Currents

Straws in the Wind

Regulation appears to have been relaunched into a headwind. A *single* issue of the *Washington Post* (3/3/90), for example, included articles on the following regulation, antitrust, and trade topics.

• A bipartisan congressional commission endorsed a proposal to provide comprehensive medical insurance and nursing home care. As in the current Massachusetts plan, all employers would be required to provide medical insurance for employees and dependants or to pay into a public plan to provide this insurance; this is estimated to cost employers about $20 billion a year. The only major disagreement in this commission concerned the failure to propose a plan to finance the additional federal cost, estimated at about $66 billion a year, of the other parts of this proposal.

• Securities and Exchange Commission Chairman Richard C. Breeden endorsed a bill broadening SEC regulation of brokerage firms to other financial activities within the same holding company, citing the bankruptcy of the Drexel Burnham Lambert Group as a case study in support of this bill. Breeden did not mention that no one other than the owners and creditors of Drexel appears to have been harmed by Drexel's failure.

• A California Superior Court judged ruled that the state's antitoxics law be extended to food, drugs, and cosmetics, which will roughly double the number of products covered by this voter-approved initiative. Under this law, manufacturers and retailers must either eliminate all ingredients that may cause birth defects or cancer or label such products as hazardous, even if these products cause no discernible health risks to humans.

• The Department of Transportation ordered airlines to provide a range of special equipment and services to disabled passengers, including wheelchair access to lavatories and free travel for any required attendant.

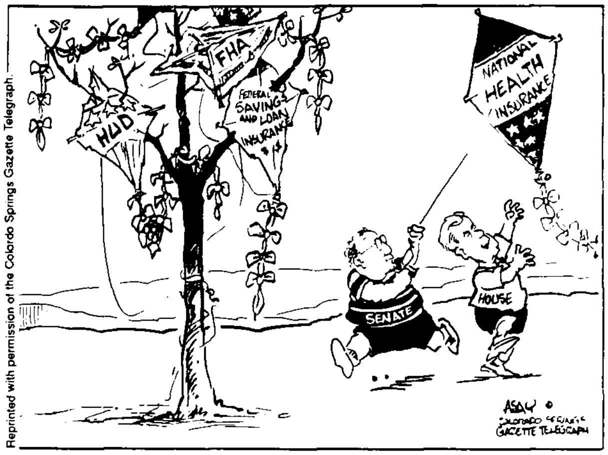
• A federal court in North Carolina ordered the Brown and Williamson Tobacco Corporation to pay $148.8 million in damages to the Liggett Group, based on a finding that Brown and Williamson sold cigarettes at a lower price than that of Liggett's own discount brands.

• And President Bush, playing the good cop to Congress' bad cop routine on trade policy, leaned on Japanese Prime Minister Toshihi Kaifu to change a number of Japanese domestic government and business practices, even though these practices are consistent with international trade rules and similar to practices in the corresponding industries in the United States. Meanwhile, Congress, in a renewed outburst of mercantilist machoism, threatened to make U.S. sanctions mandatory if the Japanese and other nations do not acquiesce to such U.S. pressure.

All in all, this was a pretty good day for those who believe that the government knows best how to run our economy and even that of other nations.

A more disturbing signal of the outlook for regulation during the Bush administration has been the emasculation of the Office of Information and Regulatory Affairs in the Office of Management and Budget. This office had been the primary check on regulatory excesses during the Reagan administration and was strongly supported by then Vice President Bush. The administrator of this office resigned last summer, and no political official has yet to be appointed to head this office. The reduced status of this office was reinforced by a number of subsequent events.

• On December 20, 1989, the Environmental Protection Agency issued a ruling that all municipal waste combusters must recycle at least 25 percent of all waste, over the objection of both OIRA and a White House Counsel. This rule will increase both the use of replacement fuels and the amount of waste deposited in landfills, thereby substantially increasing municipal expenditures without any net beneficial environmental effect—all of which was identified by the OIRA review last fall.



Reprinted with permission of the Colorado Springs Gazette Telegraph.

- On February 21, 1990, the Supreme Court ruled that the Paperwork Reduction Act of 1980 did not permit OIRA to overrule agency requirements to disclose information on food ingredients and hazardous chemicals.

- And the paperwork continues to accumulate. One example that will go from the Government Printing Office to landfills in record time is the recent report by the Department of Energy on the environmental impact of alternative siting of the new superconducting supercollider. This report, all 23 volumes and 8,000 pages, was mailed to 17,000 recipients, including those who had merely signed letters endorsing the siting of the supercollider in their district.

The White House regulatory review process, initiated in the Ford administration and strengthened in both the Carter and Reagan administrations, has been seriously weakened. This process was designed to serve a parallel role to the presidential budget process—to identify and discipline federal measures that impose significant costs on the economy. One might hope that President Bush would recognize and support a process that was one of his major contributions as Vice President.

According to Greek legend, Cassandra, a daughter of the King of Troy, was given the gift of prophecy by Apollo, who later, however, decreed that no one believe her. The editors of *Regulation* have no wish to be contemporary Cassandras. We dearly hope that our pessimistic outlook on the prospect for U.S. regulation in an increasingly competitive world will prove to be mistaken. But that will only happen if others recognize both the benefits and costs of these measures and act to discipline the political process that generates these measures.

W.N.

Europeanizing the American Economy

Most European workers enjoy benefits not broadly available to their American counterparts. Though specific labor market regulations vary across countries, a list of common European benefits might include a higher minimum wage than in the United States, mandatory employer-paid medical insurance, plant-closing notice and severance pay requirements, paid parental leave, more generous paid holidays and vacations, and requirements that private employers hire a specific proportion of disabled workers. The differences in the regulation of U.S. and European labor market conditions have not escaped notice in this country. Advocates of additional mandated employment benefits in the United States—medical insurance, pension rules, plant closing laws, and accommodations for the disabled, which this issue of *Regulation* examines—often point to the "more civilized" approach taken in Europe. Before we rush to embrace the European model of labor contract regulation, however, it is important that we take stock of all the differences that exist between the American and European labor markets.

