change. So when candidates for President promise to streamline, to reorganize, or to coordinate agencies, these people take it with a grain of salt.

In 1980, however, Ronald Reagan didn't promise to reorganize. He promised to abolish agencies, particularly the Departments of Energy and Education. Those who thought the federal government had no business being involved in energy and education rallied to his cause. At last, they thought, we have a candidate who's promising something meaningful. When President Reagan appointed secretaries of those departments who were pledged to carry out his orders, things looked even better.

Since the Inauguration, Reagan has also promised to abolish the Council on Wage and Price Stability and has discussed abolition of the Bureau of Alcohol, Tobacco, and Firearms. To those who believe the federal government is far too big and involved in far too many areas, this is good news.

But what does it mean to abolish a government agency? To most observers, the answer is probably obvious. To abolish an agency is to do away with it, the presumed purpose being to end the government's involvement in that particular activity. Of course, one might close down an agency and transfer its functions to another office, but that would likely be characterized as "reorganization" rather than "abolition."

But consider the record so far of President Reagan's "abolition" proposals:

- One of his first acts was to announce the abolition of the Council on Wage and Price Stability. However, in the fine print we learned that most of the Council's staff, budget, and functions had been transferred to another department. Only a small (though important) part of COWPS had been eliminated.

- The *New York Times* reports, "President Reagan has approved a proposal to abolish the Department of Energy and transfer most of its surviving functions to the Department of Commerce, Administration officials said today."

- Late last year the administration was debating whether to turn the Education Department into a foundation or to disperse its programs throughout the bureaucracy.

- In September the administration was reported to be considering a plan to "eliminate" the Bureau of Alcohol, Tobacco and Firearms and shift its functions to other federal law-enforcement agencies.

In no case, apparently, is the administration actually planning to remove the federal government from any of these areas. The question then becomes not a serious debate over the role of the government but simply a power struggle between agencies. In the discussion of the Energy Department proposal, for instance, Interior Department officials struggled with the Commerce Department to inherit DOE's functions. Commerce won, apparently, and Interior Secretary James Watt was moved to assure his associates, "I lost on this one, but I support the President."

One would hope, of course, that dismantling a department would at least reduce expenditures. But in the case of the Education Department, the proposed foundation would retain $11 billion in education programs, transfer $1.5 billion to other departments, and eliminate only about $150 million worth of programs. Budget Director David Stockman's proposal for abolishing the Energy Department would result in a savings of only about $1.5 billion out of the agency's $13.8 billion.

It should be made clear that those people who supported President Reagan's call for abolishing the Energy and Education Departments — and other agencies —did so for two basic reasons. First, they believed that the federal government should not be involved in energy, education, wage-price control, or whatever. There are certainly strong arguments against federal government — or any government — involvement in these areas, and Reagan implicitly or explicitly cited such arguments during his campaign. Second, many people support abolition of such agencies as a cost-saving measure. There may be a federal role in these areas, they argue, but it is simply too expensive. Neither of these groups, of course, will get their wish from President Reagan's "abolition" proposals. They are almost entirely a triumph of form over substance.

The only way to reduce the size, cost, and power of the federal government is to abolish agencies and programs. Unfortunately, President Reagan is rarely taking this course. Those who would like to see a reduced federal government should read carefully any stories about the "abolition" of an agency. And they should let their elected officials know that abolishing an agency should mean just that. ■

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1948 to 1966. Productivity growth then dropped by one third, falling to a 2.1 % annual rate from 1966 to 1973. It again fell, by one half, from 2.1% to 0.8% annually from 1973 to 1978. And since 1978, productivity growth has turned into a decline. Output per hour *fell* from the fourth quarter of 1978 to the fourth quarter of 1979 by 0.4% and again in 1980 by the same rate. Nonfarm business productivity fell at a 0.6% rate in 1980, after dropping by 0.8% in 1979. 1980 was the third consecutive year of declines for this measure of productivity.

Some would attribute our woes to the late 1973—early 1974 spurt in the cost of energy when the Organization of Petroleum Exporting Countries (OPEC) cut crude oil output and sent energy prices soaring. Then energy prices jumped again in 1979 and 1980 following the decrease in supply after the Iranian revolution in 1979 and the outbreak of the Iraqi-Iranian war in 1980. But how do we explain the fact that no other industrial nation, except the United Kingdom, has suffered such a low growth in productivity?

Japanese output per worker hour increased at a rate more than four times our own from 1973 to 1978,[4] even though the impact of the crude oil price rise in Japan was much more severe. It imports all of its petroleum, and its oil imports consume a 50% larger share of GNP.[5] We import less than half of our petroleum needs. French, Dutch, and German output per worker increased at a rate six times our own from 1973 to 1978. They, too, are more dependent on high-priced petroleum imports than we, with a one-third larger share of their GNP going for oil imports. We cannot lay the blame for lagging productivity on high cost, imported petroleum. It has had an effect, by making obsolete a part of our capital stock, but it is not as important an influence as our public policies.[6]

What Is Wrong

The problem lies in three policy areas. First, taxes and inflation are discouraging savers and investors.[7] As a consequence, the gross rate of investment in construction and in productivity-improving machinery is lower than it was in 1973 ($201 billion in 1980 IV as opposed to $220 billion in 1972 $s in 1973 IV.)[8] Normally, investment at a business cycle peak exceeds its previous peak by at least one fourth, but recently it was actually below its previous peak.[9] 1980's total output was 19% above its 1973 level, but that is only because the number of people at work was 17% higher. Output per worker is little higher today than in early 1973. Up to 1973, the amount of capital assisting each worker in his or her job increased by 3% per year. Since 1973, there has been no increase in the capital available for each worker to raise his or her output. That is a miserable record.

