Currents

The New Regulatory Order

A distinctive Clinton approach to regulation began to emerge in September. The problem is that the pieces don't fit together. Consider the following sequence of announcements:

September 7

Vice President Al Gore presented the *Report of the National Performance Review*. The theme of the *Report* is to "reinvent government" by increasing flexibility, in exchange for increased accountability, through massive deregulation and decentralization within the government. The *Report* proposes a comprehensive review of all internal government regulations, with a goal of eliminating 50 percent (!) of those regulations. Department and agency heads should have the authority to waive federal regulations or mandates on state and local governments. The federal government should severely limit the imposition of unfunded mandates on state and local governments. Federal agencies should be allowed to purchase support services, printing, and real property from any source, rather than through a centralized purchasing agency.

Most of the actions recommended by this *Report* are probably beneficial, at least as experiments. Deregulation and decentralization are probably requisite to improving the effectiveness and efficiency of the government sector. One wonders, however, why the Clinton administration seems to apply a very different standard to the private sector.

September 21

First case in point: The administration proposed a comprehensive tightening of the pesticide and food safety regulations. The proposed legislation, among other provisions, would

- extend the strict standard of "reasonable certainty of no harm" to all pesticide-treated foods, including raw fruits and vegetables;
- eliminate the consideration of economic benefits of pesticide use, except in exceptional cases and only for the next five years;
- establish pesticide use reduction goals to be met by the year 2000;
- require reapproval of all pesticides every 15 years;
- prohibit the export of pesticides not marketed in the United States; and
- initiate a program to induce farmers to use "integrated pest management" techniques.

For pesticides that are potential carcinogens, the "no harm" standard is interpreted to mean an increase in cancer risk for no more than one in a million persons over a 70-year lifetime. The administration acknowledges that "Because of the conservative nature of risk assessment, in reality this means the risk consumers actually face will likely be far less."

The explicit rejection of a benefit/cost test for pesticide regulation is bad news and could lead to an *increased* risk to health. The new pesticide standard would surely increase the price or reduce the quality of some fruits and vegetables, and the adverse health effects of reduced consumption of those foods may more than offset the effects of the tighter standard. Who knows? I don't. My point is that no one will know unless the question is asked.

The rush to new pesticide legislation would be more understandable if there were new evidence of increased risk, but there is no such evidence. A June report by the National Research Council (NRC) of the National Academy of Sciences concluded that there is a "potential for concern" about pesticides in the diets of infants and children but offered no old or new evidence that is conclusive on this issue. The NRC report was clearly more a rationalization than the reason for the proposed legislation. This case raises the general question of who should bear the bur-

den of proof when the relevant evidence is so inconclusive.

September 22

Second case in point: President Clinton summarized his proposed health plan before Congress and a national television audience. The plan is a complex maze of regulations and mandates that would transform one-seventh of the economy into one giant government-managed bureaucracy. All Americans and legal residents would be guaranteed (read: required to buy) a standard comprehensive health insurance plan, at a premium that is independent of risk, from a government-appointed monopoly purchasing cooperative in each region. All employers would be required to finance at least 80 percent of the average premium for each employee and dependent, subject to a limit on the share of payroll that is a function of firm size and average wages. Medical care providers would be subject to budgets, controls on premium increases, *ex post* assessments if a premium increase exceeds the budget target, a review of new drug prices, and fee controls. State governments may require a single payer plan. The regional purchasing cooperatives may rule out a fee-for-service plan. And so on, in the plan "summary" of 239 pages.

One wonders whether those who prepared the Clinton plan and those who prepared the Gore report work for the same administration or live in the same world. Why, for example, is extensive regulation necessary to increase efficiency in the health care sector, now larger than the state and local government sector, when such regulations are blamed for inefficiency in the government sector? Why is an uncompensated federal mandate on private employers a good idea when such mandates on state and local governments are undesirable? Why is a monopoly purchasing cooperative better for health care when such arrangements are judged undesirable within the federal government? Why assume consumers are not intelligent or responsible enough to choose their own health insurance coverage when the key to reinventing government is to treat public employees as responsible adults? Maybe Bill and Al should compare notes and have a talk.

September 30

President Clinton signed and released a new

executive order on Regulatory Planning and Review. One might have hoped that this order would have provided some coherence to the seemingly disparate themes of the several major prior actions. It did not, but the problem is not with the executive order. The problem is that those who prepared the proposed pesticide legislation and the health plan apparently paid no attention to the principles summarized in the new executive order.

For the most part, the new executive order is very similar to the two Reagan orders that it replaces. The new order, for example, reaffirms the primacy of the regulatory agencies, the legitimacy of the central review process, the importance of early resolution of potential disputes, and the maximum net benefit principle for choosing among alternative approaches.

In some ways, the new order could be an improvement. The activities of the Office of Information and Regulatory Affairs (OIRA) may be better focused on "significant regulatory actions." Increased attention to openness and accountability in the regulatory review process is probably necessary to protect this process against charges of backdoor deals with special interests.

My few criticisms of the new order are quibbles. The calculation of net benefits is supposed to include "distributive impacts and equity." I don't know anyone who knows how to do this without wallowing in subjectivity. For this reason, it is usually better to maintain a clear distinction between the allocative and distributive effects of regulation. The administration is also enamored with "consensual mechanisms for developing regulations, including negotiated rulemaking." My sense is that this is romantic, but I am open to evidence to the contrary. An early exchange of information can be valuable, but consent is more like plea bargaining when one side in the negotiations has police powers.