Of particular note over the past decade has been the dramatic divergence between the United States and Western Europe in unemployment and job creation. While the American market has flourished since the mid-1980s, many European economies have stagnated. In 1989 the unemployment rate in the United States was 5.2 percent. For the European Community as a whole, the unemployment rate was 9.5 percent. Specifically, in West Germany the unemployment rate was 7.3 percent, in Italy it was 12.0 percent, in France 9.5 percent, in the Netherlands 7.6 percent, and in the United Kingdom 6.5 percent.

Even more startling is a comparison of the number of new jobs created in the United States and Western Europe. From 1980 to 1988 the U.S. economy created 15.7 million net new civilian jobs. Despite their larger population, the economies of the European Community created just under 4 million net new civilian jobs during the same period. In the United States civilian employment increased by 15.8 percent. Our closest competitor among the six major European countries was the Netherlands, where civilian employment increased by 7.4 percent over the same period. In France civilian employment declined slightly, and in the European Community as a whole, the number of individuals employed in nongovernment positions increased by only 3.2 percent.

Nor is this job growth in the United States only a phenomenon of the Reagan years. From 1973 to 1988 the U.S. economy added 29.9 million new civilian jobs to increase the number of individuals employed in the private sector by 35.2 percent. Over this same period the European Community added 5.6 million net new civilian jobs for a 4.6 percent increase in total private-sector employment. This period is particularly important, of course, because it marked an era during which the postwar baby boom was being absorbed into the work force with women entering the job market in record numbers. Thus, it is also useful to compare how women have fared in the United States relative to the European countries.

In the Winter 1989 *Journal of Labor Research*, Department of Labor analysts Ronald E. Kutscher and Constance E. Sorrentino reported that the employment of American women rose by 50 percent from 1973 to 1986. During the same period, the employment of women in the six major European countries rose by just 13 percent. Kutscher and Sorrentino went on to note that over half of working-age women are now employed in the United States. Only Scandinavian women have higher work-force participation rates. The economic activity of women in Europe is rising but at a much slower rate than the increase in activity among American women. Only 30 percent of Italian and Dutch women work outside the home, while only 40 percent of French and German women hold jobs.

Why is it that the Europeans have failed to match the labor market performance of the United States? According to Gottfried Haberler of the American Enterprise Institute, "The microeconomic classical interpretation regards the high European unemployment as structural and spotty due to inflexibilities, rigidities, and immobilities, especially in the labor market."

In other words, the extent to which European countries have specified the benefits that must be provided by employers has increased the cost of hiring—and of firing or laying off—European workers. The minimum wage plus the cost of providing the required benefit package establishes a floor under effective wage rates. If that floor is above the market-clearing wage rate, some would-be workers will be involuntarily unemployed. Looked at another way, as the cost of the total required compensation package has become increasingly large relative to the portion of the money wages over which employers and employees have control, both employers and workers have found themselves locked into an ever-more rigid system. Neither side can offer to make adjustments that might mitigate the impact on employment of an economic downturn. Nor will employers rush to rehire laid-off workers when conditions seem to improve; the costs of a mistake are just too high. As a result, there is a lower level of total private employment in Europe than in the United States, and Europeans who are laid off tend to stay unemployed longer than Americans who lose their jobs.

Nor does the cost of a relatively high total compensation floor fall equally on all sectors of the economy. There are a multitude of labor markets within any one economy, even within a single firm. Each "market" has a different equilibrium wage depending on the skills or requirements of potential employees and the specific needs of each employer.

The larger the percentage of an individual employee's total compensation package that is accounted for by required compensation, the more likely it is that he will pay for benefits with unemployment—particularly during recessions. In a regime with extensive mandated benefits, high school dropouts are more likely to find themselves unemployed than are college graduates. Similarly women, especially less-skilled women, will more often find themselves out of work in the presence of government-mandated parental leave (even unpaid leave) than in its absence.

In their article Kutscher and Sorrentino also observed: "Employers with fewer restrictions are more willing to hire workers and are particularly less concerned with the specific education, training, or other credentials needed for a given job." This not only leads to greater upward mobility in a labor market marked by greater flexibility, but also opens more ground-level doors for the unskilled. Employers who are not burdened by a host of mandated labor costs will be more willing to provide on-the-job training and take a chance on untried employees. Increasing the costs of employment would concomitantly reduce the opportunities available to those who have not proved themselves with adequate schooling or past employment experience.

Finally, with respect to the costs of mandated benefits faced by individual workers, advocates of change should remember that the increased unemployment rates caused by enacting a host of mandated benefits will also make it easier for employers who are so inclined to discriminate against women or minorities. The greater the number of people applying for a job opening, the easier it is to hire a qualified employee with characteristics consistent with the employer's prejudices. And as Richard Burkhauser notes in his article on benefits for the disabled, even government requirements that employers hire members of disadvantaged groups are not always adequate protection.

But more strictly regulating employment contracts would not only affect employment prospects for individuals, it would also change the structure of the U.S. economy by influencing the mix of firms that survive. The costs of labor contract regulations fall disproportionately on small businesses, a fact that is not lost on larger U.S. firms that already provide their workers with many of these benefits. It is not surprising, then, as Simon Rottenburg points out in his article on mandated medical insurance, that some large U.S. firms are acquiescing to, if not encouraging, strictly legislated standards in this area. After all, making life more difficult for entrepreneurial companies would relieve large corporations of the need to remain innovative and cost-efficient. Life would no doubt have been more serene for IBM executives if Apple had been unable to get off the ground because of expensive, inflexible labor compensation rules. This in itself should give pause to individuals concerned about the overall welfare of consumers and workers.

Upstart companies not only add to the quality of life in the United States through the products and services they provide. They also contribute the lion's share of the new jobs created each year. From 1980 to 1987, for example, the number of individuals employed by the Fortune 500 declined by 3.1 million, but the rest of the private sector added 16 million jobs, and the vast majority of these were in firms with fewer than 100 employees. During the late 1980s, approximately 1.3 million new enterprises were started each year. And though 8 to 10 percent of U.S. corporations are closed or absorbed each year, David L. Birch from the Massachusetts Institute of Technology reported in the Winter 1989 *Journal of Labor Research* that recent data show that the odds of holding the same job from one year to the next are actually higher with smaller companies than with the corporate giants.

