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The Benefits of Bank Deregulation

by David Glasner

Deregulation is both a cause and an effect of the enormous changes the financial and banking systems of this country have undergone in the past decade. Since not everyone has benefited from these changes, there are those who would like to return to a system of tightly regulated banking and, in particular, to restore ceilings on the amount of interest banks pay on deposits.

Even if it were desirable to do so, however, the market for, and the technology of, providing banking and financial services has evolved to an extent that will make it extraordinarily difficult to reimpose regulation on the banking industry. Yet some influential people—business economists Henry Kaufman and Albert Wojnilower and the chairman of the House Banking Committee, Rep. Fernand St Germain, to name a few—evidently would like to try. Though the effort would ultimately prove futile, trying to restore the cozy system that used to exist but which competition has undermined could still impose needless costs on the vast ma-

David Glasner is a senior research fellow at the Manhattan Institute and author of *Politics, Prices, and Petroleum* (Pacific Institute, 1985).

majority of depositors and on the economy as a whole.

Those supporting reregulation contend that deregulation—especially the removal of controls on the payment of interest on deposits—has been harmful to the banking system and to the economy. In the *New York Times* (July 18,

“All that the regulation of interest rates on deposits did was confer upon banks a subsidy extracted from depositors.”

1984), Albert Wojnilower charged that deregulation has (1) caused all interest rates to rise, (2) been inflationary, and (3) made the banking system unsafe.

Deregulation has, in fact, had none of these effects and it is important to understand why not.

To support the contention that deregulation has forced interest rates to rise, Wojnilower and others invoke the following analogy. Deposits are the raw

material banks require to supply credit to the public, just as crude oil is the raw material oil companies use to supply gasoline to consumers. By controlling the interest rates banks paid on deposits, regulation reduced the costs banks incurred in supplying credit. The savings enabled banks to supply credit at reduced interest rates, just as controls on crude oil prices enabled oil companies to sell refined products at reduced prices.

Controls on Oil and Interest Rates

Ironically, those who cite the control of crude oil prices to show that regulation holds down interest rates could not have chosen a better example to show why precisely the opposite of what they contend is true. If anything, controls on the price of crude oil actually raised the prices of gasoline and other refined products.

The reason is simple enough. Since there was not enough price-controlled crude oil from which to produce as much gasoline as the public was demanding at prevailing prices, refiners had to import additional crude oil at the uncontrolled world price. But refiners imported the oil only because they

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Federal Reserve's Role Debated

Does the Federal Reserve Board actually follow consistent monetary guidelines that promote economic growth and price stability? Does the central bank contribute to the overall health of the U.S. economy? Can reform of the monetary regime be achieved within the current policymaking framework?

These questions were the focus of the Cato Institute's Third Annual Monetary Conference, "The Federal Reserve: Reforming the Monetary Regime,"

held February 21–22 in Washington, D.C. Twenty-three scholars and policy analysts gathered from around the nation and abroad to address some of the most fundamental and provocative issues in monetary policy and theory.

The opening session featured Lawrence K. Roos, former president of the Federal Reserve Bank of St. Louis. Drawing on his years on the Federal Reserve Board's Open Market Committee, Roos lamented the lack of consen-

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Capitalism and Change



The harsh words passing between David Stockman and his adversaries have illuminated one of the basic issues of our time: the dynamism of a capitalist economy and the stultifying effects of government. In discussing the disinvestment going on in farming, as well as in such other industries as automobiles and thrift institutions, Stockman argued:

That is the way a dynamic economy works. . . . And if you want an economy that's productive, that maximizes growth, income, opportunity over time, you've got to encourage both investment and disinvestment. You've got to have adjustment.

Government basically is a reactionary institution that tries to foster one and retard the other, and usually makes a botch of both. So that's why we want to have a kind of hands-off adjustment policy.

In response, members of Congress and interest-group leaders have made eloquent appeals to stability, tradition, and a "threatened way of life." Defenders of the family farm ranging from the South Dakota legislature to the Widow Doonesbury have denounced Stockman's view that farmers are businessmen who should compete for profits in the marketplace.

Farmers are not alone in their resistance to economic change. The autoworkers and steelworkers unions have been eager to embrace any program that would retard the flow of capital out of their industries.

In many ways the entire program of the American left today is a reactionary opposition to change. Leftists organize to save basic industries, restrict plant closings, impose price controls, and resist technological change. They even wax nostalgic over the decline of the world's largest monopoly, AT&T. As the intellectual appeal of the left declines, they find support for their campaigns of resistance among the out-of-work autoworkers and steelworkers of the rust-belt, who would prefer not to go elsewhere to find work.

But change is part of, indeed the distinguishing characteristic of, capitalism. The process of creative destruction means that new products and services are constantly being created and thus that others are constantly being outmoded. Every new development, from the cotton gin to the com-

puter chip, has created thousands or millions of new jobs—and destroyed other thousands or millions.

As James Fallows wrote recently in the *Atlantic Monthly*,

Capitalism is one of the world's more disruptive forces. It can call every social arrangement into question, make cities and skills and ranks merely temporary. To buy into it is to make a commitment to permanent revolution that few political creeds can match.

This permanent revolution disrupts not only jobs but lifestyles, and it is here that, ironically, the right often joins the left in reaction. Much of the "moral decay" decried by the New Right is a result of a dynamic, affluent capitalist economy. Capitalism means choice, and the affluence produced by capitalism gives people the wherewithal to take advantage of those choices. When the unprecedented affluence of the 1950s led to unprecedented lifestyle choices in the 1960s, many Americans reacted strongly. Like the steelworkers faced with the end of their jobs in the 1980s, these Americans just wanted things to stay the same. But as David Stockman says, change—of many sorts—is "the way a dynamic economy works." Or, as Samuel Brittan wrote in "Capitalism and the Permissive Society": "Competitive capitalism is the biggest single force acting on the side of what is fashionable to call 'permissiveness,' but what was once known as personal liberty."

The benefits of capitalism are many: a high and rising standard of living, of course, but also freedom of choice, the opportunity to be creative, to choose one's own lifestyle, even to opt out of "materialist" society and work as a nun or on a communal farm. (Try that in a society where a planning board chooses your occupation, or where every person must work from sunup to sundown just to eat.) But this dynamism has costs: the disruption of jobs and of traditional ways of life.

Ultimately, however, James Fallows and David Stockman are right: Capitalism is a permanent revolution, and government is reactionary. Which vision we will choose is what we are really debating when we talk about farm subsidies, protectionism, plant-closing restrictions, or using government to protect traditional lifestyles.

David Boaz

—David Boaz

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David Boaz Editor
David Lampo Managing Editor
Tyler Cowen, Daniel Klein, Tom G. Palmer Contributors

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could sell at a profit the additional products the imported crude enabled them to produce. Thus, for refiners to continue importing crude oil, the prices of gasoline and other refined products had to be high enough to cover their costs of importing crude. If controls on crude oil prices had been holding down the prices of products, importing crude oil would not have been profitable for refiners. The controls did no more than provide a subsidy—a windfall—to refiners at the expense of producers.

The notion that decontrol of crude oil prices raised gasoline prices is also contradicted by the evidence. In a detailed study of the behavior of gasoline prices while crude oil prices were under control, I estimated the effect on gasoline prices that decontrol would have had under the assumption that controls really had been holding down the price of gasoline and under the assumption that controls had not done so.* Had controls held down the price of gasoline, the average price of gasoline should, I estimated, have increased by 47 cents a gallon between October 1979 (shortly after gradual decontrol was begun by President Carter) and February 1981 (immediately following the total decontrol ordered by President Reagan). However, if controls on crude oil prices were not holding down gasoline prices, then the price of a gallon of gasoline should, according to my estimate, have increased (owing to increases in the price of imported oil and to inflation generally) by only 39 cents. The actual price increase over this period was just 38 cents a gallon, which strongly suggests that controls on crude oil prices were not holding down gasoline prices.