The new executive order reflects extended thoughtful preparation, political and administrative realism, and a commitment to both substantive and procedural principles. For all that, the new order does not reduce my anxiety about the regulatory review process in the Clinton administration. First, President Clinton has yet to convey any commitment to reducing or even limiting federal regulation of the private sector. This contrasts sharply with the conclusions of the Gore report about the regulation of government. Office of Management and Budget Director Leon Panetta described the new executive order as "not pro-regulation and . . . not antiregulation; it's smart regulation." This puts OIRA in the awkward position of a neutral judge, rather than an advocate for limiting regulation. An aggressive regulator faced by a neutral judge will generally carry the day. The new review process may be more open, but it will not be fair unless some participant in this process has a commitment to challenge the regulators.

My second concern is that the principles and process described in the new executive order will be brushed aside when they conflict with the interests of another policy or a favored regulator. The proposed pesticide legislation and the health plan are surely "significant regulatory actions," but they are strongly inconsistent with the principles of the new executive order signed the next week. The effective limits of the new regulatory order will not be apparent unless and until we hear grumbling from some regulatory agency or congressional subcommittee that OIRA has exceeded its authority by rejecting some proposed major regulation. I'm waiting.

William Niskanen

Antitrust in the Bingaman Era

In November 1989 we speculated in the pages of *Antitrust Commentaries* on "The New Antitrust Agenda" of Jim Rill and Janet Steiger, President Bush's choices to head the Justice Department's Antitrust Division and the Federal Trade Commission (FTC), respectively. We predicted tougher rhetoric, less conflict with the states and Congress, and somewhat tougher enforcement, especially in the merger area. That turned out to be a fairly accurate projection.

Now we have the Clinton administration, and while Janet Steiger is still there (along with the rest of the Bush FTC), Anne Bingaman has taken over at the Antitrust Division. What are we likely to see from this new team?

There are some early signs. Bingaman regularly invokes the name of Thurman Arnold, a legendary antitrust enforcer who aggressively used the antitrust laws, and especially criminal process, to carry out his view of proper competition policy. From today's perspective, his hard-

nosed approach seems a little extreme, and it certainly produced backlash. Nevertheless, Arnold is generally viewed as an effective law enforcer, with emphasis on the "law," and Bingaman's invocation of him as a role model may well be an important clue to what we can expect from the Bingaman Antitrust Division.

Over the past 30 years, antitrust enforcement at Justice has gradually shifted from Joe Friday to the Chicago School—from cops on the beat to economic regulators. Of course, criminal enforcement has been a constant priority of the Antitrust Division, but by and large criminal enforcement has been restricted to hard-core horizontal agreements—price-fixing, bid-rigging, and the like. The very occasional exception, such as the criminal resale price maintenance case against Cuisinart brought during the Carter administration, was a stark contrast to the ordinary rule.

In almost all other respects, however, the Division's work has gradually but steadily become more like a regulatory agency than a law enforcer. Merger enforcement, for example, has become a very regulatory process, with "fix-it-first" and other informal and formal adjustments to planned transactions to meet antitrust concerns very common—much more so than injunction hearings. Negotiation, not litigation, has become the most common approach to solving most antitrust problems.

This will not completely change; it is too deeply embedded, and limited resources don't permit fighting every possible fight. But Bingaman is a litigator by training and instinct, not an antitrust counselor. Many litigators view themselves more as advocates than decision-makers; they prefer to make the argument, and let a judge make the decision. For some, this mindset may well produce a greater tendency to let the courts decide the close ones.

The last litigator who headed the Antitrust Division was Sandy Litvack, who brought the criminal resale price maintenance case against Cuisinart. Litvack was action-oriented and not very interested in long analytical discussions. Bingaman seems to have many of the same instincts. Those who have dealt with her know she wants to get to the point—fast. At least at the beginning, it would not be surprising to see someone from a litigation background who thinks Thurman Arnold was a hero be significantly more aggressive than her immediate predecessors—who were themselves much more aggressive than the Reagan appointees.

Bingaman's record to date is sparse but certainly consistent with this conclusion. She decided to pick up the Microsoft investigation, after the FTC deadlocked 2-2 on commencing enforcement action. This is highly unusual. For Justice to decide to subject a company that has already been through a multi-year investigation to yet another federal antitrust investigation by a different agency certainly raises real issues of fairness and sound public policy. If this approach becomes common, it would threaten the informal clearance process by which the FTC and Justice allocate (and avoid duplicating) federal antitrust enforcement efforts, and it might even raise anew the question of why (in a time of belt-tightening and government reorganization) we need two federal antitrust agencies. Do you suppose this is on Vice President Gore's "Reinventing Government" agenda?

Another piece of corroborating evidence can be found in Bingaman's first policy speech, before the American Bar Association at its annual meeting. There, she announced two actions: withdrawing the Vertical Restraints Guidelines and expanding the Corporate Amnesty Policy. Both gave hints about her program and enforcement attitude.

The Vertical Restraints Guidelines

The Vertical Restraints Guidelines, first published by the Reagan administration in 1985, were not a particularly important statement of federal antitrust enforcement policy. For at least the past 30 years, the Antitrust Division has not been particularly interested in bringing cases challenging nonprice terms in distribution agreements, leaving private litigation as the real battleground for vertical restraints policy. Thus, the guidelines largely were an effort to encourage the courts to draw the lines of battle in a manner that favored defendants.

Notwithstanding the purely advisory status of the guidelines, their publication incensed state attorneys general and the plaintiff's antitrust bar. Vertical restraints often pit large national or international manufacturers against local retail establishments. They also prompt complaints from consumers who would prefer to shop at full-service stores but buy from discounters. Vertical restraints also can be a fertile source of

antitrust litigation, antitrust counterclaims being one of the first lines of defense in nonpayment, termination, and refusal-to-supply disputes with distributors. The guidelines, which argued that most vertical restraints were procompetitive, were viewed as a slap in the face to those interested in challenging such practices.