Increasing the costs and reducing the flexibility of the most dynamic of our firms cannot help but reduce the rate of job creation in the United States. This will lead to a larger portion of the workforce without any benefits, not even the benefit of a job and a paycheck.

If our goal is to provide all segments of the U.S. labor force with opportunities to work and advance, then there is no doubt that increasing rather than reducing the flexibility of employers and employees in the labor market is the right course. Only a select group of U.S. citizens will gain from any attempt to emulate the Europeans, and those who gain will come disproportionately from already advantaged groups.

But before leaving this subject, it is worthwhile to note that tremendous changes are afoot in the United States and throughout the world. The baby boom generation is now at work, and employers everywhere are beginning to look for new employees among the "birth dearth" generation. As *The Economist* noted in its January 6, 1990, issue, during the 1990s and into the early 21st century, the pressure will shift increasingly to employers to find ways to attract and retain qualified staff. Rather than having several qualified applicants line up for each job, several firms are likely to line up for each applicant.

As a result, many of the changes that advocates of mandated benefits seek will begin to appear voluntarily as "the shortage of younger workers will mean that companies in America, Japan, and Europe will have to find new ways to attract, develop, motivate, reward, and retain employees." Companies are expected to reach out increasingly to nonworking mothers and the elderly. It is expected there will be more attention to on-the-job training and subsidized schooling as well as benefits that enhance the quality of life for employees. Not everyone will benefit to the same degree from these changes, but to ensure that such benefits are as widespread as possible, we should oil, not hobble, the American job machine. We should think twice before Europeanizing the American economy.

C.E.

An Elegy to the Barbarians

A short history of the 1980s according to lots of people: greedy yuppies ravaged fine old companies and finally got their come-uppance with the collapse of Drexel Burnham Lambert, the junk bond specialists that fueled the takeover boom. Phil Donahue captured the feelings of many when he told a group of former Drexel employees: "You not only were arrogant, you were snobbish, and in lots of ways, very impolite and mean. . . . Nobody likes you. You're Wall Street yuppies and you've got a bad image. . . . I mean you are mostly white, mostly Northeastern, Yale, Harvard types. You are mostly Republican. You were raised in Connecticut. You never ride the subway. So who gives a damn about you guys?"

The same accepted wisdom views the RJR-Nabisco takeover by the leveraged buyout specialists Kohlberg Kravis Roberts & Co. as the low point in the takeover wars. A best-seller about this transaction, Bryan Burrough and John Helyar's *Barbarians at the Gate*, gives us a chance to evaluate this wisdom.

As they indicate in the title, Burrough and Helyar emphasize the unsavory aspects of the characters who battled for control of RJR. They are all guilty of some combination of unbridled egomania, greed, mendacity, and even bad manners. Many who read this book will undoubtedly come away with the feeling that it is about time the takeover game ended, just to get bums like this out of the way. It is time to get back to doing business the old-fashioned, genteel way.

As it turns out, you really cannot tell the bad guys by who rides the subway. In fact, we may someday see RJR-Nabisco as the takeover game's finest hour. Now that takeovers are being regulated out of existence, this transaction provides an opportunity to look wistfully at what we shall be missing.

The RJR-Nabisco takeover, as told by Burrough and Helyar, begins with Ross Johnson, RJR-Nabisco's CEO. Johnson had the good life as the chief executive of a publicly traded company with plenty of cash and not much debt. Think of the things he could do with the cash. He could have flashy golf tournaments and keep a bevy of glamorous athletes on the payroll at up to a quarter million dollars each. He could keep a fleet of corporate jets dubbed the "RJR Air Force" with a glitzy $12 million private hangar in Atlanta. (Once one of these jets was enlisted to fly a passenger listed on the manifold as "G. Shepherd," a.k.a. Johnson's dog Rocco, safely out of Palm Springs after he bit a security guard.) He could have lavishly decorated headquarters. After all, cigarettes and brand names generate so much cash that, as Johnson reportedly said, "A few million dollars are lost in the sands of time."

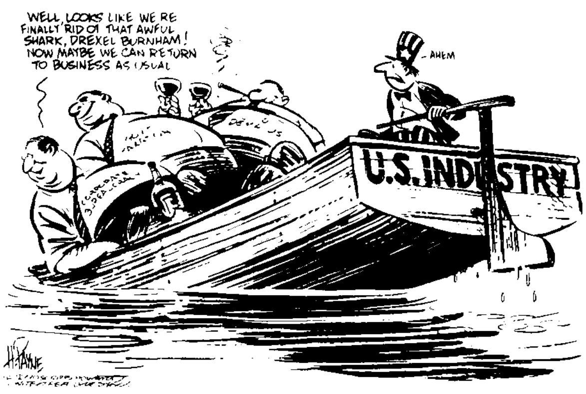
One might wonder how Johnson got away with all this. Part of it was that he was not a bad manager. He also knew how to use his control over corporate cash to take care of board members. Some got rich consulting contracts. One got his bank a contract for servicing RJR-Nabisco shareholders. Another got a chair at Duke endowed in her name.

Not surprisingly, Johnson did not leap at early suggestions that the company do a leveraged buyout. "For all his free-spending ways," note Burrough and Helyar, "the fact was Johnson remained a prude about corporate debt, the core of any LBO. . . . Banks didn't understand the need for golf tournaments and corporate jets. They cramped his style." More to the point, Johnson would not have so much cash around after an LBO because he would have to make regular principal and interest payments, and the banks might demand covenants specifying what the company was supposed to do with whatever cash it had. And any substantial investor in an LBO would certainly want some say in management. As Burrough and Helyar observe, "Johnson wasn't interested in working for anyone other than himself." Most of us would sympathize with that sentiment.