Second, labor policies, and particularly the power given to unions, slow our advance in output per person hour. Since 1973, the premium paid to steel workers has shot up from 40% of the average manufacturing wage to 75%.[10] *That is curtailing employment in the steel industry and forcing workers to accept less productive, alternative jobs.* It is also destroying capital by forcing abandonment of plant and equipment, which would be economically operable if wage rates were not set at union monopoly levels. In addition, these monopoly wage rates are forcing the steel industry to absorb capital from socially more productive uses in order to raise productivity enough to retain the remaining workers.[11] This diverts capital from other applications and slows the rate of rise in productivity in other industries. Similar consequences stem from the power of labor unions in the automobile industry, where the auto worker wage premium has vaulted from 48% in 1973 to 66% in 1979, and in the coal mining industry, where the wage premium has jumped by 24 percentage points from 45% in 1973 to 69% in 1980.[12]

Third, our economy is being increas-

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In This Issue

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THE ECONOMY (Cont. from p. 3)

ingly strangled by an ever tightening web of *counter-productive* regulation — regulation that consumes capital that could go into increasing our productivity. The design of the automobiles we buy is now dictated by the federal government. If the law required features worth what they cost, there would be no objections. But if they were worth what they cost, there would be no need to require their installation. People would want them and be willing to pay for them, and manufacturers would install them on their own. Heavier bumpers are now required, which increase the cost of repairing damage from accidents in which the impact occurs at speeds greater than five miles an hour. Mandatory safety features add to auto costs but do not add to safety.[13] These extra costs divert funds from the purchase of other types of equipment that *would* make a person safer.[14] Because I have to pay $200 more for safety features on my automobile, in which I spend about 100 hours a year, I cannot afford to buy a smoke alarm, a stair rail, nonslip treads for my front porch steps, and other safety features for my home, where I spend 4,000 hours per year.

The Coal Mine Safety Act is requiring large investments in safety equipment and the hiring of safety supervisors, but all these resources have not contributed to any decrease in person-days lost per ton of coal mined as a result of accidents.[15] The Food and Drug Administration's (FDA) regulation of drug safety and efficacy has doubled the cost of bringing a new drug to market[16] and cut the annual number of new drugs introduced by two thirds.[17] Because it has become so difficult and costly to get FDA approval of new drugs, we have not developed new, safer drugs to replace some of the *dangerous* drugs still on the market. We have had to go on using dangerous drugs for many illnesses for lack of safe replacements since the untreated illness is far more dangerous than taking the dangerous drug that will cure the illness, but sometimes kills the patient, although less frequently than the illness. But in terms of the theme of this paper, the point is that as a result of FDA regulations, pharmaceutical R & D productivity has been cut by 50% without offsetting benefits.

I could go on with an endless list of regulations that increase costs without commensurate increases in benefits. Studies show that the mattress flammability standards of the Consumer Product Safety Commission have increased the cost of mattresses by $20 million to produce $5 million of benefits for careless consumers who drink and smoke in bed. The Justice Department's Antitrust Division and the Federal Trade Commission are requiring mergers and the expansion of leading firms, causing productivity to rise less rapidly than it otherwise would. The government's aim is to prevent increasing concentration, that is, to try to prevent a rise in the share of an industry's production produced by its four leading firms. But we know that in the industries in which concentration increased in the last 25 years, productivity went up 12 percentage points more than in industries where concentration did not increase.[18] Preventing increased concentration from occurring as it would under the prod of market forces holds down productivity.

> **"The rapid rise in money wage rates in the past four years has not preserved the purchasing power of an hour of labor."**

Inflation and Taxes

Inflation is not only a tax in itself; it greatly increases the burden of other taxes on savers and investors.[19] In the late 1950s and early 1960s, our rate of inflation was practically zero. High-grade corporate bonds sold at 4% yields. If an investor was in a 50% tax bracket on marginal income, the after-tax yield on a 4% corporate bond was 2%. With a zero rate of inflation that was a real yield of 2%.

If a high-grade corporate bond today yields 14%, and you are in a 50% marginal tax bracket, your after-tax *nominal* yield on that corporate bond is 7%. (There are many more of us in that situation today than in the 1950s, even without any rise in real income, because of inflation and Congress's failure until 1981 to either index the tax brackets or to move them to higher levels.) But with a 10% rate of inflation, the real after-tax yield to the investor in a 14% bond is *minus* 3%.[20] In other words, you can't even preserve the value of your capital if you invest in a bond, much less collect a return. The income incentive to save and invest has been wiped out by our current inflation and personal income tax rates. There is still a positive real cost to borrowing but a negative yield to the saver who lends his funds.[21] It is no wonder that the rate of saving and investment is low and declining relative to income.

The net volume of investment now is 6% of national income, a one-third decline from the late 1940s and from 1973, the last major cycle peak. We are falling far behind Japan in our productivity growth where the net rate of investment is four times our own. We are also falling behind France, Austria, the Netherlands, and other countries for the same reason.[22]

Inflation and taxes are not only confiscating the entire yield on bonds, they also are confiscating the return on corporate equities. The increasing tax burden caused by inflation is the clue to understanding why stocks have been a poor hedge against inflation. In fact, the more rapid the inflation, the more the prices of stocks tend to drop.