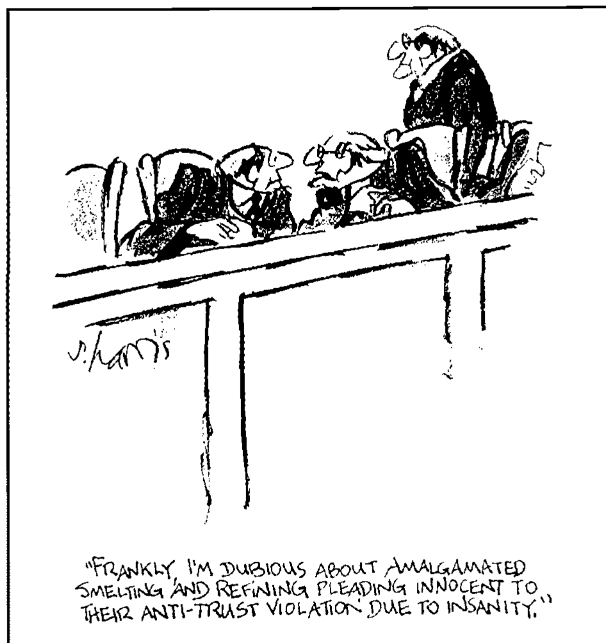
The Vertical Restraints Guidelines proceeded from the premise that manufacturers have a strong incentive to sell as much of their product as they efficiently can produce. Based on this premise, the guidelines theorized that most manufacturer-imposed distributional restrictions are designed to increase competition at the manufacturer level—what economists call interbrand competition—by encouraging distributors to provide desired services, such as product promotion and point-of-sale assistance.

From a technical legal perspective, much of this view of vertical restrictions is now embodied in Supreme Court case law—most notably in the *GTE Sylvania* and *Sharp* decisions. The opposition to the guidelines, therefore, was predominantly a function of their clear bias in favor of permissive antitrust policy toward vertical restraints. Moreover, proponents of tougher vertical restraints enforcement found the guidelines troubling in two additional respects.

First, the guidelines adopted the view that restrictions on intrabrand competition are benign, except in the case where the manufacturer truly has market power, individually or as a member of a producer cartel. This, in effect, turns the non-price vertical restraints case into something more closely approximating a claim of monopolization or facilitating practices. Such cases are very hard to win under a rule of reason analysis, particularly if the sole issue is the impact on interbrand competition. The other side of the debate views intrabrand competition as having real importance in its own right.

Second, the guidelines forced a fair amount of conduct into the rule of reason category by treating conduct that had incidental effects on price or was urged on the manufacturer by more than one dealer as non-price vertical restraints. Plaintiffs, not surprisingly, would prefer to see the former treated the same as a vertical price restraint and the latter as a horizontal agreement, leaving open a greater chance of *per se* treatment in either case.

In announcing the decision to withdraw the guidelines, Assistant Attorney General Bingaman struck at these exact themes: "These guidelines seem so thoroughly to discount the anti-competi-



"FRANKLY, I'M DUBIOUS ABOUT AMALGAMATED SMELTING AND REFINING PLEADING INNOCENT TO THEIR ANTI-TRUST VIOLATION DUE TO INSANITY."

tive potential of vertical intrabrand restraints and so easily to assume their efficiency-enhancing potential as to predetermine the conclusion against enforcement action in almost every case. I am simply not willing to sign on to that balance. There are other features of the current guidelines that I cannot accept. They seem to treat all agreements between distributors of a single manufacturer as vertical agreements rather than under the harsher strictures applied to horizontal agreements. And they are predisposed to treat vertical price fixing under the rule of reason if they find such restraints to be ancillary to non-price agreements. I find it difficult to square such views with existing case law."

So, what are we to make of this new view? Does it mean that the Antitrust Division will now become active in vertical restraints enforcement? Can we expect an aggressive program of legislative and appellate advocacy to reverse the course of recent vertical restraints law? Is this Michael J. Fox in his time machine, and if so, which future are we going back to—the fifties, sixties, or seventies?

It's obviously too early to answer any of these questions. Still, Bingaman's choice of the Vertical Restraints Guidelines as her first policy initiative must mean something. In a world of scarce resources, it is hard to imagine that non-price vertical restraints will supplant criminal enforcement and merger review as the Antitrust Division's top priority. Withdrawal of the former guidelines does not change the strong judicial predisposition to treat non-price vertical restraints under the rule of

reason, and rule of reason trials are dubious, resource-consuming enterprises. Nonetheless, it is clear that the Clinton Antitrust Division is likely to be more of a friend to state attorneys general and the plaintiffs' antitrust bar than the past two administrations have been.

Perhaps more importantly, it is not too difficult to imagine that the Clinton administration will be a supporter of legislative efforts by Senator Metzenbaum (D-Ohio) to repeal the *Sharp* and *Monsanto* decisions and open the door once more to jury trials for disgruntled distributors. Passage of such legislation would represent dramatic change, especially for those companies with extensive distribution systems. We all remember the heyday of the entrepreneurial plaintiff's bar. Will it return? Stay tuned.

In any event, it would be wrong to dismiss this announcement as a mere symbolic act. The Justice perspective means a great deal to the courts, which look to the Antitrust Division to serve as a fair broker in the antitrust policy arena. Moreover, legal theories are like fashion trends, and visible acts by the nation's chief antitrust enforcer (with or without new legislation) influence the mood of private plaintiffs. Thus, even if the Antitrust Division does not bring a raft of new vertical restraints challenges or the Congress does not pass new legislation, the announcement throws more dirt into an already muddy area of the law and certainly does nothing to discourage those inclined to bring such cases. Companies would be wise to manage their vertical relationships carefully in the future with more attention to actual case law than the Chicago School rhetoric of the past 12 years.

