Readings
of particular interest

Regulating the Shirt off America's Back

Import Quotas on Textiles: The Welfare Effects of United States Restrictions on Hong Kong by Morris E. Morkre, Bureau of Economics, Federal Trade Commission, August 1984, 85 pp.

The U.S. government has restrained the import of textiles and apparel for more than twenty-five years, starting in 1957 with quotas on Japanese imports of manufactured cotton goods. Under an international pact known as the Multi-Fiber Agreement, successive administrations have negotiated a series of "voluntary" agreements establishing import quotas for each of many apparel-producing countries. As of 1980 these quota agreements covered imports of cotton, wool, and synthetic fiber products from two dozen countries.

According to this staff report from the Federal Trade Commission's Bureau of Economics, this quota system is costing consumers and the U.S. economy hundreds of millions of dollars a year. The study looks only at imports from Hong Kong because that colony was the largest foreign supplier of textiles to the United States in 1980 (accounting for 22 percent of total imports) and because adequate information on other countries was not available. The author of the study, Morris Morkre, estimates that for 1980 the social cost of quotas on nine apparel products imported from Hong Kong amounted to $308 million.

This cost breaks down into two components. First, the quotas distort consumption patterns. Consumers buy less apparel and more of other goods than would be optimal, and they buy different sorts of apparel. The report estimates the cost of this distortion at $90 million a year.

Consumers buy less apparel than they optimally would for a straightforward reason: the price rises above the cost of production. The shift among categories of apparel is less obvious. A quota on a type of garment—say, sweaters—applies to a garment whether it is plain or fancy, expensive or inexpensive. The quota will raise the price of each sweater by the same dollar figure, say five dollars, so that a $15 sweater will sell for $20 and a $65 sweater will sell for $70. This chokes off demand at the inexpensive end of the market and encourages exporters to shift their output toward more expensive lines of apparel. Similarly, Department of Commerce classifications combine adult with children's wear to make up quota categories (such as men's and boys' cotton trousers), so that exporters produce relatively more adult and less children's clothing. Low-income consumers and large families are harmed more than proportionately by these two effects.

The second and larger cost represents an income transfer from U.S. consumers to Hong Kong producers. The United States allows the government of Hong Kong to administer its textile exports to this country, doling out quotas among its producers. Hong Kong permits manufacturers to engage in open trading in quota rights, which provides an easy way to establish their value to producers. The author calculates their value at more than $218 million a year, with the figure fluctuating according to U.S. demand, Hong Kong production costs, and the level of the import quota. (Although the existence of a quota market is often maligned, and indeed banned in most of the exporting countries, such a market promotes productive efficiency by serving to redistribute quota rights from high-cost to low-cost suppliers, the author says.)

The U.S. government could recapture the value of the quotas from the Hong Kong firms by auctioning them off to the highest bidders. It could also achieve the same effect by imposing a tariff set at a level that produces the same volume of imports as the present policy. In

either case the monopoly profits from output restrictions would flow into the Treasury instead of foreign hands—although consumers would be no better off, and the annual $90 million consumption distortion cost would continue.

The major benefit usually claimed for the quotas consists of jobs preserved in domestic apparel factories and textile mills, both of which are labor-intensive industries. In 1980, there were more than 1.8 million production workers in those industries. The report estimates, however, that the quotas increased net domestic employment in that year by only 8,900 workers—which means that the social cost of the quotas amounted to $34,500 per job saved. This sum is over and above the annual wage earned by workers in these industries: $7,600 in apparel and $10,700 in textiles.

Another way to look at it is to estimate the adjustment cost for the 8,900 workers who would potentially be displaced by imports. From information about annual wages and duration of joblessness, the author estimates the social cost of this unemployment to be $16.8 million. Accordingly, the ratio of the benefits from removing the quotas to the adjustment costs is $308 million divided by $16.8 million, or eighteen to one.

This benefit-cost ratio is likely to be understated rather than overstated. The reason is that the report estimates the unemployment costs of lifting quotas on South Korea and Taiwan as well as Hong Kong, but estimates the benefits to consumers for the Hong Kong quotas only (data on the other two being lacking). Moreover, both benefits and costs apply to only one year, 1980. If future years were considered as well, the relationship between benefits and costs would be even more one-sided, since the costs of unemployment would end after the workers found new jobs, while the benefits of lower consumer prices would continue year after year.