The reason for this lies in the way corporate taxable income is computed. The more rapid the inflation, the greater the overstatement of taxable income. To see why, imagine that the current economic production of all equipment, structures, and inventories of all nonfinancial corporations is valued at $100 billion. With a state and federal corporate earnings tax rate of 50%, taxes and after-tax profits each would be $50 billion. However, the prices on the books for equipment, structures, and inventory are much lower than their current market prices. Because of this, allowed depreciation and inventory consumption costs have been understated.[24] Let's say taxable profits are computed as $150 billion instead of $100 billion. On this, a tax of 50%, or $75 billion, is paid. Out of the $100 billion *actual* pre-tax economic earnings, then, only $25 billion is left as a return to stockholders. The effective tax rate turns out to be 75% instead of a nominal rate of 50%.

The faster the inflation, the greater the overstatement of earnings for tax purposes, the higher the effective tax rate, and the less left for stockholders. A speed-up in the rate of inflation reduces after-tax economic earnings, which causes a drop in the real value of stocks. The effective tax rate in 1974, for example, hit 87% when the rate of inflation went to double-digit levels, although the nominal tax rate was 41%.

As matters stand, inflation creates *fictitious* interest, earnings, and capital gains. A major portion of the capital gains tax is collected, as a consequence, on losses, not gains.[25] In 1973, individuals paid taxes on $4.6 billion of nominal gains on corporate stock, on which their real capital gain was actually a loss of nearly $1 billion. Being forced to pay taxes on fictitious income greatly reduces the incentive to save and invest. That is why the relative rate of investment is falling. Because of the falling relative rate of capital formation, productivity growth is suffering severely, and we are falling behind the rest of the world.

The Impact of Federal Deficits on Capital Formation

In addition to the inflation-tax effect, private investment access to the supply of capital is being squeezed by unprecedented peacetime federal deficits.[26]

In 1975, the federal deficit climbed to

(Cont. on page. 6)

Briefs

☐ A recent study by the American Society of Appraisers has concluded that the federal government could make at least $100 billion from the sale of 500 pieces of surplus property. Such proposals recently have been entertained as a way to retire some of the national debt. The federal government, on the other hand, estimates that its surplus property is worth no more than $1.3 billion and could not play a sizable role in easing the debt. The General Accounting Office has also come out against such proposals: "Gathering accurate data on federal property holdings and addressing all the problems and issues inherent in a disposal program would require an extensive staff and considerable time — up to 10 to 12 years."

☐ The proposed Los Angeles Century Freeway has already cost federal and state taxpayers $235 million despite the fact that not a mile of the highway exists. All of this money has been spent on lawsuits, land acquisition, environmental impact studies, and other necessities such as a project civil rights director, a housing advisory committee, and a "corridor advocate." Completion of the highway is expected to cost $2 billion, 92% of which will be paid by federal taxpayers. The estimated length of the future freeway — only 17.3 miles.

☐ Independent Sector, a non-profit coalition of voluntary charities and foundations, has recently produced a study that indicates that Americans contribute far more to private charity than standard figures measure. Although dollar donations run about $40 billion yearly, far more important are the 8.4 billion hours a year of volunteer labor. It is estimated that this time is worth $64.5 billion annually — over 50% more than actual dollar donations.

☐ The work backlog at the U.S. Patent and Trademark Office has grown so severe that it now takes an average of 22 months for the office to issue a patent. By 1984 this delay will jump to 24 months. Trademarks now take 25 months.

☐ The International Trade Commission has recently sent a report to President Reagan outlining their battle on behalf of American clothespin manufacturers. After foreign clothespin imports captured 50% of the American market in 1976-1977, the ITC set import quotas. American clothespin firms made $1.2 million the next year, as compared to their $500,000 loss the year before, and foreign imports declined to 30% of the market. The clothespin industry's 1981 payroll totaled 427 people, nine fewer than the federal commission that did the investigation. According to the report, the industry is located only "in four small towns in Maine and two in Vermont."

☐ A study by Department of Energy officials has revealed that nearly 75% of the DOE's $10 billion budget went to outside contractors and grantees. In fiscal 1979, these contractors and grantees were overpaid $41.4 million; in fiscal 1980, the overpayments amounted to $85.6 million. In addition, the DOE has been paying too much for its purchases of equipment and supplies. In the 1979-1981 period, these overpayments amounted to $25.5 million. Most of these overpayments are ascribed to sloppy bookkeeping. The DOE's financial records are so disorganized that their financial division shows a four-year total of $3.5 billion in accumulated debts, and no one knows which of these debts have been paid off.

☐ Although it has been only a year since President Reagan lifted all remaining controls on U.S. oil prices, the number of wells drilled last year rose to an all-time high of 79,000, a 25% increase over 1980. The number of successful oil well completions also set a record. Since decontrol, gasoline prices across the nation have either fallen or held roughly constant. ■

THE ECONOMY (Cont. from p. 5)

$70 billion, a deficit three times larger than had ever occurred before in peacetime. Despite the recovery of the economy from the 1974 recession, the deficit never shrank to zero, nor was there a surplus generated as has usually been the case in previous business recoveries. Always before, in every recovery period, the federal government has cut its drain on capital markets as the recovery progressed. It allowed the capital becoming available to go into business equipment and consumer durables. As a result, private investment boomed to recovery periods to new record levels.

That has not been the case in recent years. As federal tax receipts went up, federal spending shot up instead of declining.[27] From an outlay of $300 billion in 1974, federal spending more than doubled to a planned outlay of $663 billion (not including off-budget federal programs) in the current fiscal year. President Carter's budget for fiscal 1982 had planned another increase to $740 billion, which President Reagan tried to trim to around $720 billion. As a result of this rapid growth in federal spending, federal deficits may exceed 100 billion dollars in 1982 and 1983.