But even if crude-oil price controls had resulted in lower gasoline prices, that still would not mean that controlling interest rates on deposits would reduce interest rates generally. To suppose that it would presumes a kind of bootstrap theory in which interest rates are determined by (what else?) interest rates—in which it is the interest rates

*These estimates and the procedures I followed in making them are fully described in chapter 8 of my book *Politics, Prices, and Petroleum*.

that banks pay depositors that determine interest rates on treasury bills, bonds, commercial paper, corporate bonds, and the whole array of financial assets. Bank deposits are an awfully small tail to wag such a big dog.

At most, regulating interest rates could have led banks to reduce the spread between the interest rates they charged borrowers and the federal funds rate. But to supply the amount of credit the public demanded at prevailing interest rates, banks had to obtain reserves at unregulated interest rates from large depositors or in the federal funds market from other banks. The spread between the federal funds rate and the rate banks charged their borrowers, therefore, had to be wide

"The comparison of recent bank failure rates with those of the Great Depression is wildly misleading."

enough to make it profitable for banks to borrow reserves at the federal funds rate. All that the regulation of interest rates on deposits did was confer upon banks a subsidy—a windfall—extracted from depositors.

The second charge made against deposit rate deregulation is that it has been inflationary. By reducing the profit margin banks earned on their loans, critics suggest, competition has forced banks to increase their lending. This increase in lending by banks is alleged to be inflationary.

One should be immediately suspicious of this charge because inflation has fallen precipitously over the last four years as deregulation has proceeded. At a less superficial level, one also perceives a confusion about what happens when a bank makes a loan. The immediate result of lending by a bank is the creation of a new deposit corresponding to the IOU the bank acquires from the borrower. If the deposit at the bank continues to be held by the borrower or by someone else, then the loan constitutes an addition to the bank's asset portfolio. If not, the loan simply causes a reshuffling of the

bank's portfolio; the bank that acquires an IOU has to part with some other asset when the deposit it created is extinguished or is transferred to another bank by the borrower or someone to whom he makes payment.

There is nothing inherently inflationary about an increase in lending by banks. Lending by banks is inflationary only if it increases the total money stock (the amount of deposits) by an amount greater than the increase in the demand of the public to hold its wealth in the form of deposits.

Is there any reason to believe that additional lending by banks owing to deregulation has caused the money stock to expand more rapidly than has the desire of the public to hold money? Not at all. Under regulation, there was an artificial margin between the return to banks from expanding their asset portfolios by the creation of new non-interest bearing deposits and the cost of maintaining those deposits. Banks, however, could not increase their deposits and expand their portfolios as they wanted. For as long as deposits did not yield competitive interest, the public was unwilling to hold any additional deposits, preferring instead to hold its wealth in other less convenient but more remunerative forms. Now, with deregulation, banks are able to increase the amount of credit they supply by paying depositors higher rates of interest, thereby inducing the public to increase the share of wealth it holds in the form of deposits. Since the additional deposits banks create under deregulation are being held willingly and not being spent, their creation cannot be inflationary.

Nor does the accumulation of assets in bank portfolios necessarily represent an increase in total lending in the economy. Rather, it reflects an increase in the extent of intermediation between ultimate borrowers and lenders by the banking system.

Instead of all lending taking place directly between borrowers and lenders, the banking system, borrowing from lenders and lending to borrowers, operates as an intermediary between them. Economies of scale enable banks to lend and borrow at a cost lower than that which individual borrowers and lenders must bear. Thus, intermedia-

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tion increases the net interest received by ultimate lenders and reduces the gross interest paid by borrowers. By preventing banks from competing for deposits, ceilings on interest paid on deposits prevented banks from fully exploiting their cost advantage as intermediaries. As a consequence, costly direct transactions had to be arranged between borrowers and lenders, which could have been intermediated more cheaply by the banking system. Any additional lending the banking system is undertaking owing to deregulation, therefore, represents an efficient expansion of its operations as an intermediary between ultimate borrowers and lenders, not an inflationary expansion of credit.

If, as Mr. Wojnilower believes, deregulation has caused banks to increase the interest rates they are charging borrowers, how are they able to induce the public to borrow the additional sums they are trying to lend? One would have thought that the public would reduce its borrowing from banks as the rate of interest was being increased. If the answer is that the demand of loans has been increasing because of other factors, then it could as easily be those factors that are responsible for rising interest rates, not deregulation.

Deregulation and Risk

The third objection raised against deregulation is that it is making the banking system unsafe. To generate the revenue they need to pay the interest they owe depositors, competing banks are supposedly forced to make highly risky, but potentially very profitable, loans. It is these very risky loans that are now said to be endangering the stability of, and undermining confidence in, the banking system.

Critics of deregulation like to point out that the rate of bank failures in the past few years has been the highest since the thirties when the country was still in the midst of the Great Depression. That comparison, however, is wildly misleading. From 1929 to 1933 more than 10,000 banks, or over two-fifths of all the commercial banks in the country in 1929, closed their doors. In 1933 alone, 4,000 banks failed. But since

then, in no year have there been more than 84 bank failures, and that was in 1937. The increase in bank failures recently is thus in no way comparable to what happened during the Great Depression and has little, if anything, to do with deregulation.

What is really happening as a result of decontrol is that banks are acquiring additional assets because paying competitive interest on deposits has enabled them to create more deposits than they could before. Nothing requires banks to acquire assets that are riskier than those acquired before deregulation. The riskiness of a bank's portfolio is not something that is forced on it willy-nilly; it is a matter of deliberate choice. The management of a bank can always seek to increase the yield on

"The subsidy banks used to enjoy at the expense of depositors allowed otherwise unprofitable banks to remain in business."

its portfolio by increasing the share of risky, high-yield assets in the portfolio.

If the attitude of management is such that it is willing to accept substantial risk to increase the rate of return on the bank's portfolio, it need not have waited until deregulation to do so. The composition of the bank's portfolio is in no way related to whether the bank is or is not paying the market rate of interest on deposits. Indeed, most of the non-performing loans now plaguing the banking system were originally made either before deregulation began or when it was in its early stages.

Moreover, many of the restrictions regulation imposed on banks still prevent them from diversifying their asset portfolios and thus reducing their risks. These regulations confine the geographic range of banking operations by restricting their interstate activity and limit the kinds of loans they may make, rendering banks more susceptible to shocks that affect particular industries or particular regions. It was

not deregulation, but a high concentration of loans to troubled energy companies, that did in Continental Illinois.

A more sophisticated form of this argument would point out that deregulation has eliminated the subsidy banks used to enjoy at the expense of their depositors. Banks, therefore, might not be willing to indulge their taste for security to the same degree they did before deregulation. In other words, the richer banks are, the less risk they will choose to accept in their portfolios. Thus, by making banks less profitable, deregulation may have made them riskier.

Although in this form the argument is not logically defective, we have no way of knowing how much risk banks actually chose to shed because of the subsidy they were receiving. And in any event, the amount of the windfall from regulation was substantially dissipated by the non-price competition for deposits in which banks were engaging by offering depositors all sorts of free services and special inducements—from free checks to free toasters—as well as by heavy investments, where possible, in "brick and mortar" branches.

Having said that, I should acknowledge that there is a connection between deregulation and the stability of the banking system. Even if it is different from the one opponents of deregulation usually bring up, this connection is a legitimate cause of concern. Although largely dissipated by non-price competition, the subsidy banks used to enjoy at the expense of depositors did allow many otherwise unprofitable banks to remain in business. Once deregulation eliminated that windfall to banks, most of those banks either closed down or were taken over by profitable ones. Thus, deregulation is at least partly responsible for the fact that bank failures over the past few years have been occurring at the highest rate since the thirties.