Textile imports face high tariff rates as well as quotas. In 1980 the tariff rate on all apparel imports averaged 27 percent, compared with only 3 percent for imports generally. Although Morkre believes the tariffs impose substantial costs on consumers and the economy, he does not include these costs in the total, instead estimating the *additional* effects of the quotas. The current Multi-Fiber Agreement expires in 1986, but preparations are already under way for another round of negotiations to prolong import restrictions. Morkre estimates that if 1980 conditions continue to prevail and if future benefits are discounted at 10 percent a year, a highly conservative assumption, then the present value of the net benefit to the U.S. economy of abolishing the import quotas amounts to $3.08 billion.

The Market for Corporate Control: A New Overview

The Modern Corporation: Free Markets vs. Regulation by Nicholas Wolfson (Free Press–Macmillan, 1984), 191 pp.

Some half a century ago, in the famous book *The Modern Corporation and Private Property*, Adolph Berle and Gardiner Means advanced the theory of the separation of ownership from control in the modern corporation: that is, the split between the shareholders of the company and the group of officers and directors who control its day-to-day affairs. Because stockholders are numerous and poorly organized, Berle and Means thought, they are unable to exert genuine control over management.

This view of corporations as mini-states, accountable only to themselves, became immensely popular in later decades, and helped spawn an era of federal and state regulation. The federal Securities and Exchange Commission maintains various kinds of controls intended to defend what are thought to be vulnerable shareholder interests against management exploitation. Many aspects of corporate law have evolved on similar rationales. In this book, Nicholas Wolfson of the University of Connecticut School of Law argues that both theory and regulations were misguided. Recent developments in economic theory, he says, demonstrate that market forces are far more effective than was once thought in inducing corporate officers and directors to work for the interests of shareholders.

One of these developments is the refinement and increasing empirical validation of the "efficient-market hypothesis," which holds that stock prices quickly reflect developing events that affect a corporation. Research indicates

that management incompetence or dishonesty has an immediate negative impact on the price of the company's stock, and thus on its ability to raise funds for expansion.

The threat of takeover also serves to discipline corporate managements. Stock market prices are closely watched by takeover "raiders" who think they can manage a company's assets better than the incumbent management. Although such acquirers offer current shareholders a large premium over the market price of their stock, research suggests that there is no lasting harm to the stockholders of the "raider" itself—which implies that raiders manage the target corporation's assets better than the former management had done. More crucially, since a badly run corporation is a target for a hostile takeover, incumbent management has a powerful incentive to manage well.

The market for managerial talent itself provides another important form of discipline for corporate officers. Managers compete against each other by cultivating a reputation among their peers and supervisors for efficiency and honesty. The rewards for the winners of this competition include not only present compensation but also the offer of future jobs in other organizations.

Senior managers also tend to be financially interested in the success of their employers through ownership of stock and stock options. In fact, one study found that equity-based rewards to leading executives in fifty of the country's largest manufacturing corporations amounted to more than four times the after-tax income they received from other wages.

Wolfson critically examines longstanding doctrines of corporation law in light of this analysis. For example, he says, market constraints were believed to provide an insufficient incentive for "loyal" behavior by corporate directors. The traditional legal duty of directorial loyalty was meant to serve as a non-market legal constraint to achieve the same end. Perhaps because courts have defined the boundaries of this concept mostly as an expression of their visceral reaction to case-by-case controversies, it has proved extremely difficult to specify or explain.

The author also charges that the Securities and Exchange Commission, of which he is a former staffer, has attempted to override market forces to the detriment of shareholders. In particular, he questions the value and efficiency of the SEC's mandatory disclosure policies. Much of the agency's regulation, he claims, is simply a response to self-interested demand by lawyers; not only are lawyers in private practice a major lobby for new SEC regulation through national and state bar associations, but lawyers also dominate the SEC administrative staff.

One of the principal reforms suggested by the SEC staff, corporate lawyers, and reformers is the appointment of "independent" (nonmanagement) directors. Unfortunately for this view, Wolfson says, the economic literature indicates that the presence or absence of independent directors has no effect on the honesty or efficiency of corporations. In general, he says, nonmarket duties are largely of illusory value in restraining potential managerial misbehavior.

Wolfson concludes that the separation of ownership from control is not a vestige of original corporate sin, but a natural adaptation to economic circumstances. Shareholders, who have capital but not the desire or ability to manage, contract with specialists who lack capital but have the experience and knowledge to organize production. By overestimating the conflict of interest between owners and managers, he charges, the SEC staff and academic watchers of the corporation have created a false dilemma.