The Corporate Amnesty Program

The Corporate Amnesty Program has been around since the Carter administration, but it has been little publicized or used. It basically promises no indictment for corporations who come forward to confess, if the Antitrust Division wasn't likely to get them anyway. The key was that you had to come forward before any investigation had begun—which, of course, you couldn't determine for certain without exposing your client. Notwithstanding that disincentive, the program was used by a small number of companies over the years, and Bingaman now wants to make it more user-friendly.

Thus, the program will now permit a company to obtain amnesty *even if* there is a pending investigation, if it is first in line and the Division "does not yet have evidence against the company that is likely to result in a sustainable conviction." This obviously still leaves considerable ambiguity, but at least it opens the door for amnesty even if there already is a pending investigation.

One other important point: in the original program, the leader or originator of the illegal activity could not qualify for amnesty, even if it were the first one in the door. Under the revised program, even the leader or originator can theoretically qualify, although the criteria that will be applied make it clear that such companies will have a tougher burden to carry. Still, this clearly broadens the appeal of the program, especially when "who started what" is frequently not that clear or even in dispute.

These initial efforts portray an aggressive prosecutor with a litigator's pragmatic emphasis. What they don't say much about is how policy decisions will really be made. Bingaman knows Washington and is politically sophisticated. She may be inclined to settle issues in court but, like all prosecutors, she will quickly understand that she doesn't have the resources to litigate everything. Still, a litigator represents her client, and sounding tough may be a way to advance the client's interests. Certainly rhetoric has been a very useful tool in the past. But in the end, effectiveness depends on actions, and thus we need time to judge how much of a difference Anne Bingaman will make.

That said, predictions are easy, and we hereby make ours: There will be much more tough rhetoric *and* tougher enforcement—and not just in the merger area. There will be more emphasis on vertical enforcement aimed at big or visible targets. We will probably see more competition than cooperation between the two federal agencies, and thus more confusion about federal antitrust policy, than we have had in recent years. In short, it's going to be more complicated and more confrontational, and thus less predictable, than the past decade or so. But that is what elections are all about.

Charles James and Joe Sims
Jones, Day, Reavis, and Pogue

Outlawing Cooperation: Chapter Two

This spring, voluntary labor-management cooperation was subject to a second setback by the

National Labor Relations Board (NLRB). The first setback came down on December 16, 1992, in the *Electromation* case; the second, on May 28, 1993, in the *DuPont* case.

Since the late 1970s, in an effort to improve productivity by including employees in decisionmaking regarding production processes and work environments, 30,000 employers, including over 80 percent of the *Fortune* 1000 firms, have set up employee participation plans. Most observers agree that in the face of global competition, American adversarial labor-management relations, based on the National Labor Relations Act (NLRA), must be replaced with something like Japanese-style labor-management cooperation. In his 1991 book *The Work of Nations*, Secretary of Labor Robert Reich praised employee participation plans and asserted that they are the *sine qua non* of constructive labor-management relations. But, judging from his more recent statements and actions, he now favors labor-management cooperation only so long as it is union-management cooperation.

Electromation, Inc., a nonunion Indiana electrical parts manufacturer, set up what it called "action committees" to bring workers into its decisionmaking process. I examined this case in detail in an earlier paper for the Cato Institute ("Are Quality Circles Illegal? Global Competition Meets the New Deal," Briefing Paper No. 18, February 10, 1993). In sum, when the NLRB's dissembling is set aside, it is clear that the board used the NLRA to deliver a message to all nonunion workers: the only legal way you can have a voice in workplace decisionmaking is to unionize. The Teamsters lost a vote among Electromation employees because the firm had set up excellent labor-management relations through the action committees. A majority of workers thought unionization would be useless. After losing, the Teamsters asserted that the committees were illegal company unions under Sections 2(5) and 8(a)2 of the NLRA. The NLRB agreed with the administrative law judge who had set aside the election results. Electromation is now unionized.

Relevant Statutory Provisions

Section 8(a)2 of the NLRA states, "It shall be an unfair labor practice for an employer to dominate or interfere with the formation or administration of any *labor organization* or contribute financial or other support to it" (emphasis added). What is a "labor organization"? Section 2(5) states that "the term 'labor organization' means any organization of any kind, or any agency or employee representation committee or plan, in which *employees participate* and which exists for the purpose, in whole or in part, of *dealing with* employers concerning grievances, labor disputes, wages, rates of pay, hours of employment, or *conditions of work*" (emphasis added).

The intent of Congress in 1935, when Sections 2(5) and 8(a)2 were written, was to protect employee free choice on the question of unionization. Section 7(a) of the 1933 National Industrial Recovery Act (NIRA) forced employers to allow workers to affiliate with unions "of their own choosing." Those workers who chose to be represented by an independent union could do so. Similarly, those workers who chose to be represented by a company union (one set up and run by an employer), or who chose to represent themselves, could do so. Even Robert Wagner, the author of the original NLRA, recognized that company unions could be the legitimate choice of individual employees. Unfortunately, when NIRA became law many employers set up sham company unions to avoid having to deal with legitimately chosen independent ones. Sections 2(5) and 8(a)2 were intended to outlaw those sham unions.

Today's employee participation plans are not the same as the sham unions Congress was concerned with in 1935. Nevertheless, in both these cases unions successfully used the law to restrict labor-management cooperation to union-management cooperation. If the law compels such a result, then Charles Dickens was correct when he had Mr. Bumble in *Oliver Twist* say "If the law supposes that, the law is an ass." The law is an ass, and it should be changed.