Once again, there is a rather precise analogy with decontrol of crude oil prices, but one quite different from that drawn by opponents of decontrol. Decontrol of crude oil prices eliminated the subsidy that refiners were receiving at the expense of crude oil producers. Loss of the subsidy meant that inefficient refiners that stayed in business

only because of the subsidy had to shut down after decontrol. Just as gasoline consumers have benefited because decontrol forced inefficient refining capacity to be withdrawn from the market, the withdrawal of inefficient banks from the market in the wake of deregulation will leave us with a safer, more stable, more efficient banking system.

The Impact of Disinflation

However, the major factor contributing to bank failures has nothing to do with deregulation. What has been most responsible for bank failures is the very rapid reduction in the rate of inflation that has occurred over the last four years. Because expectations of high inflation had become so deeply ingrained, many bankers made loans before, and even after, inflation started falling, on the assumption that rapid inflation would enable borrowers to generate enough income to repay them. In some instances, borrowers have been able to increase efficiency enough, or have benefited enough from falling input prices, to be able to repay those loans despite falling inflation. But, for many firms—especially those in primary resources such as petroleum, metals, lumber, and agriculture—prices are too far below expectations to be able to pay off their original loans. The banks that made loans to such firms, or to countries producing such products, are now suffering from their debtors' inability to repay.

The remedy for this problem—which is real and troubling, but which has nothing to do with deregulation—lies in a more stable monetary policy that eliminates the risks of unanticipated inflation and unanticipated deflation. Such a monetary policy would aim at eliminating the unnecessary and costly uncertainty inherent in the absence of any clear and credible commitment by our monetary authorities to long-term stability in the price level. Just how such a commitment could be made credible is a difficult question that cannot be answered here. But it is that question, not how to restore an inefficient and inequitable system of banking regulation, that those concerned about the stability of our banking system should begin thinking about. ■

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sus in Fed decision making. "Within the FOMC," said Roos, "there were usually as many goals as there were chairs around the table. In my experience at the Fed, I cannot recall any significant prioritization of objectives."

The lack of consensus leads to policies concentrating on short-term goals subject to political pressure from Congress and the president. Concluded Roos, "My main point is simply that we must have clearly defined and achievable goals upon which to base policymaking decisions. Furthermore, it isn't enough to hammer out clear and consistent goals if public and political pressure is exerted upon the Fed to abandon them whenever it seems like the politically expedient thing to do."

Robert Black, president of the Federal Reserve Bank of Richmond, also emphasized the need for a definite goal in the conduct of monetary policy. He would limit the discretionary powers of the Federal Reserve Board by instituting a monetary rule designed to achieve price-level stability.

William Poole, professor of economics at Brown University and former member of the Council of Economic Advisers, concentrated on the subjective nature of monetary decision making, observing: "the political process



New York Post financial editor Maxwell Newton addresses the conference.

that has given us a procyclical monetary policy operates with a vengeance at the congressional level."

Poole continued, "Under the present institutional arrangements controlling monetary policy decisions there is no reason to expect that we have seen the last of stop-go monetary policy."

In what evolved into a consistent theme among the speakers on the first day of the conference, Poole concluded: "Only a rule constraining the creation of money can lead to a determinate

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Paul Craig Roberts and Robert Black take notes as Lawrence Roos addresses the conference's opening session.

Legal Services Corporation Violates Mandate

The Legal Services Corporation has routinely used taxpayer funds to promote political objectives that are irrelevant to the legal needs of the poor, according to a Cato Institute study.

Economists James T. Bennett and Thomas J. DiLorenzo of George Mason University, authors of the forthcoming book *Tax-Funded Politics*, write, "The poor have been used as pawns by Legal Services lawyers to procure taxpayer funding for their personal political agendas."

The authors found that Legal Services organizations have filed suits for such purposes as forcing the use of taxpayer funds for sex change operations; preventing the implementation of literacy tests for high school graduation; requiring U.S. Steel to sell a factory to a community organization; blocking construction of a nuclear power plant; and opposing a warfare program for welfare recipients. Bennett and DiLorenzo write, "Whatever one may think about the goals of these lawsuits, it is clear that none of them involve the mandated function of the Legal Services Corporation: ensuring that the poor have access to legal assistance. Rather, in these cases the LSC is using taxpayers' money to get courts to make decisions on political issues that are clearly the province of legislative bodies."

The LSC has also abused its charter by frequently using its funds for political organizing. It attempted to defeat a California tax-cut initiative, spending \$61,655 on a Proposition 9 Task Force. After President Reagan was elected, LSC set up a "survival campaign" to resist administration and congressional efforts to reduce or terminate LSC funding. This involved three elements: (1) an outside lobbying effort initiated by LSC, (2) a grass roots lobbying campaign, and (3) "sister corporations" that could "launder" funds so that congressional restrictions on political advocacy and representation could be subverted.

In 1982 LSC awarded contracts to produce "between 35 and 50" training manuals—not on how to represent the poor but on political organizing. The manuals actually derogate the role of the individual attorney in helping individual clients, stressing the greater impact of "organizing to achieve social change."

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The authors point out that while LSC officials insisted that they could not afford any budget cuts, they had amassed tens of millions of dollars in unspent balances from 1980 to 1982 and had purchased some \$30 million worth of property and equipment during that period. LSC spend some \$2.25 million

on dues to various organizations, including labor unions.

When President Reagan appointed LSC board members who were critical of the organization's activities, files were destroyed to prevent the new board from investigating LSC.

Bennett and DiLorenzo's study, "Poverty, Politics, and Jurisprudence: Illegalities at the Legal Services Corporation," is part of the Cato Institute's Policy Analysis series and is available for \$2.00.

Nobel Laureate F. A. Hayek Named Senior Fellow of Cato

F. A. Hayek, the 1974 Nobel Prize winner in economics, has been named Distinguished Senior Fellow of the Cato Institute.

Cato President Edward H. Crane said, "It is a tremendous honor to have F. A. Hayek formally associated with the Cato Institute, since his writings underlie so much of the work we publish. He is the most distinguished social thinker of our century, and I imagine that most of our adjunct scholars would cite his works as a seminal influence on their own thinking. More than any other person, he is responsible for the revival of classical liberal ideas in the modern era."

Hayek, who said he was "very honored" to accept the invitation, is best known for his 1944 bestseller, *The Road to Serfdom*. He is also the author of two major works in liberal political philosophy, *The Constitution of Liberty* and the three-volume *Law, Legislation, and Liberty*; economic treatises, like *Prices and Production* and *The Pure Theory of Capital*; and books in other fields, like *The Sensory Order*, *The Counter-Revolution of Science*, and *John Stuart Mill and Harriet Taylor*. His essays have been collected in such works as *Individualism and Economic Order*, *Studies in Philosophy, Politics and Economics*, and the recent *Essence of Hayek*.

A leader of the Austrian School of



F. A. Hayek was Cato's first Distinguished Lecturer in 1982.

economics, he is particularly associated with such ideas as spontaneous order, the rule of law, inflation and the business cycle, and the principles of a modern liberal order.

Hayek has taught at the University of Chicago, the London School of Economics, and the University of Freiburg. The Cato Institute has provided financial support for his work for several years.

The Myth of Government Job Creation

High school debate topics are notoriously biased toward government intervention in the economy. The topic's wording often forces the team supporting the resolution to propose interventionist plans. The opposing team must then support the status quo, which is often interventionist as well.

The 1984-85 high school debate topic, *Resolved: That the federal government should provide employment for all employable United States citizens living in poverty*, follows in this tradition, one in which free-market ideas are aired but rarely.

But economist and Cato adjunct scholar Thomas J. DiLorenzo of George Mason University has produced a study providing free-market ammunition for high school debaters, at the same time filling an apparent dearth of free-market information in the standard briefing books provided to debate teams.

According to DiLorenzo, government programs cannot create jobs. "Government taxing and spending programs only redistribute existing jobs; taxation reduces the economic vitality of the private economy, destroying jobs there, even though jobs may be 'created' elsewhere by government spending or jobs programs."