A Flaw in Health Care Reform?

"Hospital Readmissions in the Medicare Population" by Gerard F. Anderson and Earl P. Steinberg, in *New England Journal of Medicine,* vol. 311, no. 21 (November 11, 1984), pp. 1349-1353.

The federal government's new "prospective payment" system of Medicare reimbursement could inadvertently create incentives for hospitals and physicians to increase readmission rates, according to this report by Gerard Anderson and Earl Steinberg, both affiliated with Johns Hopkins University. That could lead to more premature hospital discharges and higher program costs, the authors warn.

Anderson and Steinberg examined data on readmissions in the Medicare program before

the prospective payment system was put into effect. They found that during the period from 1974 to 1978 more than 5 percent of Medicare patients discharged from acute care hospitals were readmitted within five days, 22.5 percent were readmitted within sixty days, and nearly half were readmitted within one year. The cost of these readmissions was quite substantial: the authors project that even if historical readmission rates remained unchanged, the cost of readmissions that occurred within sixty days of discharge may have exceeded $8 billion in 1984. (A readmission tends to cost about as much as the original hospital stay.)

Unfortunately, the authors say, the new prospective payment law could lead to an increase in readmission rates. Since the government pays one price for a given illness regardless of how long a patient stays, hospitals have an incentive to discharge patients as early as possible, even at the risk that a premature discharge will result in a subsequent readmission. Furthermore, the authors believe that the new system's method of measuring output—the diagnosis-related group—does not adequately adjust payments to cover patients with multiple problems. Consequently, they say, a hospital can obtain a financial gain (or at least avoid a financial loss) by "unbundling" multi-problem admissions into multiple admissions.

Both of these factors could increase Medicare reimbursement payments beyond what was originally projected. Although data are not yet available to test their hypothesis, Anderson and Steinberg have developed a benchmark for comparing past with future readmission rates so as to judge the extent of the problem.

Partly in response to such worries, Congress established official peer review organizations to scrutinize, among other things, physicians' decisions on admissions and discharges. These groups might be well advised to monitor readmissions, the authors say, arguing that "even a small decrease in the readmissions rate could result in substantial savings for the Medicare program." A 10-percent reduction in readmissions within sixty days, for example, would have saved $1 billion in 1984. The article identifies several characteristics of patients (such as the reason for Medicare eligibility and whether surgery was performed) and hospitals (such as the number of beds) that correlate with readmission rates. Further study of the characteristics of patients who are readmitted could be used to identify high-risk patient groups for whom increased outpatient supports and better discharge planning might prove to be cost-effective. Such techniques, the authors say, could be important to corporations, unions, health maintenance organizations, and other groups that are concerned with rising health care costs.

The "Misregulated" Networks: Constraint without Competition

Misregulating Television: Network Dominance and the FCC by Stanley M. Besen, Thomas G. Krattenmaker, A. Richard Metzger, Jr., and John R. Woodbury (Chicago, 1984), 202 pp.

Since the 1930s, the logic of economies of scale has made it likely, if not inevitable, that broadcasting stations will be linked together for the simultaneous transmission of the same programs. Today, the three major commercial television networks (ABC, CBS, and NBC) capture the vast majority of television viewers and, together with their affiliated stations, the lion's share of the revenues and profits of the television industry.

Almost from its inception, the Federal Communications Commission has been concerned about the dominance of broadcasting networks (or chains, as they are referred to in the Communications Act of 1934). In 1941, the commission adopted what are called the chain broadcasting rules to regulate the dealings between radio networks and their affiliated stations, and it later extended these rules to television networks. In the early 1970s it added regulations restricting television networks from acquiring a financial interest in programs produced by independent suppliers and limiting the amount of network programming that network affiliates may carry during the heaviest viewing hours.

The adoption of these rules has done little to reduce network dominance. In the late 1970s, each of the television networks supplied almost 100 hours of programming per week to its affiliates, and the stations broadcast more than 90 percent of the network programs made available to them. Moreover, both affiliates and pro-

gram suppliers complained that the payments they received for carrying or producing network programs were inadequate. In response, the FCC formed a network inquiry special staff to address these complaints and to determine whether new rules were needed to regulate the networks' relationships with affiliates and program suppliers.

This book is an outgrowth of the network inquiry. The authors, who were co-directors and members of the inquiry staff, conclude that past FCC regulation of the television networks has largely been misguided and ineffectual. Moreover, they contend, the problem of network dominance of television is largely of the commission's own making.