That has forced interest rates up and is draining the lifeblood of the housing and machinery industries.[28] Housing construction and productivity-improving investment are below their 1973 peak despite the higher gross national product. The federal government continues to soak up capital to finance its deficits that would otherwise go into equipment and structures. *We sorely need the application of expenditure controls to total federal spending.*

The Right Policy

To create jobs, avoid recession, and turn our productivity around, what is required is a larger supply of capital. The first step is to curtail government outlays — both off-budget and on-budget. That will free the capital now being borrowed to finance the budget deficit and off-budget outlays. With more capital available for the mortgage market, home building will start up again. With more capital available for plant modernization, spending on equipment will increase and productivity will begin to rise.

Besides decreasing government spending to stop the government's absorption of capital, we also must redress the balance of taxation between consumption and investment. We impose much heavier taxes on income from capital than on income from other sources. Corporate capital bears real property taxes, state and federal corporate earnings taxes, and then personal income taxes on dividends and capital gains. Income other than from property bears *only* the personal income tax.

"Inflation and taxes are confiscating the return on corporate equities and bonds."

A first step toward more equitable taxation with less differential impact on investment and consumption was the enactment last year of the 10-5-3 program — that is, allowing depreciation of structures over a 10-year period, depreciation of machinery over five years, and depreciation of transportation equipment over three years. This will largely offset the increased burden of taxation created by the inflation-induced increase in effective corporate tax rates. Also, we must reduce the absurdly high federal corporate earnings tax from the current 46% rate.

In addition to reducing government outlays, we also need to curtail the unproductive outlays being forced on private businesses by the regulatory agencies.[29] These, too, are absorbing capital that would otherwise be available to increase productivity. The budget for 1981 increased the funds available to 57 federal regulatory agencies by 15%. This is the time for cutting the appropriations of the regulatory agencies — not for increasing them. If the benefits to us were as great as those sacrificed by this appropriation of resources forced on business, there would be little objection.

To continue the story of costly and overly stringent regulation, consider the case of automobile emission controls. The level of control required in 1975 cost $4 billion annually and produced about $5 billion in benefits.[30] But the increasing stringency of requirements that must be satisfied by 1985 will raise the annual cost to $11 billion. That extra $7 billion will return less than $1 billion in extra benefits. This will simply make automobiles more costly, will make the survival of automobile companies more difficult, and leave us worse off. We should freeze the pollution requirements at the 1975 level. I would also suggest that we eliminate at least one regulation a day from the 93,000-page Code of Federal Regulations and abolish at least one federal regulatory agency a year. (Under current law, the Civil Aeronautics Board will expire in 1985.)

Let me turn to a less controversial proposal — one to deal with the short-term problem that I mentioned in my opening paragraphs. We want to tame inflation and restore full employment. The Federal Reserve has embarked on the right path to meet those ends. It must maintain a steady rate of growth in the money stock, but much slower than the growth rate of the past decade (6.7 percent annually compounded). It must not yield to any temptation to increase the rate of money growth. If it starts pumping money up more rapidly because that is thought to be the road to full employment, like it did in 1967, 1971, and 1977, it will destroy for decades any belief that anything will ever be done about inflation. Note that our productivity began to slip after 1966 when inflation began to heat up and slipped even further after 1973 when we brought inflation to a boil. And in 1979 and 1980, when the inflation lid blew off, is when our productivity actually dropped. Let us not again throw away the fruit of our inflation-

fighting effort in 1982, as we did in 1967, 1971, and 1977, in a vain quest to cure unemployment with a dose of inflation.[31] Once we have paid the cost of taming inflation, then let us collect a return on that effort by holding money growth rates at the level that is consistent with price stability. Only in a noninflationary environment can our economy truly flourish.[32] ■

Footnotes

[1]Total receipts of all governments in the United States in 1945 amounted to 29.4% of national income. That is the highest proportion reached during World War II. Total government receipts in 1980 reached 39.3% of national income, a new record. Total expenditures reached 41.0% of national income. In addition to these expenditures, the federal government made loans and guaranteed loans amounting to $80.8 billion in 1980.

[2]This view, of course, appears to dispute the rational expectations theory. However, see Philip Cagan, "Reflections on Rational Expectations," *Journal of Money, Credit and Banking,* vol. 12, no. 4, part 2 (November 1980), pp. 826-832.

[3]In the Chicago area, weekly earnings of manufacturing production workers in 1967 dollars declined from $147 in 1974 to 123 in December 1980, a 16% decline with a 1% decline in hours worked per week. The decline in real earnings occurred despite a rise in the money weekly wage from $242 for a 40.7-hour week in 1976 to $319 for a 40.2-hour week in December 1980. U.S. Bureau of Labor Statistics, *Real Earnings in Chicago,* December 1980.

[4]From 1960 to 1973, Japanese output per worker increased 10% in manufacturing and 9.9% in the private sector as a whole, compared to 3.1 and 2.8 for the United States. From 1973 to 1979, the figures were 4.1 and 3.5 for Japan compared to 1.5 and 0.8 in the United States. "International Comparisons of Manufacturing Productivity and Labor Costs," U.S. Bureau of Labor Statistics *NEWS,* 22 May 1980; K. Daly and A. Neef, "Productivity and Unit Labor Costs in 11 Industrial Countries: 1977," *Monthly Labor Review,* 11 November 1978; John A. Tatom, "The Productivity Problem," *Federal Reserve Bank of St. Louis Review,* vol. 61 (September 1979).