A number of high school debate teams, many of which participated in high school debate seminars sponsored by the Institute for Humane Studies and the Foundation for Economic Education, will receive the study. DiLorenzo's paper is particularly timely, given its wealth of recent data, as teams prepare for district and national competitions.

DiLorenzo points out that jobs programs are politically appealing because the jobs they create are highly visible and the recipients are grateful at election time. By contrast, the costs of jobs programs—the private economic activity crowded out by government taxing and borrowing—are almost invisible.

DiLorenzo concludes: "The only way for government to encourage the creation of jobs is to lessen its role in the economy by (1) reducing taxes; (2) re-

ducing the regulatory costs imposed on all businesses, and which are especially burdensome to the small businesses that create most of the jobs in this country; (3) reducing government spending; (4) reducing inflation by not printing money to finance government programs; and (5) reducing regulatory restrictions on labor markets, which . . . retard economic growth and employment opportunity. In short, although

government jobs programs are a response by politicians to public requests to 'do something' about unemployment and poverty, the appropriate course of action is to *undo* something."

DiLorenzo's paper, "The Myth of Government Job Creation," is part of the Cato Institute's Policy Analysis series and is available for \$2.00. It includes a lengthy bibliography on poverty and unemployment.

Post Office Study Makes Splash

A Cato Institute study on the failings of the U.S. Postal Service, released the week of the latest postal rate increase, drew widespread national attention.

Author James Bovard charged, "Mail service is becoming slower, more expensive, and less reliable. . . . Americans are suffering a gradual extinction of mail service." Bovard called for ending the legal monopoly on postal service to allow private companies to compete with the USPS. He concluded, "it should not be a federal crime to provide better service than the government."

Bovard cited studies showing the deterioration in mail delivery time and soaring wage rates. He argued that recent experiments with electronic mail have been disastrous and that USPS is slowly phasing out home delivery, beginning with new homes.

Confronted on a Cable News Net-



James Bovard speaks at Cato Policy Forum, broadcast nationally by C-SPAN.

work interview with the USPS response that his study was biased and inaccurate, Bovard replied, "The Cato Institute is having a forum tomorrow on Capitol Hill, and the Postal Service was invited to come and give criticisms, but they refused to come." USPS also refused to supply a representative to the CNN program.

Radio commentator Paul Harvey and NBC Radio News both noted Bovard's charge that the Postal Service is "one of the worst-managed, least honest corporations in America." CBS News emphasized the study's call for "private competition with the flagging postal monopoly."

Besides appearing on CNN, Bovard was interviewed on a number of radio and television shows, including the Michael Jackson Show in Los Angeles, WOR in New York, and the RKO network. He also addressed the National Association of Postmasters.

At a Cato Policy Forum congressional postal expert Wayne Schley defended the postal service and charged Bovard with ignoring many government studies of USPS quality. Bovard responded that it was clear that mail service has deteriorated and that competition for first-class mail is illegal. He urged again that the Postal Service test its services in the marketplace by legalizing competition.

Bovard's study, "The Last Dinosaur: The U.S. Postal Service," is part of the Cato Institute's Policy Analysis series and is available for \$2.00.

Should Automobile Import Quotas Have Been Extended?

Every month the Cato Institute sponsors a Policy Forum at its Washington headquarters where distinguished analysts present their findings to an audience drawn from government, the public policy community, and the media. A recent forum featured Robert Crandall, senior fellow at the Brookings Institution. Commenting on Crandall's remarks was John E. Barnes, Jr., executive director for external environment evaluation on Ford Motor Company's corporate strategy and analysis staff.

Robert Crandall: The argument against trade protection stems not only from economic theory but from one's observation of the world. Just recently, Mancur Olson, who has gotten a great deal of attention from his book *The Rise and Decline of Nations*, has written a paper in which he looked at the ability of less developed countries to export. He divided countries into those with highly protectionist policies and those with fairly open economies and borders. It turns out that the open economies are those that have the greatest propensity to export; trade protection typically stifles innovation and competitiveness and reduces the propensity to export. This is an interesting result because there is a widespread belief among the American electorate that somehow the protectionist policies of our trading partners have strengthened their companies and allowed them to compete aggressively in the U.S. market.

Why is it that the automobile industry, once a paragon of American strength, an invincible three-firm oligopoly, was reduced by 1980 to pleading for trade protection? How did it get into trouble? What sort of trouble was it in? Is there any reason to believe that its troubles would be better solved behind the veil of trade protection than with open and aggressive competition?

The industry's profits before taxes (with the inventory-evaluation adjustment) bottomed out in 1980 at -\$4.8 billion in constant 1984 dollars. The industry had declined from the late fifties and early sixties, when it was earning

as much as 25 percent on equity, to actually losing \$4 billion in a single year. How had it fallen so far and so fast? One reason was that labor costs were very high. By 1980 the average compensation per hour (in current dollars) of the average automobile worker had reached 65 percent more than that



Robert Crandall: "Trade protection stifles innovation and competitiveness and reduces the propensity to export."

Policy Forum

in the manufacturing sector. By comparison, compensation in most of the European auto industries is somewhere between 10 percent and 20 percent higher than the manufacturing average.

Productivity growth had been very sluggish. The long-run rate of growth of productivity had been around 2.7 percent, but it had recently been trending downward because volume was falling off. In fact, productivity growth is somewhat higher in the automobile industry than similar measures for other industries because the auto companies' product is quality adjusted. No other product in the manufacturing sector is.

By 1980 the cost disadvantage vis-a-

vis the Japanese had been estimated to be as high as \$1,600 to \$2,200 per small car. Some companies were very slow to introduce new models.

Is it possible that trade protection would help solve these problems better than simply subjecting the companies to forceful competition from the Japanese, and even from the Europeans? I would argue that the answer is generally in the negative.

For instance, would it increase the industry's resolve to negotiate wage decreases? Chrysler, in its troubled times, did go through a period of negotiation with its union resulting in a rather substantial reduction in wages for a short period of time. In 1982, Ford and GM followed with some reductions. The average compensation in the industry did grow more slowly after 1982, as did inflation. But in 1984, the industry negotiated some small real wage increases once again. Would they have done so had the Japanese market share here been 30 percent and rising? I rather doubt it.

Would competition have increased productivity more rapidly? There was a substantial increase in estimated productivity after 1982 because of the recovery and because the companies did take some rather tough actions. Because there was a sharp drop off in demand, they were hoarding labor so they were overstaffed, as almost any firm is during a recession. Looking at the long-run trend of productivity in relation to output levels, 1983 is above-trend by about 6 percent. By contrast, 1984 is about .7 percent below what might have been expected. I would argue that there has been no significant departure from any long-term trend as a result of what happened in the past few years.

Would free trade have led to a more rapid improvement in product quality? One of the industry's most serious problems is quality—particularly the reliability of its cars in the first few years and the so-called fit and finish. The industry now admits that it had fallen substantially behind the Jap-

anese. Judging from the *Consumer Reports* Repair Ratings based on reader surveys the differences in quality between Japanese and American cars are quite striking. Giving the best possible rating a 1 and the worst possible rating a 5, Chrysler was hovering dangerously close to a 5; the Japanese were moving toward ratings of 1.0. Since 1980 the gap between U.S. and Japanese imports seems to have widened rather than narrowed. The impression from surveys taken from car buyers by a major survey research company is that things had gotten worse, not better. Out of 30 nameplates that this survey ranks, the 5 nameplates of GM rank in the bottom 9. Had the Japanese import share been 30 percent and rising, rather than 18 percent, we might have seen a more rapid improvement in quality.

Would we have seen a more rapid introduction of new models? Probably yes. The larger companies have always been rather slow to design and introduce new cars, and there would have been greater pressure on them to do so had the Japanese been free to export to the United States. There have been some delays in new model introductions on the part of most of the companies that might not have occurred if the industry were not protected.