Johnson ultimately went along with the idea of an LBO because he believed that RJR-Nabisco stock was "underpriced" compared with companies such as Philip Morris. Maybe Johnson was genuinely interested in shareholder value. Or maybe the stock price made him nervous because he saw the writing on the wall. The takeover market would not ignore forever the opportunity for a profit in RJR. Best if Johnson got the idea first.

The original buyout bid was $75 per share, for a total of $17 billion. Johnson initially objected to a higher price because that would require more debt, less free cash, and more belt-tightening. Burrough and Helyar describe Johnson as "a man with absolutely no stomach for cost cutting, certainly not if it meant cutting back the RJR Air Force or other perks." They quote him as saying "I don't want my life-style to change. I've got a great company, a nice life, I don't want to change the way I live."

Under the management agreement advanced in connection with Johnson's original LBO proposal, he got the buyout manager to cede to Johnson a veto power over major strategic decisions. He said, "For Christ's sake, I'm not going to have a bunch of bloody investment bankers on my board telling me what I can do and what I can't do."



Reprinted with permission of UFS, Inc.

Johnson and six other managers would also get up to 18.5 percent of the equity at no cost if the postbuyout company met incentive objectives.

Then began the auction for RJR-Nabisco. It was an auction Johnson's group seemed sure to win. To fund a deal of this size, Shearson Lehman lined up what it thought was all of the bank financing in the world available for a single deal. The negotiating committee of the board was hand-picked by Johnson. And any competing bidder would start out well behind the eight ball in trying to get information from insiders (who suffered from "collective memory loss" when talking to KKR people) and securing their agreement to cooperate with the takeover.

Nevertheless, Kohlberg Kravis won the auction with a bid of $109, almost 50 percent more than Johnson's original bid. This enormous increase in price suggests that Johnson had tried to steal the company. KKR prevented the theft for one simple reason: they got junk bond financing arranged by Drexel. This much debt could be serviced only by taking tight control of the company. There would be no veto power for incumbent management. Most of the jets were sold, the expensive athletes were released, and corporate apartments were sold. (The airplane hangar proved to be unsaleable.) Premier, a $300 million smokeless cigarette that could not be lit with a match, was buried.

What is the moral of this story? One possible view, seemingly the popular one right now, is that takeovers are bad. This takeover unsettled thousands of employees and creditors and left Winston-Salem bereft of a major corporate benefactor. Driven by Henry Kravis' tremendous ego, KKR ran up the bidding to the point that RJR-Nabisco has become dangerously leveraged. So the law should step in and make takeovers more difficult.

Indeed, the law has done just that. Drexel, the major market-maker for junk bonds, is now gone. The ultimate cause of its demise is still in doubt, but the firm was not helped when it was forced to either pay a $650 million fine or face virtually certain shutdown under RICO. In addition, it is not likely in the current regulatory environment that any firm will commit the resources necessary to build a junk bond juggernaut comparable to Drexel's. Banking regulators have reduced banks' abilities to finance takeovers with loans, and the savings and loan bailout has forced thrifts out of the junk bond market. (Deposit insurance and other misguided regulation may have caused these problems, but junk bonds are what regulators chose to fix.) Finally, state antitakeover statutes have proliferated and become stronger.

Even more antitakeover regulation looms. A statute passed in Pennsylvania virtually bans hostile tender offers. U.S. Sen. Terry Sanford, in cosponsoring a bill that would limit the ability of banks and pension funds to invest in LBOs, vowed to "keep other communities from suffering from the 'Barbarians at the Gate.' "

The recent Time-Warner combination provides a good example of the effects of the new takeover landscape. Here the takeover battle was begun when the Time board resolved to merge Time and Warner. The exchange ratio of Time stock for Warner stock included a hefty premium for Warner. Just as the shareholders were asked to vote on the transaction, Paramount made a takeover bid for Time at a price significantly above both the current trading price of Time and the likely per-share price of Time-Warner.

The Paramount bid understandably made Time's directors nervous. So the Time board simply restructured the Warner transaction into a two-step tender offer by Time for Warner that did not require a vote by Time's shareholders. This transaction was designed to be completed before Paramount would have a chance to acquire Time. In other words, the Time board made sure that Time's shareholders would not have the opportunity to choose between the Warner merger and Paramount's cash bid.

It is at this point that we see the effect of the new takeover landscape. If Time was better off without the combination, or better off combined with somebody else like Paramount (as indicated by the price of Paramount's bid), it was technically not too late for Paramount or somebody else to make a bid for the combined company (which had about the same value as RJR-Nabisco), sell off one of the pieces, and maybe toss out the executives who thought up this transaction. True, it would have been too late for the Time shareholders whose money was already in the Warner shareholders' pockets. But at least the final result would have been a stronger company. And the simple fear of this potential market discipline might have prevented the Time-Warner transaction in the first place.

But the regulators had seen to it that potential sources of financing for takeovers were in sufficient disarray that financing could not be found for another transaction the size of RJR-Nabisco. In short, the Time board had nothing to fear. Nobody could make a bid for the combined company.

And now the Time-Warner transaction itself has spawned a new threat to the viability of takeovers. Paramount sued to block Time's restructuring of the Warner transaction from a merger to a tender offer. The Delaware Supreme Court could have upheld the transaction on the narrow ground that the Time board was technically within its rights to continue with a corporate acquisition. Instead, the Court left the distinct impression that it would allow boards of directors of target companies to take even stronger actions to preclude the shareholders from having the last word. For example, a board may now be able to leave a strong "poison pill" in place, precluding any bid for the company.

This means a bleak future for takeovers. True, something of the board's fiduciary duties to shareholders survives in the new takeover landscape. If management proposes a buyout, it still must open the bidding. But who can now get into a highly risky bidding war with incumbent management? And more important, management does not have any pressing need to start any auctions for the company. Why should a low stock price make managers nervous? Even if a hostile bidder does try to start something, and even if the bidder is able, despite everything, to obtain financing, managers may be able to crouch behind an impregnable legal fortress.

So gentility has returned, for now, to the corporate world. The greedy egomaniacs are in retreat. We are left with selfless managers who think only of their shareholders and the good of society. Or so many people seem to believe.