The only difference between the *Electromation* and the *DuPont* cases is that the former involved a nonunion workplace and the latter involved a unionized one. The board's analyses of the implications of Sections 2(5) and 8(a)2 are the same in the two cases. Since the *DuPont* case involved an employee participation plan in a unionized setting, the board also had to deal with Section 8(a)5 of the NLRA which forces an employer to bargain exclusively with a union elected by a majority of workers.

The DuPont Case

DuPont had set up seven labor-management

committees—six to deal with safety, and one to deal with physical fitness. Management designed the committees to include both labor and management members, and employees were invited to volunteer to serve on them. When there were more volunteers than places on a committee, management selected the volunteers who would serve. DuPont supported the committees with paid release time for their members and with facilities for them to use.

The committees worked on a consensus basis; that is, each committee discussed, changed, and developed each proposal until all the members could agree that it should be adopted. The committees were able to settle some issues affecting workers that the union had not addressed and others that the union had failed to resolve. For example, the fitness committee established a recreational area for employees after the union had failed to do so, and a safety committee established incentive awards after the union's attempt to do so through collective bargaining failed.

The Chemical Workers Association, the union in this case, threatened with becoming irrelevant in the eyes of the workers, filed unfair labor practice charges against DuPont. The NLRB agreed to protect the union against competition from the committees.

First, the board considered whether the committees were "labor organizations" under Section 2(5). Employees participated in them, and they definitely dealt with issues of "conditions of work." Indeed, any employee participation plan would meet those two tests for being a labor organization.

The third test is whether the committees "dealt with" the employer. The NLRB said they did. Following the U.S. Supreme Court's 1959 *Cabot Carbon* ruling, the board said that "dealing" is not limited to "bargaining." Bargaining requires compromises, but "the concept of 'dealing' . . . involves only a bilateral mechanism between two parties. That 'bilateral mechanism' ordinarily entails a pattern or practice in which a group of employees, over time, makes proposals to management, [and] management responds to these proposals by acceptance or rejection by word or deed, and compromise is not required." Since the committees reached decisions by consensus, management could accept and reject employee proposals. Thus, according to the main opinion, the committees did at least deal with the employer. Member Dennis Devaney, in a concurring opinion, found that the committees *bargained* with the employer since, in reaching consensus, management inevitably compromised with employee members.

The board gave three examples of not dealing. First, a "brainstorming group" which suggests a "whole host of ideas" and does not make "proposals." (Only in the world of labor law is it necessary to distinguish between suggesting ideas and making proposals.) Second, a committee that "exists for the purpose of sharing information with the employer," and which "makes no proposals to the employer." Third, a "suggestion box" through which individual employees "make specific proposals to management."

The DuPont committees were found not to "fall within any of these safe havens." They were formally structured and permanent rather than ad hoc, they included employees who represented other employees, and they made proposals to management all of which management could accept or reject.

The NLRB said the committees could have avoided that last fault if they made their decisions by majority vote and if management members constituted a minority. The board did not say how it would regard a majority coalition between minority management members and a minority of employee members. Apparently it assumed employee members would maintain class solidarity.

The important common denominator of the board's three examples of not dealing is the absence of some employees representing other employees. In any company of more than a few employees, any employee participation plan inevitably involves such representation. On that basis alone, assuming that management personnel are part of labor-management cooperation, a pro-union NLRB can invalidate most employee participation plans.

Having found that the DuPont committees were labor organizations under Section 2(5), the board went on to find that DuPont dominated the administration and the formation of the committees and supported them in contravention of Section 8(a)2. To avoid liability under 8(a)2, management would have to have a hands-off attitude to labor-management cooperation. Management would have to "cooperate" by being uninvolved. Management is inevitably

involved in setting up employee participation plans, and is inevitably interested in supporting them. Once an employee participation plan is found to be a labor organization that deals with the employer, the 8(a)2 question is just frosting on the union cake.

When DuPont used its employee participation plan to settle issues about which it was under a legal obligation to bargain with the Chemical Workers Association, it broke the law. Notwithstanding that the committees were much more effective, from the point of view of both the employees and the employer, DuPont was ordered to disband them. Labor-management cooperation must be union-management cooperation.

On this issue, the NLRB may be legally correct. The NLRA clearly does impose a duty on employers to bargain in good faith with exclusive bargaining agents. These two decisions illustrate why the NLRA is an outdated law that ought to be repealed. It assumes that employers and employees are natural enemies and that confrontation, not cooperation, is the best form of labor-management relations. The labor-management relations structured by the NLRA do not serve the best interests of modern workers. As long as the NLRA exists in its present form, the interests of workers will continue to be sacrificed to the survival of unions.

Charles W. Baird
California State University, Hayward

Federal Flood Insurance: Managing Risk or Creating It?

The 1993 savage summer floods in the Midwest again demonstrate the self-defeating nature of the federal government's handling of natural disasters. Federal policies systematically subsidize the cost of living in risky areas such as floodplains and hurricane zones. They do so in two ways. First, the federal government underwrites much of the cost of building infrastructure in those areas, including sewage treatment plants, roads, and, most important, levees, which along with other modifications of the Mississippi River create more severe flooding down river.

Because of those subsidies, people who live in hazardous areas face lower expenses than they otherwise would. For people who bought property after the infrastructure and other amenities were added, the subsidy may be at least partly offset by increases in real estate prices. Those who bought property at the old prices reaped a windfall.

The risk of living in hazardous areas is also subsidized by federal disaster relief policies. Those policies include not only formal property and crop insurance programs administered by the Federal Emergency Management Agency (FEMA) and the Department of Agriculture, but also ad hoc relief appropriated by Congress in the wake of any natural disaster.