It is not that the U.S. industry cannot build new plants. In this respect, the auto industry is quite different from steel. The fact that the U.S. auto industry can build new plants and expect to amortize them successfully suggests that it can compete if subjected to a small amount of competition—if it has sufficient incentive and makes the right decisions.

The usual story of trade protection is the need to raise the profits of an industry for a short time in order to get it to invest and modernize, but capital spending in the auto industry was rising in real terms in the early eighties. Under trade protection, capital spending fell off. In every case of trade protection that I am aware of—textiles, specialty steels, carbon steel, automobiles, etc.—there has been a corresponding decline in capital spending with the onset of protection. One of the reasons is that trade protection is usually sought in a period of declining demand, after firms have overinvested and their expectations have not been



Detroit News editorial page editor Thomas Bray talks with Heritage Foundation senior fellow David Fand.

fulfilled. They need the government to bail them out. Entering the deep recession in 1982, capital spending by U.S. automakers fell off, and there was certainly no evidence of a reverse trend as they played catch-up ball. Presently, they are spending at 1977 and 1978 levels. I don't see any evidence that there have been any major adjustments.

So if competitiveness has not improved, what has the cost of the quotas been? Earlier this year, I calculated that the quotas increased the price of Japanese cars by approximately \$1,000 per car, and of U.S. cars by approximately \$400 per car. The total cost of the quotas to consumers was \$4-\$5 billion. The quotas can be said to have increased employment directly (in the auto industry) only by perhaps 26,000, and this number might be doubled to account for supplier industries. But trade protection has costs in terms of the value of the dollar and its effect on exporting industries, where it has undoubtedly reduced employment in a dispersed way. If the 26,000 figure is divided into the \$4-\$5 billion, that's a very expensive employment-creation program—and not at all atypical of government policies. Almost all policies designed to create employment by trade protection cost \$100,000 or

\$200,000 per job created.

There is, then, a substantial increase in the cost of cars—particularly Japanese cars. By the way, the same thing will happen with steel quotas if the administration is successful in its negotiations. The price of imports will increase far more than the price of domestic steel, conferring substantial benefits on Japanese, Korean, German, and Canadian exporters and somewhat smaller benefits, short-run, on our steel companies. The same is true in the auto case: enormous benefits for Japanese, smaller proportional benefits for American, companies.

Notice that in terms of equity, protection subsidizes \$20/hour autoworkers at the expense of the average worker in the manufacturing sector, who makes \$12 an hour. (The wage of the average worker in the economy is even less.) One wonders at the justice of all this.

John Barnes, Jr.: I would like to address the question of prices and profits under export restraint, and whether progress has been made in the industry. All of us approach the subject of trade restraint with uneasiness because it conflicts with free trade and free enterprise traditions in this country. It is

Import Quotas (Cont. from p. 9)

easy to assume that the international market isn't much different from the domestic market. The same conventional wisdom says that trade restraint inevitably drives up prices and causes domestic manufacturers to slack off in their efforts to become more competitive. But trying to judge what might have happened had there been no voluntary export restraints (VER) on Japanese cars is at best a speculative exercise—we are not dealing with a laboratory experiment where all the variables are held constant.

Let's start by recognizing that the VER concerns international trade; it is not just a domestic market issue. This sounds like a truism, but the economic environment is different outside our borders and the differences *do* have an impact on determining which policies are in the long-run interest of the United States. Foreign governments, not the United States, set the rules for international trade, and they treat auto production as essential to their own domestic employment. As a result, they use various measures to restrict Japanese car exports to countries that account for 90 percent of car sales outside the United States. In other words, restraint is the norm for international trade in autos.

Within our borders, we conduct trade with a common currency. We don't have the yen, for example, which has become 30 percent cheaper relative to the dollar since 1980, thus creating a windfall advantage for producers in Japan and a windfall disadvantage for producers here. If U.S. producers move to countries whose currencies may be temporarily cheap, U.S. production and jobs are lost permanently.

Finally, the United States is running an enormous deficit in international trade and is borrowing huge amounts of capital to finance it. No one thinks this position sustainable, but it will not be corrected unless the chronic trade deficit with Japan is reduced considerably.

One consequence of these facts is that the situation is not as simple as economic models portray. Let's look at the arguments Bob Crandall has raised in his *Brookings Review* article and how

his conclusions compare with actual events.

First, let's examine the claim that consumers have paid a high price for restraint. The article used a theoretical economic model to predict what normally would have happened to average prices of new cars based on those components of market behavior that Bob identified and forecast. When he found a \$400 difference between what his model predicted prices would be and what prices actually were, the whole



John E. Barnes, Jr.: "If U.S. producers move to countries whose currencies may be temporarily cheap, U.S. production and jobs are lost permanently."

difference was ascribed to the VER. But this process—of projecting what will happen, then comparing the result with the actual event, then attributing it to VER—strikes me as very indirect and analytically risky. It requires the researcher to be omniscient about all the factors affecting market behavior and car prices. It is easy to overlook a major factor, thus producing misleading answers.

The second oil shock in 1979 drove up the sales mix of small cars; the long recession through 1982 discouraged sales of optional equipment. Both these factors reduced the average revenue of the fleet of new cars being sold, right at the beginning of the VER. Then, as the economy recovered, these factors did a U-turn: real gasoline prices declined and demand for mid-size and larger cars and equipment rose sharply, raising average car revenue considerably. This revenue change, however, did not represent a change in prices, car-for-

car, obviously. No one could have predicted the size of these swings, and I don't think the study should be faulted for that. But the analysis is obviously vulnerable to mistakes of this kind, and apparently the published data didn't indicate whether some of the residual might have been caused by some other factors—even after the evidence was clear that such factors had changed.

I suggest a more direct way to measure whether the VER has any significant effect on car prices: look what actually happened to the prices of U.S. cars that compete directly with Japanese models. Look at the prices of Japanese cars, both list prices and dealer markups. Look at the actual transaction prices of U.S. and imported cars and adjust for variations in such important factors as sales mix, so that the comparison can be car-for-car and based on real price changes. That is how the BLS [Bureau of Labor Statistics] publishes its price data.

If we do so, the following is evident: First, price increases for U.S. small cars competing directly with Japanese imports have averaged about 2.5 percent per year since early 1981. That is less than half the U.S. rate of inflation. List prices of Japanese (and unrestrained European) cars have gone up about 5 percent a year—still less than the U.S. inflation rate. Second, the markup dealers actually collect may have drifted up over this period, cumulatively by 2-3 percent in terms of sales value. Third, for a constant car (that is, the same sales mix of cars over time), average transaction prices of new domestic and import autos combined, including dealer markups, have increased about 4 percent a year—well under U.S. inflation.

Bob's next claim, widely quoted in the press, was that the VER has cost consumers \$160,000 for each job saved by shifting sales from a quantity of Japanese cars to a quantity of U.S. cars. The study takes a large price penalty, which doesn't really exist, and divides it by the number of estimated jobs involved in producing the additional U.S. cars. Bob admits he has underestimated the number of jobs created in the first place because he counted only a small fraction of the industry—the auto plants without the supplier plants. In addition, it is clear that the VER is the

principal reason why Japanese producers are investing about \$2 billion in this country to assemble more than 1 million cars and trucks here. Even though the vehicles produced are to have only 50 percent domestic content, the effect is still to double the number of American jobs attributable to the VER.

Therefore, if you add suppliers and parts jobs and jobs created by the Japanese assembly programs, Bob's estimate of 26,000 would grow to 100,000 or more. Four times the number of jobs divided by practically no price impact makes these jobs very inexpensive indeed. In fact, if you go on to recognize that the production of additional U.S. cars increases U.S. GNP by \$4 billion and U.S. tax revenue by \$1 billion a year, you can quickly see that there are substantial savings for each VER-created job.