Larry E. Ribstein
George Mason University
School of Law

Good Enough for Government Work: Why *Moving America* Is Unsatisfactory

Moving America: New Directions, New Opportunities, Secretary Samuel K. Skinner's Statement of National Transportation Policy, is a typical government document. Prepared by a committee, vetted through an interagency process designed to remove anything controversial, it is replete with such *bold* statements as: "Nothing is more important to the American people than their safety and security, and the security of the Nation." "The environment and the quality of life are important to Americans." "The Federal Government sets a standard for fiscal responsibility [sic]." "It is Federal transportation policy to spend transportation trust fund balances over time in a fiscally responsible way."

Bromides such as these would have their place if they had content, were believable, or led to important policy proposals, but the policies actually proposed are half-hearted. The recommendations are tame and consistent with the conventional Washington policy mind set. What is finally most disappointing about this tract is not what it says but what it leaves out.

According to Secretary Skinner, this document was needed because "it is time to take a new look at our transportation policies, to take stock of what those policies are doing well and poorly, and to set a course that will ensure we have a transportation system that supports our national goals for the future."

Notwithstanding those sentiments, the policy statement pays little attention to those policies that have worked well, such as airline deregulation, nor does it devote much space to those policies that are doing poorly. For example, if the department were to be honest about policies that were functioning poorly, *Moving America* would have analyzed FAA operations and made recommendations.

Policy Proposals

Moving America contains a number of worthwhile proposals, but they will take political pressure to implement. In particular, the report emphasizes peak-load pricing, user charges, reduced spending on mass transit, airport passenger charges, reforming railroad labor legislation, eliminating subsidies for Amtrak, limited reform of merchant marine subsidies, and abolishing the remaining regulations on trucking.

Peak Pricing. The policy paper does recommend that prices be used to reduce congestion. Peak-load pricing would help alleviate traffic jams by inducing the public to travel at less busy periods. The proposal is vague, however, and appears to refer to auto traffic, although peak load pricing could also have a major role to play in rationing scarce landing and takeoff rights at crowded airports. Except for three brief references to using the pricing mechanism to control congestion, the report provides no specifics or examples.

Peak pricing of landing charges would help alleviate congestion at many busy airports. At the end of the Reagan administration, the Department of Transportation charged that levying higher rates during congested periods at Logan Airport was discriminatory and was prohibited. If the report had repudiated that position or, at a minimum, had specified that peak charging for landing fees was appropriate, the issue would have been clarified. Instead, a useful opportunity was wasted.

In fact, *Moving America* includes a puzzling ambiguity about peak pricing. One section calls for "greater attention to . . . peak period or congestion pricing;" another part simply suggests that "research is . . . needed on . . . the effective use of pricing mechanisms to manage demand;" a third section asserts that "the Department will encourage pricing . . . for all modes where there is system congestion."

User Fees. In two other useful but brief sections, the Department of Transportation vows that the government will rely more heavily on user charges. The emphasis in these few sentences is primarily on the revenue aspects of user fees, probably reflecting the insistence of the Office of Management and Budget on including such revenue devices in the report. In addition to raising revenues, user fees have other benefits. Charging for a service, such as using air traffic controllers, rations the demand for the service to those who find that its value exceeds the cost. When a service is provided without charge, consumers will use the service excessively.

In a section dealing with aviation legislation, the department claims that it "will recover a higher portion of program costs from user fees and increase the size of Federal aviation programs." That sentence comes as close as the report gets to discussing the issue of proper payments by general aviation. General aviation receives significant benefits from the air traffic control system and from federal aviation expenditures without paying anything close to the costs it imposes on the system. But general aviation has had strong political support on Capitol Hill and has managed to fend off attempts to impose user charges. By neglecting to mention the subject, this report contributes to the impression that general aviation will continue to benefit from the system without having to pay adequately for it. Not only does the present system impose a cost on taxpayers and other users, but it results in private pilots' overutilizing the system since they do not have to pay the full cost.

An important innovation, although it has received only poorly thought-out criticism, is the proposal to allow greater use of toll financing on federal-aid highways. Again charging for the use of highways not only makes budgetary sense but also rations the use to those who value driving the highway more than the cost of the toll. If imposed, tolls would reduce congestion and provide funds for maintenance and construction.

Reduced Federal Subsidies. The report recommends reduced federal subsidies for mass transit, Amtrak, and the merchant marine. Urban mass transit systems are inherently a local issue. There never has been an adequate justification for federal aid to mass transit. Any benefits from a mass transit system go to the residents of the community.

Moreover, federal aid has tended to foster the construction of inefficient, wasteful projects. *Moving America* recognizes this failing when it claims that federal aid "has encouraged the construction of new rapid rail systems and discouraged investment in more cost-effective alternatives." Moreover, the report admits that "the results of [investment in new rapid rail systems] were often disappointing." This is undoubtedly an understatement. Ridership has been almost universally less than forecast and has been inadequate to pay the capital costs or even cover the operating expenses in most cases. Taxpayers, either federal or local, have normally been forced to pay for these systems.

While *Moving America* stresses the need to save energy and implies that mass transit would be useful in that regard, it fails to take into account the energy cost of constructing fixed rail systems.

It often takes more energy to build the system than will ever be saved by riders' shifting to mass transit from cars or other modes of public transportation.

The Department of Transportation's policy document has wisely called for reducing operating assistance for mass transit. A more forthright approach would be to abolish such assistance entirely; but, as is typical in this report, a timid proposal is put forward rather than the bold and more appropriate recommendation.

The Department of Transportation also urges that Amtrak's subsidy be eliminated. Virtually all of the Reagan administration's budgets also recommended zero funding for Amtrak but without success. Amtrak has, however, made progress in reducing its need for a subsidy and is close to being able to operate without any federal taxpayer aid. In the Northeast corridor it is likely that Amtrak could cover its costs if it were freed from railroad labor legislation that restricts its ability to keep expenses under control.