In 1968 the National Flood Insurance Program (NFIP) was established to offer insurance policies to homeowners living in floodplains on river banks and coastal areas. The rationale for the program was that if property damage claims were paid from insurance premiums, the taxpayers would be saved the cost of the disaster relief that previously had been approved routinely. The program also vowed to move development away from the hazards as a *quid pro quo* for the insurance, a subtle form of national land-use restriction. To date, the program has more than two and a half million policies and more than $200 billion worth of insurance in force.

But the taxpayers still pay. Federal coverage is voluntary, and only 13 percent of eligible property owners are covered. People forgo coverage either because they are fatalists or because they are counting on federal relief anyway. In past years the federal government has made relief payments to property owners without insurance, although the payments were smaller than those the policyholders received.

As might be expected, the federal insurance program is run on something other than a sound business basis. Premiums total about $700 million a year, but NFIP needed a billion-dollar infusion from Congress in the early 1980s. Another billion dollars in Treasury loans have been forgiven. From 1978 to 1987, the program ran a $650 million deficit. Before the Midwest floods, the program was $18 million in the red. The next 25 years could be much worse since we are in a new "super hurricane" cycle, according to the National Hurricane Center.

During the summer flooding, Congress passed a

$5.7 billion appropriation for the affected states. Some $2 billion of that will pass through FEMA to rebuild infrastructure and government buildings and to finance temporary housing. President Clinton has decided to require the states to pay only 10 percent of their rebuilding costs instead of the usual 25 percent.

Insurance claims are not paid from the special appropriation but from premiums—if there is money in the fund. If not, the program can borrow from the Treasury. In late October the program was $30 million in deficit, having already paid $103 million in claims this year and having come off a bad year in 1992, which included Hurricane Andrew. NFIP expects the final total for 1993 to be $150 million. (The average claim paid was $21,000. Since 1974, claims paid have totaled $2 billion.)

People who did not have flood insurance when the Midwestern rivers flooded can still get money from FEMA's general fund to rebuild their homes as long as they buy a NFIP policy. In effect, they get insurance after the fact.

The guarantee from the U.S. Treasury and payments to the uninsured constitute a subsidy to those who live in hazardous areas. In essence, the government is encouraging its citizens to live on floodplains. This is a secret to no one except, apparently, the current administrators at FEMA. While they brag that the insurance program has saved money by steering building away from coasts and river banks, nearly everyone else disagrees. The General Accounting Office has called federal insurance a "safety net" for shoreline development. About a decade ago, FEMA itself confessed that its program "has not constricted coastal development to any measurable degree." In fact, more than a third of total payouts have gone to 3 percent of all claimants, so-called "repetitive loss" cases, since the policy allows for multiple claims without an increase in premium. Most of the money has gone to owners of beachfront homes, not to residents in riverfront areas.

Most critics of NFIP would tighten the land-use restrictions and perhaps make participation mandatory. But those reforms bring their own problems. Federal land-use rules violate property rights, and mandatory insurance denies homeowners freedom of choice and aggravates the very ills that NFIP already suffers. The program is not operated soundly with voluntary participation; forcing participation could make the administrators even more complacent.

Since there is private insurance for other risks, one naturally wonders why a federal flood insurance program is needed at all. Federal officials and the insurance industry give the stock answer that floods are not an insurable risk, which presumably means premiums would be prohibitively expensive if not infinite. Two problems are apparent in that reply. First, it is inconsistent with NFIP's persistent claim that its premiums are actuarial. That is its defense against the charge that the program subsidizes risky activities. NFIP cannot have it both ways. (Moreover, former FEMA chief Harold T. Duryee acknowledged in 1990 that the program does not charge full-risk premiums and that to do so would add at least $10,000 to the cost of a policy.)

Second, if an activity is so expensive that private insurers won't underwrite it or will insist on very high premiums, that is market information that ought to be heeded and not circumvented through coercion of the taxpayers. In a free market, insurance is a way of pooling risk. People facing a particular risk pay into a fund, which is invested and is available to pay claims if damage occurs. Just as important, the premium also provides information about the relative riskiness of a certain type of behavior. Private insurers would have no incentive to understate the risk. But bureaucrats have such an incentive. The bureaucrats do not risk their own money, and their agency can't go out of business. The lower the premium, the more people will buy their policy and the bigger and more prestigious the program will be. But the lower premium encourages more people to locate in dangerous areas, exposes more assets to risk, and increases the economic loss from natural disasters. The program also operates monopolistically—the competitive, entrepreneurial element to premium-setting is lacking. For all those reasons, the administrators merely *play* at insurance.

Thus, if NFIP charges actuarial rates, the program is superfluous. If it doesn't, it is self-defeating.

Incidentally, the claim that floods are not an insurable risk is refuted by the willingness of Lloyd's of London to write flood insurance on the value exceeding $185,000, the limit of NFIP coverage. Lloyd's rates are high ($25,000 to $50,000), but policies are available. Insurance companies like State Farm defend the need for NFIP, but that could have something to do with their being able to make money selling the government's policy; they pull in a percentage of the premium without taking any risk.

There is reform talk in the air. Sen. John Kerry (D-Mass.) has introduced S. 1405, which would prohibit new federal insurance policies in high-risk erosion areas, expand the requirement for federal flood insurance, and encourage and assist financially in damage-limitation activities in hazard zones. The prohibition on new insurance is a welcome acknowledgment of the basic problem, but Kerry's bill does not go far enough. Instead of removing the government from this area entirely, the bill would direct the federally sponsored mortgage enterprises, Fannie Mae and Freddie Mac, to require borrowers to buy the existing flawed insurance policy in less risky areas, and it would mandate FEMA to use premium discounts to encourage community damage-limitation measures (mitigation), such as directing development away from the water's edge. Thus, it would expand federal land-use control and violate property rights, which over the years have eroded more than the beaches.