[5]Douglas R. Mudd and Geoffrey E. Wood, "Oil Imports and the Fall of the Dollar," *Federal Reserve Bank of St. Louis Review,* vol. 60, no. 8 (August 1978), p. 3.

[6]Anaconda, for example, has abandoned its copper refining plant after investing $80 million in pollution controls because it could not meet the new requirements imposed by the Environmental Protection Agency. In addition to the loss of capital resulting from such abandonments, EPA estimates that we will have to invest $711 billion over the next decade to meet pollution control standards.

[7]In addition to discouraging savers and investors, inflation also causes an over-allocation of resources for economizing on the use of money balances. The cost of a 5% rate of inflation, as a consequence of this misallocation, has been estimated to amount to as much as 25% of the GNP. Martin S. Feldstein, "The Welfare Cost of Permanent Inflation and Optimal Short-Run Economic Policy," *Journal of Political Economy,* vol. 87, no. 4 (August 1979), p. 765. Also, inflation obsoletes price information, causing an increase in the search costs, and disrupts markets. See Dennis Carlton, "The Disruptive Effect of Inflation on the Organization of Markets" (presented before the Applied Economics Workshop, University of Chicago, 24 February 1981).

[8]An intermediate peak rate of gross private domestic investment at $239 billion occurred in 1979 II. At normal rates of growth, the intermediate high would have been $297 billion.

[9]Real investment in plant and equipment normally grows at a 7.8% annual rate during a business expansion. During the current expansion it has grown at only a 3.7% annual rate. J.A. Tatom and J.E. Guley, "Inflation and Taxes: Disincentives for Capital Formation," *Federal Reserve Bank of St. Louis Review,* vol. 60, no. 1 (January 1978). Peak to peak, real investment normally grows at a 4% annual rate.

[10]Council on Wage and Price Stability, *Prices and Costs in the United States Steel Industry* (Washington: U.S. Government Printing Office, 1977).

[11]Yale Brozen, "Foreword," in Stephen P. Sobotka, *Profile of Michigan: Economic Trends and Paradoxes* (New York: Free Press of Glencoe, a division of The Macmillan Co., 1963), p. vi.

[12]See Samuel Brittan, "How English is the English Sickness?" *Journal of Law & Economics,* vol. 21 (October 1978), for a discussion of this aspect of the English disease. From 1948 to 1965, compensation of employees in the United States rose from 64% of national income to 70%. This was followed by a decline in productivity growth from 3.2% annually to 2.1%. From 1965 to 1973, employee compensation rose from 70% to 75% of national income. This was followed by a decline in productivity growth from 2.1% to 0.8% from 1973 to 1978 and to minus 0.4% from 1978 to 1980. The attempt to get a larger slice of the national pie for workers is reducing the size of the pie available and reducing the level of worker income as worker share increases. If worker productivity growth had continued at the 3.2% rate since 1966, national income in 1980 would have been $1,538 billion (1972 dollars) instead of $1,194 billion. If the share of national income received as employee compensation had remained at 64.3% instead of rising to 75.3%, total employee compensation would have amounted to $989 billion (1972 dollars) instead of the $899 billion actually received. The smaller share of national income received by workers would have been more than compensated by the large income available for sharing.

[13]Sam Peltzman, *Regulation of Auto Safety* (Washington: American Enterprise Institute for Public Policy Research, 1975).

[14]Yale Brozen, "The Ethical Consequences of Alternative Incentive Systems," in *Can the Market Sustain an Ethic?* (Chicago: University of Chicago Divinity School, 1978), pp. 16-17.

[15]David Henderson, *Coal Mine Safety Legislation: Safety or Monopoly* (dissertation, University of California at Los Angeles, 1978); George Neumann and J.P. Nelson, "Regulation and Safety: The Effects of the Coal Mine Health and Safety Act of 1969" (Report 7934), Center for Mathematical Studies in Business and Economics, University of Chicago, August 1979.

[16]Ronald W. Hansen, "The Pharmaceutical Development Process: Estimates of Current Development Costs and the Effects of Regulatory Changes" (unpublished, Center for Research in Government Policy, University of Rochester, August 1977).

[17]Sam Peltzman, *Regulation of Pharmaceutical Innovation: The 1962 Amendments* (Washington: American Enterprise Institute for Public Policy Research, 1974).

[18]Steven Lustgarten, *Industrial Concentration, Economic Efficiency, and Consumer Welfare* (Washington: American Enterprise Institute for Public Policy Research, to be published); Sam Peltzman, "The Gains and Losses from Industrial Concentration," *Journal of Law & Economics,* vol. 20, no. 2 (October 1977).

[19]"Since taxes are levied on nominal rather than real returns, effective tax rates rise and fall with inflation. For most investors, a reduction in the inflation rate of 5% or so would produce a bigger tax cut than the 30% reduction in tax rates." A.F. Ehrbar, "A Strong Start in the Economy," *Fortune,* 23 March 1981, p. 47.

[20]See Michael Mussa and Roger Kormendi, *Taxation of Municipal Bonds: An Economic Appraisal* (Washington: American Enterprise Institute for Public Policy Research, 1979).

[21]The difference between the pre-tax yield (the social value of return) and the after-tax yield (the private yield) has been dubbed "the wedge" by Professor Arthur Laffer.