While Secretary Skinner has the political courage to call for the abolition of Amtrak subsidies, he is less courageous in dealing with water-borne commerce. This policy document simply asserts that "subsidy programs for the U.S. merchant marine must be re-examined" and that the operating differential subsidy should be reviewed and restructured. Given the timid nature of the DOT document, it is scarcely surprising that it should take such a weak position.

Since there is no economic justification for this subsidy, these programs are normally rationalized on the basis of national security. In reality, however, any national security rationale is specious. Should a national emergency arise, merchant shipping could be expanded rapidly. For example, in the first three years of World War II, the U.S. multiplied over thirty-one times the output of U.S. shipyards, from 53 new merchant ships in 1940 to 1,661 in 1943.

The Department was somewhat more forthright in recommending that U.S. operators in foreign trade be permitted to acquire vessels from foreign shipyards. The requirement that U.S. flag vessels be built in U.S. yards is simply protectionist and imposes serious competitive disadvantages on our merchant marine.

While most of the recommendations in *Moving America* are helpful as far as they go, an endorsement of the Jones Act is harmful. This act restricts all water transport between U.S. ports to U.S. flagships. Not only must such vessels be built in U.S.

yards, but they must be manned by Americans. Since U.S. shipyards are two to three times more expensive than foreign construction and since U.S. merchant marine employees cost roughly double those abroad, domestic water transport outlays are significantly higher than those in much of the rest of the world. The costs of these policies are endured mainly by consumers in Hawaii, Alaska, and Puerto Rico.

As a result of this form of protectionism, domestic coastal shipping is virtually dead. In addition, Congress has prohibited the export of Alaskan oil to force the use of U.S. tankers manned with American seamen. Alaskan oil could more profitably be exported to Japan than dumped on the West Coast or taken expensively through Panama.

Airport Fees. To increase revenue for airports, *Moving America* proposes legalizing the right for airports to collect passenger facility charges. Under this recommendation airports could charge a head tax for passengers who either depart from or arrive at an airport. The funds generated would then be used to expand the airport, increase landing capacity, or improve the airport's amenities. This revenue would also make airports less financially dependent on their tenant carriers and would encourage them to provide more facilities for new carriers, a significant benefit that the document ignored. Competition at airports that are dominated by one or two carriers could thus be enhanced.

The Airport and Airway Trust Fund currently collects revenue from a tax on airline tickets, an international departure tax, a way bill tax, and a fuel tax. The Department of Transportation allocates grants to airports for constructing and maintaining landing facilities and certain other activities. Airports often have to defer expansion plans until they win funding from Washington. If the transportation plan had also proposed authorizing airports to opt out of the airport/airways trust fund financing and, in return, receive a portion of the ticket tax directly, airport authorities would have had much more flexibility in developing their facilities.

Air Traffic Control. The cautious nature of the report is reflected in its failure to consider further privatization of air traffic control. The document does maintain that "private sector participation . . . offers significant benefits [at] air traffic control towers at *low*-activity airports" (emphasis added). If privatization works for low-activity airports, why not for other airports? In fact, Britain has successfully privatized air traffic control with lower costs and greater flexibility. Moreover, the training of air traffic controllers could also be privatized, with the likely benefit being lower training outlays.

Airports allowed to hire their own controllers would have greater flexibility to expand their facilities without having to ask Washington for grants and more controllers. As other DOT documents have pointed out, a number of airports are operating at close to capacity and cannot offer additional gates or landing rights to carriers that are not already tenants. As a result, competition is being stifled.

Airline Competition. Secretary Skinner's report does propose "new approaches to allowing additional [foreign] air service to U.S. communities." He adds, however, the caveat that the interests of U.S. carriers will be properly taken into account. How about the interests of the flying public? Protectionism is alive and well in the Department of Transportation.

There is no consideration at all of weakening or eliminating the cabotage laws. Allowing foreign carriers to transport passengers between points solely within the United States would increase competition on domestic routes. In addition, to the extent that consolidations in the domestic industry have reduced competition, removing cabotage restrictions would reinvigorate it. Certainly it is hard to see how a foreign-owned airline would harm the national interest. Such an airline would undoubtedly have to employ American pilots, mechanics, flight attendants, and baggage handlers. Only the stockholders and perhaps top management would be foreign. Currently, any American who is qualified can start an airline. Why not foreigners? This issue was not even hinted at in Skinner's document.

Railroad Labor Legislation. The sections the national transportation policy statement devotes to railroads are commendable. The Secretary's document calls for reform of work rules, pension requirements, and labor legislation that apply only to railroads and impose significant costs on the industry. Such rules were introduced when rail transportation was the principal method of moving goods and people. These laws not only are unnecessary today but retard the ability of railroads to compete with other modes of transportation. Although organized labor will fight any reform efforts, the Department of Transportation is right on target in recommending the repeal of these laws.

Surface Transportation Regulation. The Department of Transportation has followed the Reagan administration in recommending that all remaining regulation of trucking, intercity bus, interstate rail passenger, interstate barge, ferry, pipeline (other than water, oil, or gas), household goods freight forwarder, and freight broker services be repealed. Such a move is long overdue. The Reagan administration, which did recommend abolishing the remaining controls in its last term, passed up the opportunity to advocate deregulation during much of its time in office. The Bush administration has moved more expeditiously.

The remaining controls on trucking are adding to paper work, limiting price competition, and leading potentially to higher rates and monopoly profits. Firms attempting to enter the motor carrier industry, for example, must still apply for certificates of public convenience and necessity. These operating permits specify the products that can be carried and the territory in which the firm may offer its services. After the motor carrier receives its certificate, it must file its tariffs with the Interstate Commerce Commission. Whenever it wishes to change its rates, new tariffs, subject to challenge by competitors, must be filed. In recent years the Interstate Commerce Commission has been reasonably permissive about granting new certificates and allowing firms relative freedom in rates, but a less competitively minded commission could become much more restrictive.

Secretary Skinner has actually taken one major step beyond the Reagan administration. Because of its dedication to states rights, the Reagan administration was reluctant to preempt state regulation of trucking. The new policy document recommends that the government "ensure that State economic regulation of motor carriers, including intrastate operations of Interstate motor carriers, does not conflict with Federal economic regulatory standards for interstate commerce."