The VER helped on the volume side by allowing U.S. factories and workers, and the U.S. economy, to capture the rebound in car demand that came with recovery from the recession. This volume improvement got a big boost from almost 50 new-model cars and trucks that U.S. producers introduced over the last four years.

But the fundamental profit improvement came on the cost side with major cuts in operating expenses and big increases in efficiency. You can see this in the large reductions in break-even volume that Wall Street analysts talk about in such glowing terms. In Ford's case, we've cut annual operating costs by more than \$4.5 billion a year and improved productivity by 35 percent on a constant-car basis, that is, hours per car. We also raised quality by 55 percent. That's a fact. We've proved it to the FTC. Without these actions, there would have been no profits at all.

At the same time, U.S. producers have made massive investments in new products, new plants, and new research and development. Almost \$60 billion since 1980—that's hardly slacking off.

Initially, these investments came on top of dismal profits; Ford, GM, and Chrysler saw \$25 billion in cash from operations flow right out the door between 1980 and 1982. When profits recovered in 1983 and 1984, the Big Three generated positive cashflow of about

\$5.5 billion a year. This is the number to keep your eye on, not the profits you read about.

We think the VER should be extended because the job it was meant to accomplish is not yet finished. The recession set back the sales recovery by two years, and the currency misalignment is worse than ever. Continuation would help the economy and would not harm the basic interests of most consumers. For one thing, more than 3 million Japanese cars and trucks will be available to U.S. consumers next year even if the VER is left unchanged—hardly a drought of product choice or a closed market. Second, U.S. consumers prosper when the U.S. economy is strong. The economy will not be strong if the enormous trade deficit is not reined in, especially that portion with Japan. Autos remain at the core of the trade deficit with Japan; so if the VER is ended and imports rise dramatically, how can we shrink that deficit, which doubled last year alone?

Of course, the VER is not the ideal solution. But when market fundamentals, like exchange rates, do not adjust to trade realities, second-best solutions are a practical means of maintaining a semblance of equilibrium until the underlying causes of our national trade problems are remedied.

Robert Crandall: The notion that exchange rates are volatile but that domestic currency values are not would be news to American farmers and others who have been betting on continued Democratic administrations and high inflation rates. The fact is that the unit of account, the medium of exchange, is frequently volatile in value. This is a situation that we will have to learn to live with. We may go back to fixed exchange rates, but not any time soon.

If we allow continued currency misalignment and enact trade restraint only for the politically powerful and the represented, we will get a terrible distortion of relative prices and will put further upward pressure on exchange rates.

As for the notion that somehow the auto industry massively rebuilt itself during this period, I gave figures that showed that there was in fact no massive increase in investment. The indus-

try always invests a lot because its capital stock depreciates very rapidly. The numbers always sound bigger because of inflation—but there is no net increase and no trend of increase.

As for the notion that product mix explains all the differences in prices, I rather doubt that. If you look at what has actually happened to individual list prices, the results show that in real terms prices have increased 13 percent-15 percent since the quotas—not less than inflation.

In any industry when new products are introduced, prices of older products—the ones dying off—are not increased as rapidly. The Chevette will not live forever. The price of the "state of the art" J-car is raised more than the price of the Chevette. The reason that Mr. Barnes can say that small-car prices have not risen is because he is looking only at four older small cars on the market. He hasn't looked at what happened to the new cars—those that did not exist before the quotas. What happened to their prices? That is BLS's problem. If the companies are phasing out their old cars and keeping the prices of those cars down, but are introducing new cars at higher prices for the same attributes, then prices are rising even though BLS cannot measure them. That is exactly what is going on.

It is true that more Japanese cars are now available here because they are beginning to be produced here. But the same can be said by an Australian today: "What is all this talk about protection? You can buy Japanese and American cars in Australia—they are produced here." But they cost 100 percent more there than the world price because they are inefficiently produced. It seems to me that what we want is an international division of labor and competitive pressure from outside our borders.

I wouldn't have been surprised if, without trade protection, U.S. prices had actually declined because of the competition. Those of you who bought a Honda Accord in the United States for around \$9,000 could have purchased it in Japan for about \$5,000. If the Accord had been priced here at, say, \$6,500 last year, would Ford's prices have been the same? How, then, is it possible to say that quotas have not raised U.S. car prices?

Conference (Cont. from p. 5)

price level and an end to the procyclical monetary policy that has afflicted the U.S. economy for so many years."

Jerry L. Jordan, senior vice president and economist for First Interstate Bank, discussed monetary policy as fiscal policy. Expanding on themes presented in an earlier paper by Karl Brunner of the University of Rochester, Jordan stated that Fed policy is a reflection of the budget decisions of the federal government: its primary purpose is to finance government spending. In terms of reforming the monetary regime, then, "reform of the fiscal regime is a necessary, but not a sufficient condition for reform of the monetary regime."

Georg Rich, a director of the Swiss National Bank (SNB), outlined the recent history of Swiss central bank policy with its emphasis on price stability. Said Rich, "Switzerland's success in maintaining a relatively low inflation rate is attributable to the fact that the SNB was one of the first central banks to adopt growth targets for the money stock."

A paper by Marc Miles, economist for H.C. Wainwright & Co., argued that monetary policy overemphasizes the role of the Federal Reserve. The Eurodollar money markets and other competing national currencies seri-



Warren Weber and Arthur Rolnick discuss their findings on free banking after presenting their paper.

ously dilute the effectiveness and impact of U.S. central bank decisions on the world market.

Anna Schwartz of the National Bureau of Economic Research sharply criticized Miles's paper, claiming that its economic arguments were weak and included misinterpretations of the financial markets and available empirical evidence. Miles responded that he is

proposing a new perspective and theory about monetary policy in a global environment.

Arthur J. Rolnick and Warren E. Weber, senior economists at the Federal Reserve Bank of Minneapolis, rounded off the conference by discussing the free banking era of the nineteenth century. The problems associated with free banking, they concluded, were not inherent in the system, "but were caused by real and presumably unavoidable shocks to the economy."

Among the other speakers were David Meiselman of Virginia Polytechnic Institute and State University, Paul Craig Roberts of the Center for Strategic and International Studies at Georgetown University, Lawrence White of New York University, Maxwell Newton of the *New York Post*, Phillip Cagan of Columbia University, and Richard Timberlake of the University of Georgia.

The two-day conference was covered by many newspapers and news agencies, including the *Wall Street Journal*, the *Christian Science Monitor*, *U.S. News and World Report*, the U.S. Information Agency, the Associated Press, and numerous financial newsletters. All the papers and comments presented at the conference will be published in the Fall 1985 issue of the *Cato Journal*. ■



William Poole, outgoing member of the Council of Economic Advisers, asks a question at luncheon session.

Bill Moyers on Defining Defense

CBS News correspondent Bill Moyers recently presented the following commentary on "CBS Morning News." He is discussing *Defining Defense: The 1985 Military Budget* by Earl Ravenal, published in 1984 by the Cato Institute.

"The beginning of wisdom is to become clear about our situation." I wish I'd said that first, but I didn't. The author of this little pamphlet said it. His name is Earl Ravenal. He's a scholar, former official of the Pentagon and a key man at the Cato Institute in Washington. That's a libertarian research foundation which asks questions conventional politicians can't.

Sometimes the answers are slipped over the public tansom to plop unexpectedly into the general conversation, and I think that'll be true of Mr. Ravenal's ideas. Whether you agree with him or not, you'll see the coming debate on defense spending in a different light if at least you entertain his analysis. There's no fog around his opinions, and the clarity of his language would please George Orwell. You'll recall that Orwell believed, "Whoever writes English is involved in a struggle that never lets up for a sentence. He's struggling against vagueness, against obscurity, against the worn-out phrases and dead metaphors with which the language is cluttered up."