Advocates of federally encouraged mitigation say it is proper because government provides the insurance. That's the point. Americans should understand that the more that government insures them against risk, the more plausible its case for running their lives. Responsible citizens should be free do to what they wish with their own land—and should accept the consequences.

What is the alternative to government insurance? Deregulated private insurance. The insurance industry is one of the most heavily regulated industries in the nation. Fifty state commissions dictate every aspect of the business, and bureaucratic inertia stifles innovation. One cannot predict what innovations the insurance industry would develop if the regulators stepped out of the way, but see Lawrence Haar's Current in this issue for one possibility.

Sheldon Richman

Financial Derivatives and the Insurance Industry

The 1980s witnessed an explosive growth in the development and use of financial derivative products (options, futures, forward rate agreements, interest rate swaps, etc., which are derived from an underlying spot market) and the creation of new securities backed by predictable, periodic receivables (for example, mortgage or Visa payments). There is, however, a vast untried new market of global proportions in which these developments await application. While foreign exchange markets, interest rate markets, and commodity markets alike now offer hedgers, speculators, and arbitragers a myriad of products and strategies, the global insurance industry has no such features. Apart from the financial derivatives that may be used in the management of an individual company's cash flow, insurance industry management has no access to derivative products for management of the liabilities inherent in underwriting. Moreover, laws and regulations preclude the transformation of predictable cash flows arising from insurance premiums into securities. Given the manifest problems facing the insurance industry, those deficiencies are striking.

This article will consider how derivative instruments might function in the insurance field and how the invisible hand of the marketplace, rather than further regulations, might lead us out of the current morass. First, however, it is important to understand some of the fundamental differences between insurance and other markets.

Although carrying insurance, be it for motor accidents, medical malpractice, or environmental hazards, is a hallmark of modern life, only a hundred years or so ago commercial and retail insurance coverage was very limited, apart from major industrial ventures. Religious faith and respect for Lady Luck's capricious ways sufficed. In the twentieth century, the protection of everyday assets from loss took precedence. Modern underwriting was born—and with it actuarial science. For many decades, managing exposures through the pooling of risk allowed satisfactory returns to the insurance industry while providing adequate coverage to the insured. Money management yielded profits in addition to those gained by underwriting.

Historically, benefits akin to insurance coverage were often achieved through other means, such as futures markets. The rice future markets, which developed centuries ago in Japan, effectively insured farmers against massive price movements. Notwithstanding the similarities, insuring against price risk parted ways with insuring against loss to physical assets centuries ago.

During the Renaissance, Venice's merchants

awaiting a caravel on the high seas would commonly sell their spices forward to secure a price. What never developed, however, were derivative products for hedging the loss of physical assets (protecting a specific position by buying or selling offsetting positions), even though the financial implications of, say, a price collapse and a physical loss were and still are indistinguishable.

In the last decade, the effectiveness of risk management through the use of financial derivatives has blossomed in terms of range of coverage, liquidity, and performance. In contrast, technical innovations in the insurance industry have been limited, and often directed towards satisfying new regulatory obstacles.

The problems facing the modern insurance industry can be laid at several doorsteps. Actuarial techniques—how risks are aggregated and analyzed—have been politicized, and insurance rates have become a handmaiden to social policy, for example, in the cross-subsidization of risk classes. Regulation by state commissions pits angry voters against "big business," yielding less than enlightened policy. And our parasitic tort system, with its broad liability and excessive punitive damages, promotes inefficiency. The net result is that with very few exceptions, underwriting of insurance itself no longer generates profits. Today, the insurance industry earns the overwhelming bulk of its profits from managing the float, i.e. wisely investing its enormous cash flow.

A comparison between the use of derivatives in commodity markets and insurance underwriting will illustrate the profound difference in risk management between those two industries. Conceptually, insurance underwriters may be viewed as long on cash (holding an asset without having an offsetting position) and short on "options," having sold claims exercisable against themselves without an offsetting position. That approach is curiously distinct from how an industrial firm would use options to hedge exposure.

Consider an oil producer and refiner who is inherently long on product and who hedges his revenue from refining and marketing by purchasing put options, or rights to sell oil at a fixed price in the future. If the market price of oil falls, his profit potential is as large as the difference between the option's strike, or exercise, price and the eventual spot price, adjusted for the price of the put; whereas if prices rise, his loss is limited to the price of the put. By transforming his exposure from spot price risk to basis price risk (the difference between the future exercise price and the future spot price), his downside income risk has been limited. To offset the price of the put, he might consider selling a call, or rights to purchase product in the future, exercisable above a certain price. This combination, known as a spread, is ideal for parties inherently long in the underlying asset. Through the use of derivatives, divergent views on future market conditions may be expressed and risk transformed.

The third party who purchased the call may have been an inherently short consumer, fearful of a price increase. Broadly speaking, that and any other hedging transaction, however, would not have been possible without the presence of a well-traded derivatives market having participants with distinct tastes for risk and different commercial and financial objectives. In combination, those factors contribute to liquidity.

In comparison, insurance policyholders are tantamount to risk-averse hedgers. The insurers/underwriters are akin to speculators and risk takers: having written event-dependent options (on a hurricane, for example), they money-manage the premiums while waiting and hoping for fine weather. The creators and market makers of those "derivative instruments," that is, the insurance coverage, undertake a speculative exposure only because they are able to manage the risk through actuarial techniques. However, the taking of an equal and opposite position in the same or other basis-related market is not possible. The underwriter, as market maker, is writing options to be exercised against *itself*. It is only the company's cash position or solvency that gives the option its value and prevents it from being—in industry parlance—"naked." Although risk pooling among insurers does occur, equal and opposite transactions may not be undertaken to hedge the risk.