In fact, the most onerous regulation of trucking in the United States today is practiced at the state level. Texas, for example, is notorious for its limitations on entry and consequent high freight rates. The movement toward state deregulation, which was strong in the early 1980s, has apparently stalled. Since state regulation is a form of protectionism for certain vested interests, forcing states to abolish their controls over intrastate trucking is warranted.

The department also pledges that the federal government will "vigorously oppose efforts to reregulate railroads and airlines." For both modes, attempts to reimpose regulation continue. Coal shippers, power companies, and some grain interests want to increase price controls over railroads. In fact, the partial deregulation of railroads has resulted in lower rates overall for rail transportation, but these shippers believe that they can force even lower rates with regulation.

Airline deregulation has been opposed from the start by pilots, mechanics, and flight attendants. Indeed, organized labor lost bargaining strength with deregulation, and wage rates and working conditions have become more like those throughout the rest of the economy. In fact, the only significant losers from airline deregulation have been the unionized employees and their unions.

For some communities, mainly small cities, air fares for short trips to nearby hubs have increased. Where airlines have achieved dominant positions at certain airports in the process of establishing hub and spoke systems, rates between those hubs and small cities without much competition have become higher than those for long-haul routes through the same points. But even travelers from these communities have benefitted from the lower fares on the long-haul routes. Despite these gains, a recent up-tick in air fares, which was perfectly understandable under recent market conditions, has contributed to a disenchantment with air service. As airlines have achieved the potential economies of deregulation, rates have, of course, stabilized and with higher fuel prices and increased demand have even increased in the past year.

These conditions have led some who have failed to study the matter to conclude that reregulation would be in the public interest. Studies have shown that deregulation has produced over $12 billion in annual benefits. Actually, based on the history of regulation, reregulation would simply strengthen the hand of the existing carriers and result ultimately in more, rather than less, monopoly pricing.

Policy Omissions

Unfortunately, the national transportation policy statement fails to discuss a number of important policy issues, in particular, subsidies to general aviation, the air traffic control system and the FAA, and the Corporate Average Fuel Economy (CAFE) standard. Of these, I have addressed the first two above, but CAFE warrants special attention.

While *Moving America* claims that "safety is the top priority for the Department of Transportation" and discusses a number of factors contributing to traffic deaths and injuries, the report fails to mention that small cars are much less safe than large ones, although Secretary Skinner recently acknowledged just that in a letter to Congress.

The CAFE standard requires automakers to market and sell enough high-gas-mileage cars to offset less-fuel-efficient vehicles to meet an average mileage standard. The most direct method to achieve this balance is to price their small autos low enough to ensure that a sufficient number will be sold to offset consumers' desires to purchase larger, safer, and more comfortable cars. As Skinner has admitted, however, the probability of surviving an accident is inversely related to the size of the occupant's vehicle. Nor is this simply a theoretical proposition. Studies by Brookings and Harvard scholars have shown that CAFE contributes to the death of about 2,200 to 3,900 drivers and passengers a year.

CAFE is promoted as a scheme to save energy, but it probably saves little if any energy. Drivers with fuel-efficient cars, which are cheaper to operate, are tempted to drive them more miles than owners of gas guzzlers. Since small cars are also less expensive than larger autos, more such vehicles are bought and driven. Large, less-fuel-efficient cars, on the other hand, will be driven farther and kept longer than if these large, safe cars were cheaper. Since new cars of the same size are normally more fuel efficient than older models, driving old cars longer uses more fuel. In other words it is unlikely that CAFE saves gasoline. The certainty is that it reduces safety.

Despite studies to this effect, one of Secretary Skinner's first acts was to require that auto companies attain a fleet average of 27.5 miles to the gallon for the 1990 model year. He even suggested that higher CAFE standards might be called for to "save the environment."

Conclusion

Moving America is better than I expected. It makes several good points, many of which were made by previous administrations. It fails to tackle the more difficult or controversial issues. The report accepts the conventional wisdom. If we recognize that government documents must be cleared through an interagency process that is bound to remove controversial proposals, we can conclude that this opus is "good enough for government work."

Thomas Gale Moore
Hoover Institute of War, Revolution, and Peace

Snake Oil in the SPR

A little iconoclasm may be in order as Congress, alarmed about rising oil imports, prepares to expand the Strategic Petroleum Reserve (SPR). Now a 600-million-barrel store of crude oil, accumulated at an average price per barrel substantially higher than the current price, the $25 billion SPR rests in underground salt caverns in Texas and Louisiana under the watchful eyes of Department of Energy (DOE) bureaucrats. It is problematic whether they will ever release it; they might as well be storing snake oil.

On February 1, 1990, the Secretary of Energy delivered a study to Congress that discourages expanding the SPR beyond its currently authorized 750 million barrels. Yet legislative proposals call for a SPR of one billion barrels, the goal chosen by the Carter administration; H.R. 3193, introduced in August 1989, would also add regional stockpiles and even stocks of oil products—to further increase our demand for imports from OPEC and other exporting countries. With reauthorization of the 1975 Energy Policy and Conservation Act coming up, this is a good time to reexamine the purpose and operation of the SPR and to expose some myths.

A fundamental principle of all analysis is that oil is a fungible commodity. An oil crisis, whether caused by an interruption in the supply network or a shortfall in world production, will manifest itself as a price increase to oil consumers everywhere. It is consumers—not nations—who compete with each other by bidding up the price. The world oil market "shares" an oil shortage by allocating the available oil to all those willing to pay the higher world price.

Myth #1: The SPR assures energy security in case of an embargo. This myth stems from the 1973 Arab oil "embargo" declaration, blamed at that time for shortages of gasoline that were really due to price controls and administrative misallocations; the embargo itself never reduced imports. An embargo cannot be effectively directed against the United States unless a naval blockade physically interdicts oil shipments to the East Coast, the Gulf, and the West Coast, including shipments from Alaska. (In 1988, U.S. refiners imported as much oil from Alaska as from the Persian Gulf.)