No clutter here. Ravenal takes just 46 pages to argue a basic reappraisal of America's role in the world. Defense budgets, he says, are not for nothing. They're for something. The dollars buy forces, the forces have missions, the missions are in regions where the United States has defensive commitments or supposed strategic interests. These, in sum, are practically equivalent to the nation's foreign policy, and they're expensive. Consider the *Nimitz*-class nuclear carrier. The carrier and its battle group are servants of our foreign policy, the means by which we project our power to distant shores and seas. Ravenal reckons the lifetime costs for one of the battle groups to be approximately \$400 billion over 30 years. Four hundred billion, he says, "to increase our greatness as a nation by the capability to wage 35 attack sorties a



Bill Moyers

day, or to be fair, to patrol a few of the world's sea lanes."

This ratio between cost and pay off leads him to ask if our foreign policy isn't being priced out of reach, and to conclude that large cuts in the defense budget can be made only if there is a significant change in foreign policy. You don't need all the carrier groups if you don't attempt all the missions. But you can't retain the same foreign policies, and simply trim the means to carry them out. The so-called defense reform won't save much money—the idea that "leaner is tougher"—or eliminating waste, fraud and mismanagement, or killing this or that weapon.

These, he says, are at best transient savings. Solvency, our ability to do what we're obliged to do in full faith and credit, requires something more, including being honest with ourselves. Ravenal thinks we have reached the

predicament, through a long string of administrations Democratic and Republican, of living beyond our means. But our ambitions somehow have to be paid for, and they will be—through higher taxes or further cuts in domestic programs, or printing money, or borrowing in the ordinary credit markets. Any of these can be costly in other ways, including the frayed quality of private and public life.

Or, says Ravenal, we can find a foreign policy, a national strategy, appropriate to our economy, appropriate to our liberties, and appropriate to the character of American society. This will mean hard choices about what we want to do in the world, the alliances we make, the adversaries we challenge. His own bias is to reduce our defensive commitments and design a nuclear program to protect a far smaller perimeter shielding our core values. We should not just draw lines in the sand, he says. We'll always need a strategy that discourages direct nuclear attacks or the threat of nuclear blackmail. But enough is enough, says Earl Ravenal. An extensive, engaged foreign policy and a large active military require big, intrusive demanding government, the kind, he reminds us, that President Reagan told us in the first inaugural address "is the problem."

There's no free lunch and no free lease on the world. That's the trouble with dangerous ideas in little books. They first make you uncomfortable, then they make you think. ■

Cato Journal Examines Judiciary

Twenty scholars and policymakers examine the relationship between economic freedom and the courts in the Winter 1985 *Cato Journal*.

U.S. Circuit Court Judge Antonin Scalia and Richard Epstein of the University of Chicago, both possible Supreme Court appointees, disagree on the role the judicial system should play in the area of economic liberties.

Bernard Siegan, director of Law and Economic Studies at the University of

San Diego, argues that the Constitution protects economic as well as civil liberties.

The chairman of the Federal Trade Commission, James C. Miller III, discusses antitrust laws along with Robert Tollison, director of the Center for Study of Public Choice and former director of the FTC's Bureau of Economics.

The volume is available from the Cato Institute for \$5.00. ■

New Light on Free Banking

Free Banking in Britain, by Lawrence H. White (New York: Cambridge University Press, 1984), 176 pp., \$29.95.

After over 70 years of monetary experimentation with a central bank, it is clear that the American economy has been unable to avoid the recessions and depressions from which the founders of the Federal Reserve promised us relief. Still, defenders of the Fed tell us about the horrible days of the nineteenth century when the economy was even more cyclically unstable than it is now. If defenders of laissez-faire argue that nineteenth-century American banking was "decentralization without freedom," the Fed advocate claims that laissez-faire was a historical myth that has never existed and never can exist.

The publication of Lawrence White's *Free Banking in Britain* puts this debate in an entirely new light. White's book consists of a systematic examination of banking in nineteenth-century Scotland. During this period, Scotland had a system of financial institutions that were virtually completely unregulated, a legacy inherited from the early eighteenth century. White concludes that the Scottish experiment was a smashing success. Not only did the Scottish economy experience extremely rapid growth during the nineteenth century, but it also had very few bank failures or economic downturns. England, on the other hand, had both a strong central bank and serious economic fluctuations throughout the same period. Despite (or perhaps because of) the lender-of-last-resort function performed by the Bank of England, the British economy also had many times more bank failures, even on a per capita basis.

One particularly interesting feature of White's book is that he shows how nearly everyone at the time knew about the soundness of the Scottish banking system and considered it one of the major factors behind Scotland's rapid economic growth. Even socialists and advocates of central banking were unable to deny the virtues of Scottish free banking. Yet these testimonials are now almost completely unknown. Special privileges eventually prevailed and Scottish free banking ended in 1845. Not surprisingly, Scotland

soon lost her position as one of the fastest-growing nations in the world.

White's book also contains two chapters on the theory of free banking, as well as an examination of some of the debates over the Bank of England in the nineteenth century. However, for many readers the most interesting chapter will be the final one, "The Relevance of Free Banking Today." Here White discusses the possibility of free banking as a solution to our current "money muddle." While White does not think it is possible to draw any definitive conclusions from the Scottish experience, he feels that it certainly reflects favorably upon the notion of free banking as a current policy option. In fact, the more advanced an economy may be, the more difficult money management by a central authority may prove.

Free Banking in Britain is one of the most important books on money and banking written in the last half century. As laissez-faire starts to reenter monetary debates, policymakers would do well to examine the Scottish experience. White's book is clearly the best place to start.

Policy Report Reviews

Theory of Public Choice-II, ed. James Buchanan and Robert Tollison (Ann Arbor: University of Michigan Press, 1984), 453 pp., \$30.00/\$14.95.

For those seeking an introduction to modern theories of public choice, there is no better place to begin than with this volume, a sequel to the earlier *Theory of Public Choice* published in 1972. At the time it was written, the earlier work was the best available introduction to public choice theory. The immense progress of public choice theory over the last 13 years, however, has necessitated the present, updated collection of essays.

The current volume reprints many of the best and most important public choice essays from the last 15 years. Among the authors included are James Buchanan, Gordon Tullock, Robert

Tollison, Robert Ekelund, Dennis Mueller, and Richard Wagner. A contribution by Bruno Frey, one of the leading European representatives of the public choice movement, is also included. The book is divided into seven sections: "Introduction," "Public Choice, circa 1980," "Percent Contributions to Public Choice Theory and Methods," "Applications," "Empirical Public Choice," "Constitutional and Philosophical Issues," and "Future Directions and Prospects." As this list would indicate, the topics covered provide an overview of the entire public choice approach.

Perhaps the most frequently recurring theme in the book is the ability of models of self-interested behavior to shed light upon the political process. Just as economic actors pursue their self-interest in the marketplace by profit-maximization, so political actors attempt to profit- or utility-maximize in the political arena. Thus, politicians cannot simply be considered servants of the public good. This insight is the defining characteristic of the public choice approach. James Buchanan points out in one of his essays in the volume that public choice theory has constructed a theory of "government failure" that explains why government performance does not always meet (and sometimes is far beneath) our ideal standards of efficiency. This theory is intended to complement the standard microeconomic theory of "market failure," which explains why market performance is not always up to scratch. With public choice theory, however, efficiency judgments can now be made by comparing market performance with government performance, instead of simply comparing the market with some unapproachable ideal as economists have so often done in the past.

Nearly all of the essays in this volume are well-written and instructive, and a few require some technical knowledge of economic theory. Robert Tollison's introductory essay is especially valuable for its excellent overview of the public choice movement in America and throughout the world.

Rights and Regulation: Ethical, Political and Economic Issues, ed. Tibor Machan and M. Bruce Johnson. (San Francisco: Pacific Institute, 1983), 320 pp., \$35.00/\$11.95.