[22]From 1960 to 1973, even the United Kingdom did better than we did. Its output per manufacturing worker rose at a 4.1% annual rate while ours rose at a 3.0% annual rate. B. Boner and A. Neff, "Productivity and Unit Labor Costs in Twelve Industrial Countries," *Monthly Labor Review,* vol. 100 (July 1977). We have been restraining our saving and investment in the post-war period by taxing the return on capital much more heavily than income from other sources. There are three layers of heavy taxes on capital income (property tax, corporate earnings tax, and personal income tax) but only one tax on income from other sources (the personal income tax).

[23]D.F. DeRosa, *Rate of Return on Common Stocks and Inflation: Theories and Tests* (dissertation, University of Chicago, 1978).

[24]The understatement occurs despite accelerated depreciation and last-in-first-out (LIFO) accounting allowed by the IRS.

[25]Martin Feldstein and Joel Slemrod, "How Inflation Distorts the Taxation of Capital Gains," Harvard Business Review, vol. 53 (September-October 1978).

[26]R.W. Spencer and W.P. Yohe, "The 'Crowding Out' of Private Expenditures by Fiscal Policy Actions," *Federal Reserve Bank of St. Louis Review* (October 1970). Karl Brunner and A.H. Meltzer, "Government, the Private Sector, and 'Crowding Out'," *The Banker,* July 1976.

[27]"Since 1975, the red ink in the federal books has averaged around $50 billion, and it shows no signs of receding from this peacetime high-water mark even though unemployment has declined by three percentage points and the growth in federal revenues since the recession has been running at a munificent $40 billion a year." Juan Cameron, "Waking up to the Budget Menace," *Fortune,* 3 July 1978, p. 54.

[28]"Continuing business expansion will increasingly require access to external sources of finance . . . In order to sell more and more securities in this environment, the Treasury yield will have to be increasingly tempting, pulling up all interest rates in the process. The Federal Reserve will come under increasing pressure to resist the resulting rise in interest rates by buying more securities and providing more money to the system — thus threatening an acceleration of inflation. . . . If the Fed instead lets Treasury credit demands push interest rates up, that must weaken interest-vulnerable spending on such critical areas as housing. Reducing the government's deficit is the only escape from this dilemma . . . The old-fashioned notion of 'fiscal responsibility' has rarely been more relevant." "Will Budget Deficits Threaten Expansion?," *First Chicago World Report,* November-December 1977.

[29]Y. Brozen, "Government Regulation: Its Economic and Political Impact," *St. Croix Review,* vol. 14, no. 1 (February-March 1981), pp. 17-25.

[30]L. Lave and E. Seskin, *Air Pollution and Human Health* (Baltimore: Johns Hopkins University Press, 1977), pp. 231, 233.

[31]Milton Friedman, "Nobel Lecture: Inflation and Unemployment," *Journal of Political Economy,* vol. 85, no. 3 (June 1977).

[32]See Gottfried Haberler, *The Great Depression of the 1930s: Can It Happen Again?* (Washington: American Enterprise Institute for Public Policy Research, Reprint No. 118, 1981).

✓Washington Update

By a 3-to-1 vote, the Federal Trade Commission dismissed the nine-year-old antitrust case against the three leading makers of ready-to-eat cereals: Kellogg Co., General Foods Inc., and General Mills Inc. The cereals case has been heralded as a test of how well federal laws can deal with shared-monopoly allegations and was considered one of the most important antitrust suits of the last decade. After dismissal, the case can no longer be brought again.

The Reagan administration is drawing up plans to cut the American contributions to such multilateral lending agencies as the World Bank. Although final figures have not yet been released, it is likely the administration will reduce its contribution to the World Bank's subsidized loan pool from the current $1.1 billion to $750 million. Funds for the Inter-American Development Bank will be cut from $175 million to $50 million. Only the Asian Development Bank and the African Development Bank will be immune from these cuts; each will receive a slight increase in funding due to their "efficiency."

After several months of indecision, President Reagan has announced that he will ask Congress to dismantle the four-year-old Department of Energy. Under the Reagan plan, the Interior Department would receive nearly one fourth of the $11.5 billion Energy Department programs, including operation of the strategic petroleum reserve and government-owned hydroelectric dams. The Commerce Department would receive DOE's nuclear weapons production program as well as all of the government's energy-related research and development programs.

Seven of America's largest steelmakers have announced that they will file massive and unprecedented trade complaints against European steel producers. Such countries as West Germany, France, Belgium, Luxembourg, Italy, the Netherlands, and the United Kingdom have been accused of violating U.S. trade laws by subsidizing their weak steel companies and allowing them to sell here at illegally low prices. Investigations of the complaints by the Commerce Department and the International Trade Commission may lead to stiff duties on foreign steel imported into America. A spokesman for the European Economic Community replied to these complaints by saying, "The troubles in which the American steel industry finds itself today have nothing to do with us."

After a vigorous and controversial internal debate, the Reagan administration has decided to end the Federal Maritime Commission's authority to regulate ocean freight rates and to seek sweeping antitrust and regulatory exemptions for the ocean shipping industry. In order to effect such changes, the Transportation Department will ask Congress to allow the shipping companies to join international rate-fixing groups, pool shipping capacity, apportion profits, and set freight rates for goods that also are carried by rail or truck. This request is intended to restore the economic viability of the American merchant fleet, which now only carries a quarter of the dry goods entering or leaving the country.

The Department of Labor recently launched a review of the policy that it uses to determine whether carcinogens are present in the workplace. The policy, which had been developed by the Carter administration, was considered fairly strict; carcinogens were defined very broadly and any dose of a potential carcinogen was defined as dangerous. The new standards are expected to incorporate recent ideas such as a "threshold" or "no effect" exposure level and cost-benefit effectiveness.