The real security threat is not a naval blockade, but sabotage and terrorist attacks against our oil refining and distribution system within the United States. The SPR cannot protect against these.

Myth #2: SPRs provide a cushion against supply shortfalls. Not quite true. As might have been anticipated, national SPRs reduce the incentives for private stockpiles. Refiners can now rely on government to carry the cost of stockpiles. If, in the future, stockpiles are set up for oil products, we can confidently expect that the level of private storage will drop. Taxpayers would then pay the cost, instead of oil companies.

Myth #3: An American-owned SPR benefits Americans. Not quite; remember that oil is fungible. Oil released from our SPR subsidizes foreign consumers by reducing a supply shortfall and thereby moderating a global price increase. As physical barrels of oil move from the SPR into U.S. refineries, they reduce the demand for imports and make more oil available to the rest of the world at a lower price. These truths have been stated repeatedly; they need to be reiterated here for the benefit of a new generation of bushy-tailed bureaucrats and politicians.

Thus, a cutoff of oil from the Persian Gulf would hurt all consumers, including Europeans and Japanese. We should keep this fact in mind as we review our military expenditures for the U.S. Central Command (started as the "Rapid Deployment Force" by Jimmy Carter)—especially as the Soviet strategic threat to the Gulf recedes. Its cost of over $40 billion per year, now borne only by U.S. taxpayers, far exceeds the SPR carrying cost of about $2.5 billion.

Myth #4: The SPR must store ninety days of imports. There is no rationale for this rule. The 90-day figure is reached by outdated modelling, a hangover from the days when the SPR was thought to be necessary to replace "lost imports" on a barrel-for-barrel basis. Further, for the sake of world equity, national stockpiles should be proportional to oil *consumption* rather than oil imports. Since oil consumers everywhere pay the same price (net of transport costs) in a free oil market, even exporting countries, such as Great Britain and Norway, should carry stockpiles scaled to their use of oil.

Myth #5: Oil will be released from the SPR in the event of an oil crisis. This pious hope begs several questions. What is an oil crisis? And, can anyone act in time to do any good? According to this myth, the president determines the presence of a crisis. Do not believe it. There exists no definition of what constitutes a crisis—such as a specified price increase on the world market. Through several administrations the DOE has steadfastly refused to define and announce a release policy. But one can visualize the many daunting steps required to release oil from the SPR. With the necessary proclamation drafted by a GS-15, with the spelling corrected by a deputy assistant secretary, with the assistant secretary seeking approval through the chains of command and Congress, with interagency coordination, and finally with international coordination involving also the State Department and the National Security Council—the crisis may well be over before the pumps start pumping.

Actually, it may never come to this. Bureaucratic incentives being what they are, there will be reluctance to release oil from the SPR—even during a "crisis." After all, suppose the oil is drawn down and the crisis has not abated? Yet no one will blame a prudent, highly risk-averse bureaucrat—and there are so many in the chain —for saving the oil for a rainier day.

Myth #6: The agreement to share oil through the International Energy Agency (IEA) will protect the consuming nations. The IEA was set up in Paris in 1974, based on the facile idea that since OPEC is a cartel, consumers should also form one. But a little reflection demonstrates that oil sharing makes little sense. One has only to ask the price of the oil that is to be shared. If it is the world price, then we do not need the IEA; the oil market provides an automatic sharing among those willing to pay the price. If, on the other hand, the price is to be at the (much lower) level existing *before* the supply crisis, then countries giving up oil from their SPRs are subsidizing the others. Thus, the sharing agreement, the main rationale for the IEA, is either useless or preposterous; it is also dangerous because it keeps alive the idea of oil allocation by political entities rather than by the market.

Myth #7: Releases from the SPRs must be coordinated by the IEA countries. This attractive-sounding proposal can actually cause severe problems, worsen the oil crisis, and delay or frustrate any action. Since the fundamental aim of SPR releases is to moderate a temporary price increase —that is, to achieve some measure of price stability—it is best to randomize release decisions. Even if coordination could be accomplished, it would reinforce a price swing—if everyone guesses wrong about the duration of the supply interruption. There is no advantage to coordination; countries that release their SPR oil would make money and could replace the oil later at a lower price. Countries that do not release oil would miss the opportunity to make money (unless the crisis persists); but their citizens benefit though lower prices no matter whose oil is released. (Remember the Fundamental Principle!)

What to Do?

We start from the fact that we now have a large government-owned stockpile. Its fundamental function, as we have discussed, is to reduce price peaks. Since we have to replace the oil, we can also fill in price valleys if we buy the oil when the price is low. One way to achieve these goals is to privatize at least part of the SPR by selling options: "call" options that permit the holder to buy oil at certain (high) strike prices and "put" options that require the SPR to buy oil from the holder at certain (low) strike prices. The selling of options provides income for the SPR; buying low and selling high can make it profitable *and* promotes price stability.

Beyond this, a publicly owned SPR does have the benefit of discouraging Congress from instituting price controls, rationing, or similar nonmarket allocation mechanisms for fear that speculators would profit from price swings.

The DOE report to Congress also included a study on financing an expanded SPR. The report recommends more of the same—on-budget purchases from general revenues—but opens up the option of "leasing." To some extent the study was stimulated by the idea that we could save money by leasing oil from Saudi Arabia and storing it in the United States. A report dating to 1976, prepared for then-Secretary of the Treasury William E. Simon, discusses a similar but less costly proposal. It points out that storing crude oil in the United States represents a unique opportunity for the Saudis by creating for them a financial nest egg out of reach of their enemies, without in any way upsetting OPEC—since the stored oil would not be marketed unless there were a supply shortfall and a corresponding price increase.

It makes sense for the U.S. government to permit the Saudis, and others with excess production capacity, to enter into private agreements with U.S. companies to store crude oil here. They can produce, transport, and store it at a cost of a few dollars a barrel and sell it for a large multiple at some future date of their choosing. All parties would benefit from such privatized oil storage—above all the United States, because it would remove the need to expand or maintain a large and costly government SPR financed by taxpayers.

S. Fred Singer
University of Virginia and
Washington Institute for
Values in Public Policy