This volume is an excellent synthesis of the moral and economic critiques of economic regulation. While there are many economists who have studied the inefficiency of regulation (Peltzman, Brozen, etc.) and many philosophers who have written abstract moral critiques of government intervention (Nozick, Mack, etc.), these two points of view have rarely been integrated with or even confronted each other. Harvard political scientist Harvey Mansfield calls the book "a brilliant combination of economics and moral theory, with economics made to answer questions of value and ethics forced to face facts. The authors agree from many perspectives that true freedom needs the spice of risk and that our rights will not be safe until they are deregulated."

The papers in *Rights and Regulation* were originally given at a Pacific Institute conference designed to forge an interdisciplinary approach to the problem of deregulation. Conference participants included such leading scholars in the fields of economics, law, political science, and philosophy as Leland Yeager, Tibor Machan, M. Bruce Johnson, Rolf Sartorius, and J. Roger Lee. Most of the debate concerns the various arguments for and against government regulation of economic activity.

While most of the essays take a skeptical view toward the moral propriety of regulation, other views are presented as well. Some of the latest arguments for government intervention, such as intergenerational inequity and the "utility-enhancing case for paternalism," which is based upon new developments in choice theory, are well represented here.

Despite the worthy nature of the book's goal, its content is not completely satisfactory. One senses that the arguments for and against regulation would have been considerably strengthened had professional economists comprised a greater percentage of the volume's contributors. A number of economists, like Kenneth Arrow and James Buchanan, have demonstrated

expertise in the field of moral philosophy. As the volume stands, many of the non-economists utilize arguments from choice theory that are not nearly as strong as they could be. Nonetheless, *Rights and Regulation* still represents an excellent first step toward an interdisciplinary theory of regulation.

Regulating Consumer Product Safety, by W. Kip Viscusi (Washington: American Enterprise Institute, 1984), 116 pp., \$14.95/\$5.95.

When a federal agency is given the authority to eliminate what it sees as "unreasonable risks" associated with consumer products, one can be certain that the ultimate motivation for the agency's actions will be the personal desires of those at the agency in Washington. Also to be expected are systematic biases in the agency's actions for government intervention and against individual liberty, a necessary result of powerful federal agencies with vaguely stated guidelines. The guidelines are vaguely stated, we should note, not because too little care was taken in formulating them, but because the very objective of the agency is impossible. The government practitioner himself does not understand what he is doing.

W. Kip Viscusi's skeptical study of the Consumer Product Safety Commission does a fine job of researching the ways of this agency. With 11 case studies and much additional information he shows how the agency operates. Then, more importantly, he analyzes its behavior on the basis of systematic biases in its procedures.

For example: "The total number of accidents [involving the product under investigation] is the focus of analysis, not the value to society of the likely accident reduction." The deficiencies of this approach are that risk reduction is sought irrespective of costs and that the actual chance of accident is ignored because the frequency of harm per unit of time that the product is used is not considered. Another systematic bias is that "direct costs to firms of product modifications are included, but if a product is banned, the costs to the firm are set at zero. This procedure creates a bias toward fully comprehensive bans." This assumption of zero costs arising from a ban is obviously absurd. As Viscusi

points out, "if firms were in fact indifferent to providing the good [which zero costs to discontinuing that provision would imply], presumably most would not be in that line of business."

The CPSC assumes that when a product disappears from the market due to a ban or extensive regulation, there is no cost to consumers.

In assessing the value of its intervention, the CPSC makes a much more optimistic assumption of the effect its measures would have than history warrants. Viscusi shows statistically that safety regulation has had little effect on the frequency of accidents involving the regulated products. Viscusi discusses many other systematic biases in the CPSC, each one illustrated with the case studies.

This booklet does a fine job of showing how undesirable the existing system is, but fails on the fundamental question. The most important point to consider in any assessment of the CPSC is that there is no single or objective measure of risk even in the most controlled setting, much less in the area of product safety. There can be no rigorous basis on which the CPSC acts. The only thing left to govern its intervention in the private economy, then, is the random and momentary pressures of the powers involved.

Rather than call for the complete abolition of safety regulation, Viscusi hopes to put the safety program on a "more efficient basis" by shifting its function to the executive branch and by changing the evaluative procedures. He feels that subjecting product safety policies to the White House oversight process would assure more intelligent regulation. Viscusi suggests ways of making safety measures less ad hoc, for example, "establishing an explicit cost-benefit test" for all actions. Costs and benefits, however, like risk, elude any attempts at rigorous measurement. Again, it is the desires of the powerful that would reign, in this case through the rigged findings of supposedly objective tests.

There is hence an irony to Viscusi's study. If his alterations were instituted today, 15 years from now some think tank would likely publish a study pointing out the unsatisfactory nature of the arrangement and suggesting new political remedies. ■

"To be governed..."

Okay, that does it. No more laws. Ever.

Saying it isn't healthy for birds, a [Connecticut] state legislator has proposed a bill that would ban the traditional showering of newlyweds with uncooked rice at weddings.

—*Washington Post*, Feb. 13, 1985

We mean it. No more.

"There's been a lot of legislation that's been introduced that was thought to be frivolous, but it's law now," [says] Fred Williams, Missouri state legislator, defending his bill making it a crime to blow your nose in a loud or offensive manner in a restaurant.

—*Washington Post*, Jan. 3, 1985

Dubious Achievements Award

[Outgoing Treasury Secretary Donald] Regan listed among his achievements the fact that under his tenure he has raised more money in the financial markets than any other Treasury secretary.

—*Washington Post*, Feb. 2, 1985

Also State, Treasury, . . .

Mondale thanked the 35-member executive council for the [AFL-CIO's] early endorsement in 1983, and said later that he believes that he got a "bad rap" in being labeled a tool of labor. . . .

"I thought that was a bad rap," he told reporters as he hurriedly left a closed-door session. . . . "They never asked me for anything except for justice."

—*Washington Post*, Feb. 19, 1985

That's a chance we'll just have to take

Italy's Istituto per la Ricostruzione Industriale (Iri) . . . was started in the 1930s as Mussolini's last-gasp attempt to save his banking system. Fifty years on, Iri owns more than 600 companies in every corner of Italian business. . . .

When asked why Iri should not sell its holdings and return its companies to the private sector, one perplexed official replied, "But then there would be no Iri."

—*Economist*, Jan. 5, 1985

Finding just the right word

Projects in the Washington suburbs won several major appropriations from the [Virginia legislative appropriations] committee. . . .

"We made out like bandits," said Del. Robert E. Harris (R-Fairfax). . . . "But we have to be humble about it."

—*Washington Post*, Feb. 3, 1985

Thus reflecting the relative value of vice presidents and household cleansers

Proctor & Gamble, the people who make Mr. Clean, say their man is more recognizable than [Vice President George] Bush. . . .

The company's recent poll of shoppers found that 93 percent of them recognized Mr. Clean.

But the 60-year-old Mr. Bush, the company said, was identified by just 56 percent of those shoppers polled in a recent *People* magazine survey.

—*Washington Times*, Jan. 23, 1985

Oh, then you're only an authoritarian

The state of siege in Chile is different from those in other places, where all constitutional guarantees are canceled; here just some are canceled while others are restricted.

—Secretary-General Francisco Javier Cuadra of Chile, interviewed in the *Washington Times*, Jan. 24, 1985

Writing laws, no doubt

Prince George's [County] Del. [Albert] Wynn keeps dumbbells in his office.

—*Washington Post*, Feb. 15, 1985

Awash with money, the federal government seeks spending opportunities

New York ad man Harvey Kipnis has plotted marketing strategy for a hodgepodge of products. . . . None quite prepared him, however, for his current assignment—"repositioning food stamps in the marketplace." . . .

Mr. Kipnis hopes to produce public-service ads that will make the food-stamp program more appealing to the estimated 15 million eligible Americans who aren't applying for government assistance. "Food stamps have a stigma because they have been positioned as welfare in the consumer's [!] mind," says Mr. Kipnis. . . . "We have to change the image by positioning them like Social Security, as something people are entitled to receive."

—*Wall Street Journal*, Jan. 31, 1985

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