The Occupational Safety and Health Administration has announced that it will cite subcontractors who violate health and safety rules at construction worksites. Previously, the agency would only cite the primary contractor for violations incurred by the subcontractor. This change has received strong support from both business and labor leaders.

The Treasury Department has estimated that the corporate sale of tax breaks under the new tax bill will reach $14.7 billion by 1986 — more than a quarter of the business tax reduction. These figures were disclosed at Senate hearings where Treasury officials testified in favor of the bill. The Treasury supports these "tax sale provisions" on the grounds that they are necessary to prevent a wave of tax-motivated mergers and to spread the benefits of the tax cut to corporations without tax liability.

A new Labor Department proposal has recently been drawn up that will phase out the Comprehensive Employment and Training Act and replace it with a new training project that relies more on assistance from private businesses. The new program would: 1) Substantially reduce dependence on government welfare for job-training participants; 2) Use performance-based tests to determine the amount of federal aid given to different job training programs; 3) Eliminate stipend payments for job-training participants; and, 4) Prohibit the payment of recruiting fees for persons or agencies that bring workers into the program. The 1973 law that established CETA will expire 30 September, 1982. ■

PR Reviews

Instead of Regulation: Alternatives to Federal Regulatory Agencies, ed. Robert Poole Jr. Lexington Books, Lexington, Mass., 1982. 404 pp. $25.95.

There has been a drastic increase in government regulation of business in the last decade. Robert Poole points out that since 1970 the size of the combined staffs of all regulatory agencies has tripled. Regulatory expenditures have risen six-fold since 1970, and even more importantly, the total cost impact of these regulations on the economy has been estimated at well over $100 billion per year.

Because of this burdensome regulatory growth, deregulation has become one of the most important economic issues of the day, and *Instead of Regulation* is an important contribution to the public policy debate in this area. The book asks, "What would be the results of abolishing each of the major federal regulatory agencies? Would there be cut-throat competition or monopoly profits? Would we have no protection from threats to quality of life, health, and safety? Or would we be shedding an increasingly burdensome drain on the federal budget, providing more effective ways of achieving the goals of regulation, and promoting freedom of choice?" Among the agencies examined are the Civil Aeronautics Board, the Department of Energy, the Securities and Exchange Commission, the Food and Drug Administration, and the Occupational Safety and Health Administration. Contributors include George W. Hilton, Alan Reynolds, Peter Aranson, and Poole. In each case the author argues that it is both possible and desirable to abolish federal regulation in the area he examined.

This book is not without a few minor flaws in the area of economic analysis.

(Cont. on p. 10)

Regulatory Watch

DEPARTMENT OF EDUCATION

The Presidential Task Force on Regulatory Relief has asked the Department of Education to review its regulations that prohibit any educational program receiving federal funds from discriminating against the handicapped. The task force has expressed concern that the application of these regulations may violate President Reagan's strictures on costs and benefits of federal regulations. As a result of this review, it is expected that the Education Department's Office for Civil Rights will issue amendments reducing the fiscal and administrative burden placed on aid recipients.

DOE has proposed regulations to implement Title III of the Higher Education Act of 1965, as modified by the Education Amendments of 1980. Title III provides federal financial assistance to institutions of higher education for solving fiscal and administrative problems. Starting in fiscal year 1982, eligible institutions will be able to apply for funding under the following three new grant programs:

1. The Strengthening Program, which grants aid for the improvement of academic quality, institutional management, and fiscal stability.
2. The Challenge Grant Program, which provides federal assistance on a matching basis in order to induce institutions to seek additional private financing.
3. The Special Needs Program, which provides assistance to institutions with special needs in order to bolster their planning, management, and fiscal capabilities.

Final regulations have been issued for the Educational Opportunity Centers Program that reflect the statutory changes contained in the Education Amendments of 1980. These regulations primarily cover federal grants in fiscal year 1982 and thereafter. The changes consist basically of a clarification and simplification of the general grant criteria governing the program.

Funding priorities for research activities to be supported by the National Institute of Handicapped Research (NIHR) have been proposed by Secretary of Education Terrell H. Bell. Such a proposal is required under the Rehabilitation Act of 1973, as amended, in order to develop a long-range research plan that adequately provides for the needs of the handicapped. Among the proposed priorities are research on job site modification, public and private sector collaboration, methods of rehabilitation, and a comprehensive rehabilitation research and training center.

Secretary Bell has proposed changes in the funding procedures of the National Direct Student Loan, College Work-Study, and Supplemental Educational Opportunity Grant programs. These changes will provide for verification of student aid applicant information and will affect the procedures by which campus-based funds are allocated. The alterations originate from the recommendations of a 1978 panel of experts on student financial aid.

The Educational Opportunity Centers program is accepting applications for new awards for projects designed to provide disadvantaged persons with information on financial assistance for educational purposes. Recent amendments have stipulated that at least two-thirds of the participants in these programs must be low-income individuals who are first-generation, or potential first-generation, college students. ■

(Cont. from p. 9)

Nonetheless, *Instead of Regulation* does an excellent job of refuting the economic arguments that are used for government regulation.

Markets and Minorities, by Thomas Sowell. Basic Books, New York, 1981. 141 pp. $13.50.

The year 1981 has shown that Thomas Sowell is one of the most effective and prolific free-market economists in America. Although Sowell's longer work, *Ethnic America*, has attracted most of the attention, *Markets and Minorities* is equally praiseworthy. Along with Sowell's *Race and Economics* and *Pink and Brown People*, these works make him America's foremost authority on the economic problems of minorities.