Imagine that a gold mine could only sell calls, giving purchasers the right to buy gold from it at a specified price and delivery date. This would be speculation, since the only purpose would be to raise money and not to hedge an underlying position. (The mine's buying puts, however, would be a hedge.)

For an insurance company, however, actuarial techniques are the *only* avenue for risk man-

agement, and the profits of money management may only offset the losses of modern underwriting. If insurance companies could act like brokers or collectively like a market, matching insurers (hedgers) against potential speculators, profitability could be engineered and solvency and liquidity better managed. Let's see how this might operate.

The insurance market, like any other financial market, has the greatest use when it shifts risk to those who can carry it at the lowest cost. In this way, the cost of risk is reduced across the economy. To see how this truism could be applied in the insurance field, first consider the requirements for applying derivatives to insurance markets before we turn to the practical aspects. The first requirement is that disinterested third parties must be able to speculate on events in which they have no natural insurable interest. In nearly all jurisdictions, legal restrictions prevent such parties from having an insured interest in another's personal or commercial risk. One is legally prevented from betting on whether John Doe will fall from a train and naming oneself as beneficiary.

Historically, the potentially criminal and fraudulent aspects of such behavior dominated the debate. Yet, in commodity, interest rate, and foreign exchange markets, parties without any inherent or underlying exposure (be it long or short) undertake such risks all the time. (It's called speculation and arbitrage, and without such activity derivatives markets would cease to function. Hedgers alone do not make a market.) One is not required to own an oil refinery to speculate on the cracking spreads between crude oil and product prices. (Indeed, Cargill Investors, the world's largest commodity broker, "refines" more oil on its video screens than Exxon does in its refineries; that is, it purchases crude oil and sells products, and thereby plays the spread without owning a single distillation unit.)

To develop derivatives for the insurance field, regulators must allow disinterested third parties collectively to have an insured interest in the risks of others. The pooling of related risks might easily overcome the issues of confidentiality, criminality, and fraud.

The next requirement is the identification of suitable risky and insurable events. For derivatives to be developed in the insurance markets, the scope arguably must be limited to physical risks with either an unknown probability distribution or at least a distribution with a wide variance, for example a hurricane in the Gulf of Mexico or a flood of the Mississippi River. In contrast, a well-defined random variable, such as coronary thrombosis among males of age 60 or over, might be a problematic application of derivatives: hedgers (the insured) and speculators would unfortunately have the same view towards such events. (It would simply be a matter of biometrics and epidemiology.)

Finally, on the regulatory front, as an insurance derivatives market must function at a national level, new legislation and laws would be required, which would probably involve federal and state securities and exchange commissions. The past decade has seen many new products incorporated successfully into established exchanges. There are precedents.

With those obstacles surmounted, derivative instruments could be applied to insurance markets in the following manner. In the future, rather than pooling and reinsuring exposures, insurance companies could enter into equal and opposite derivative transactions to offset the risks arising from the original underwriting. For the right price speculators with proven financial resources might be willing to accept such risks as a Gulf of Mexico hurricane. If disaster struck, the calls they have written would be exercised by the insurance company to pay policyholders. Speculators may or may not choose to offset some or all of their exposure. After all, profits are the reward for accepting risk. A speculator might take equal and opposite positions in related markets: orange juice futures to hedge speculation on a Florida hurricane, for example. But then again, he might not.

In the future, the insurance company would function as an intermediary and broker matching exposures, like an exchange. Both natural and synthetic hedging by an insurance company could be employed as the basis risks between related events became fully understood. For example, petroleum product prices are often bumped up after news of a major oil spill or a hurricane in the Gulf interrupts crude oil lifting. Options on the New York Mercantile Exchange might be used to hedge the exposure that arises from insuring tankers on the high seas against spillage.

The benefits and public policy implications of traded insurance derivatives might be enor-

mous. Because of Hurricane Andrew, two major insurance groups are facing insolvency, while some smaller groups have already gone bust. Those developments suggest that the system is not performing as designed. Insurance payments for personal and commercial risk arising only from Hurricane Andrew have absorbed approximately 5 percent of total premium income in 1992. Policies have not been honored, and coverage has been dropped. With insurance derivatives, these conditions might not have developed, obviating the need for new liquidity and solvency legislative and regulatory initiatives now under consideration at the federal level.

Recognizing the financial difficulties of many insurance groups, numerous corporations are finding it cheaper to forgo some forms of insurance; they instead choose to treat the risks of industrial injuries and dents to the company car like exposures arising from downturns in the business cycle or movements in foreign exchange. If because of those self-coverage and no-coverage trends the insurance industry is left with a portfolio of customers who have the most inadequate risk-management policies, the problems of underwriting may escalate further.

In the United States, the slow growth in premiums and the competitive structure and conduct of the insurance industry has yielded declining real prices for property and casualty insurance, rendering insurance companies almost entirely dependent on investment rather than underwriting income. Unless new approaches are considered, we soon may regard the present dire situation as halcyon days. We need to radically rethink the nature of insurance risk, the role of underwriters, and how third parties could be involved.

The lessons of other financial markets might prove useful when applied to the risk-underwriting industry. Allowing third parties to speculate on physical risk might alleviate the current pressure points and inefficiencies. The power of derivative markets for risk management is indicated by the fact that during the Gulf War, neither petroleum prices nor even gold—the classic risk hedge—even blipped for any significant period. Derivative markets allowed interested parties to hedge and third parties without inherently short or long positions to speculate. Perhaps someday insurance markets without physical-risk derivatives will be remembered as primitive institutions, indeed.

Lawrence Haar
Texas Securities, Inc.