Misregulating Television argues that the preeminence of the three major networks is the product of two interrelated FCC policies. First, the current spectrum allocation plan for television, which the FCC adopted in 1952, provides for more than three VHF commercial licensees in only a limited number of markets. Thus, in many markets a fourth network would have no station with which to affiliate, while in others it would have to affiliate with a less attractive UHF station. As a result, the authors say, a fourth over-the-air advertiser-supported network has not developed, and is unlikely to do so, even though the three major networks and their affiliates earn profits that would seem substantial enough to provoke competitive entry in an ordinary industry.

Having made it unlikely that a similarly structured network would emerge to compete with ABC, CBS, and NBC, the FCC compounded the problem by restricting the development of new networks that might use other means of distribution or finance. Thus, during much of the period in which network dominance was a putative concern of the commission, the FCC was maintaining regulatory barriers to the creation of networks that use cable systems to distribute programs or that support themselves through direct viewer payments instead of advertising. It was not until the late 1970s, when strong deregulatory winds were blowing, that the commission removed the most important of these restrictions.

With network dominance thus entrenched, the FCC attempted to limit its effects by adopting a variety of rules designed to make it easier for other program sources to gain access to network-affiliated stations. The authors contend that because these regulations do not deal with the source of network power, they are likely to be at best ineffectual and at worst economically harmful. For example, in the 1940s the FCC issued a rule limiting the number of stations that a single entity could own. The networks responded by entering into an extensive pattern of affiliation agreements with individual stations. Then, after the commission adopted a rule preventing networks from acquiring options on affiliates' time, the networks changed the manner in which they compensated affiliates for carrying network programs, achieving results similar to those that the options were designed to achieve. When the FCC in turn moved to regulate these compensation arrangements, the networks responded by using other devices to encourage affiliates to carry their programs. Throughout these regulatory endeavors the amount of network programming carried by local affiliates continued to grow despite all the commission's attempts to reverse the process.

The authors are especially critical of the prime-time access rule, which bars the networks from filling more than three-and-a-half of the four prime-time evening hours. The rule, they say, confuses constraining the networks with helping the interests of the viewing public. Local stations frequently have to fill the extra half-hour with less attractive programming, and viewers are unlikely to be better off as a result. Another effect of the access rule may have been even more perverse. "The networks may actually have profited from this government-orchestrated joint schedule reduction," the authors write, "because it decreased the inventory of prime-time commercial minutes each had available for sale," in the same way as a cartel would have done.

In the early 1970s, the commission shifted its focus to dealings between the networks and their program suppliers by enacting the financial interest and syndication rules. These rules prevent the networks from acquiring an equity share in programs produced by independent suppliers and from acting as agents (syndicators) in the sale of network programs on a station-by-station basis after their network runs. One of the commission's major (and stated) objectives at the time was to improve the profits of independent program producers. The

theory was that if producers could make a lot of money selling programs first to the networks and later to stations in the syndication market, they could more often afford to start competing directly with the networks by producing first-run shows for local stations, bypassing the networks entirely.

There are two problems with this analysis, the authors say. First, the rules are unlikely to succeed in shifting profits from networks to program suppliers, since they do nothing to affect the source of whatever market power the networks possess: the fact that there are only three of them. Since networks can no longer acquire rights in independent programs, suppliers must bear more of the risk of program failure than they might otherwise choose to do. (If larger producers are better situated to handle risk than smaller producers, one effect may be to make the program supply industry more concentrated.) Moreover, since a network will place less value on programs when it cannot participate in the profits from their syndication, it will reduce the amount it pays the producer for a show's initial run.

Second, even assuming that the rules do affect the distribution of profits between networks and suppliers, there is no reason to believe that the public will get better viewing fare as a result. If first-run syndication is unprofitable when the profits from sales to networks and reruns are small, it will still be unprofitable when they are large.

The authors argue that networks will always be with us, but that their power to dominate television could be lessened by dismantling FCC barriers to competitive entry. In the last few years, the commission has begun to do that, they say. It has authorized new services such as direct satellite-to-home broadcasting and low-power television, and eased restrictions on over-the-air pay television service. It has eliminated virtually all its program restrictions on cable. And it has allocated more spectrum space to multipoint distribution services in order to promote the development of networks using that technology. In their concluding chapter, the authors set out a comprehensive plan of network regulation designed for an environment without artificial entry barriers in which viewer welfare is the FCC's principal criterion for assessing its rules.

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