The purpose of *Markets and Minorities* is to take many of the emotionally charged phenomena surrounding minorities (such as "racism") and try to explain them in cause-and-effect terms. In this framework Sowell compares the outcomes resulting from the free market with the outcomes resulting from government intervention into the market. The conclusion is that when the government tries to force, penalize, or subsidize individual decisions, this will usually hurt rather than help the interests of minorities.

Perhaps the most impressive feature of this book is how Sowell refutes many of the time-honored myths surrounding racial discrimination. For instance, although it may appear that blacks earn a smaller percentage of national income than they "deserve" (given their population), such income differentials drop out almost completely when the data is cross-adjusted for such variables as age, education, and location. Among the other topics skillfully covered are job markets, consumer markets, the economics of slavery, and the deleterious effects of government policies on minorities.

Although it is a short book, *Markets and Minorities* covers a lot of important ground and is highly recommended.

The Governing of Agriculture by Bruce L. Gardner. The Regents Press of Kansas, 1981. 148 pp. $17.50/$9.50.

Whatever the alleged ills of market agriculture, government solutions have been far worse, according to Professor Bruce Gardner of the University of Maryland. He argues that any improvements in farm policy, from the standpoint of farmers *or* taxpaying consumers, will be the result of further deregulation and de-subsidization of agriculture. This slim volume makes unbelievably complex layers of government programs understandable to the reader.

For anyone interested in agricultural issues, this is the book to read. Professor Gardner's knowledge of his subject and his understanding of market processes are a welcome antidote to countless pleas for taxpayer support by "agricultural economists." ■

GOVERNMENT SPENDING MONITOR

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

EXPENDITURES (annual rates in billions of $)

	1981 4th Q	1981 3rd Q	1981 2nd Q	Average for Last Year
Federal Government	781.6	661.1	669.7	695.3
Defense	176.5	165.0	159.9	169.3
Labor	23.4	26.5	28.2	28.1
Education	16.4	13.7	14.9	15.6
Health and Human Services	299.6	245.5	229.2	250.1
HUD	16.0	11.3	16.8	14.4
Energy	7.6	12.8	14.5	11.1
Transportation	20.2	23.4	18.3	-22.1
Federal Aid to State and Local Gov'ts.	82.9	87.0	88.7	87.2
Federal Interest Paid	125.4	92.7	107.0	101.6
Federal Transfer Payments	297.2	292.1	275.2	284.1
Federal Surplus or Deficit	-192.8	-34.3	16.2	-84.8
Reported Federal Debt (at close of quarter)	1,028.7	1,003.9	974.8	993.0
Total Government Employment, All Levels (millions)	16.1	15.3	16.0	15.9

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

"To be governed . . ."

What about tiny?

USDA has reached a compromise with California's olive growers over how many sizes of canned ripe olives there should be. Before 1977, there were nine sizes; then USDA cut that to five. But the olive growers wanted more sizes. Now the consumer can choose from small, medium, large, extra large, jumbo, colossal and super colossal olives.

—*Washington Post,* Jan. 11, 1982

They're also buying the Brooklyn Bridge

Consumers Solar Power Corp., a California company that claims to make fuel out of water and whose top executives have been accused of fraud by two federal agencies, is one of the finalists for $8.4 billion in federal subsidies from the U.S. Synthetic Fuels Corp.

—*Washington Post,* Jan. 8, 1982

Let him walk

Arthur Hartman, the U.S. ambassador to the Soviet Union, wants to replace the 1977 limousine assigned to him and is entitled to do so this year, but there is a hitch. Hartman wants another Cadillac, while Congress now allows only $6,500 for the purchase of any ambassador's car. For that money, even at the fleet rates that U.S. automakers offer the government, Hartman may have to settle for an Oldsmobile. Washington has refused to make an exception despite heated protests from Hartman's staffers. They argue that in Moscow, where an official's car is viewed as a significant measure of his importance, anything less than a Cadillac would lower the U.S. ambassador's prestige.

—*Newsweek,* Jan. 25, 1982

Reaganomics?

In a move to prop up the staggering farm economy by pushing up prices, the Reagan administration yesterday urged farmers to reduce their 1982 planting of wheat, feed grains, cotton and rice by 10 to 15 percent.

—*Washington Post,* Jan. 20, 1982

We could trade them for Toyotas

The American inventor of aluminum baseball bats was forced by regulators to stop selling in Japan on the ground that his bats had the wrong kind of aluminum. A Japanese baseball league bars the use of all foreign-made aluminum bats.

—*U.S. News & World Report,* Feb. 1, 1982

After all, it's his city

When your silver-gray car has D.C. license tags that proclaim "City Council Chairman," people notice how you behave in traffic. So David C. Roberts was annoyed when he observed Arrington Dixon's car parked recently in a no-parking, tow-away zone.

Asked for comment, Carol Richards, Dixon's press spokeswomen, replied: "What's [Dixon] supposed to do? . . . He has a million appointments . . . and to do it on time, he has to park in places that, you know, might be illegal."

—*Washington Post,* Jan. 20, 1982

You always hurt the one you love?

"Economic sanctions are almost always applied for political reasons," said a former U.S. ambassador who now represents business interests. . . . "The question always is, which part of society is going to pay the price? You know that you are going to hurt yourself at the same time when you make a decision like this, but that is what a president has to do — you have to lead your own country."

—*Washington Post,* Jan. 17, 1982

Wish we could believe you

"A lot of federal agencies are just dying out there [because of Reagan's 12% budget cut]" a senior member of the staff of the Senate Budget Committee explained.

—*Washington Post,* Jan. 19, 1982

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