Currents

GATT Riddance?

The Uruguay round of General Agreement on Tariffs and Trade (GATT) talks has now dragged into its seventh year and its third U.S. presidential administration. The talks formally commenced in November 1986 at a meeting in Punta del Este, Uruguay (hence the round's name); they were originally due to conclude in December 1990, but broke down at that time because of a dispute between the United States and the European Community over agricultural subsidies. President Bush obtained a two-year extension of "fast-track" negotiating authority to keep the talks going, but two years have not proved long enough.

Now President Clinton has expressed his intention to request new fast-track authority to wind up the talks. (Fast track allows any resulting agreement to be subject to a simple up-or-down, amendment-free vote in Congress. Without it, U.S. negotiators lack the practical authority to strike conclusive deals with other countries.) How long an extension and what other trade-related provisions will work their way into fast-track legislation are questions that for now remain unanswered.

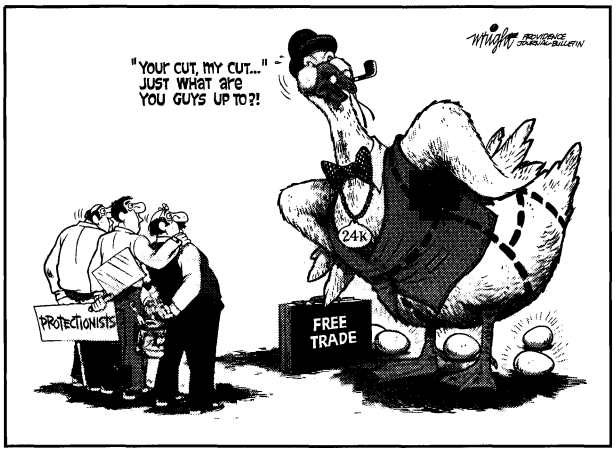
By all means we should commend the Clinton administration for continuing the U.S. commitment to the Uruguay round. Those negotiations are likely to be the administration's only trade-liberalizing initiative and should provide a welcome contrast to the mishmash of protectionist nickel-and-diming that will pass for trade policy over the next four years (possible examples include minivan tariff reclassification, revival of Super 301, punitive taxation of foreign-owned U.S. companies, new import quotas for steel, and market-share limits for Japanese autos). Furthermore, actual consummation of the talks would mark real if modest reform of the world trading system.

Supporters of free trade must face the unpleasant fact, though, that the GATT process is incapable of achieving truly substantial liberalization of international trade and investment. That is a hard message to sell, since throughout the postwar era support for open markets and support for GATT talks have been practically synonymous. Nevertheless, a clear-eyed assessment reveals that decade after decade and round after round, the GATT simply does not work in reducing protectionism. The Uruguay round should be seen through to the end, but it should be the final round. It is time for free traders to change strategies.

The GATT's fundamental problem is that it adopts and institutionalizes the very mercantilist premises that underlie protectionism—that exports are good and imports are bad. Protectionists, whether in Adam Smith's day or our own, have always regarded international trade as a zero-sum game: one country's gain (exports) implies another country's loss (imports). Hence the obsessive concern with balances of trade and with "unfair" foreign trade practices that block our exports and favor their imports.

Unfortunately, the GATT, the international institution supposedly dedicated to resisting and reducing protectionism, is based on the same mercantilist mindset. In GATT negotiations (which proceed in so-called rounds, of which the Uruguay round is the eighth), countries offer to reduce import barriers in exchange for reciprocal offers by other countries. Obtaining better access for a country's products abroad is regarded as the goal of entering into negotiations; opening up markets at home is considered the price that a country must pay to secure that improved access. Indeed, reductions in import barriers are referred to in the GATT nomenclature as "concessions." Thus, the logic and structure of GATT negotiations affirm and codify the worldview that exports are good and imports are bad.

It is often argued that the GATT's structure is "realistic"; it takes the mercantilist impulses of its participants as given and tries to channel those impulses in a constructive, liberalizing direction. In effect the GATT is a kind of "noble lie" to trick mercantilist governments into freer trade. Economists and other supporters of free trade who know



full well that open markets are beneficial regardless of the policies and conditions of other countries routinely succumb to that argument. Despite the GATT's miserable record over many decades, they unflinchingly support continued negotiations as the only practical means to liberalize trade.

It is admittedly an attractive scam, but it is too clever by half. The GATT basically asks participating countries to gamble, to take a chance that the gains from improved export opportunities will outweigh the pain of increased import penetration. From the perspective of a mercantilist national government, though, the risks are not evenly balanced. On the one side is the risk of foregoing hypothetical new export-related jobs, and on the other is the risk of losing real, existing import-competing jobs. The incentives are strong to negotiate in bad faith: to stonewall in the hope that other participants will give in first, or to make concessions so vague and loophole-ridden that they can easily be circumvented.

And that is precisely what we have gotten from the GATT for many, many years—hemming, hawing, and stalling, culminating in meaningless agreements that simply paper over unresolved differences. No wonder detractors have dubbed the GATT the "General Agreement to Talk and Talk."

Let us take a look at the GATT's record over its forty-five-year history. On the plus side, developed countries' average tariff rates on manufactured goods have been gradually whittled down from over 40 percent in the late 1940s to around 5 percent today. Most of those reductions, though, occurred early on. In 1962, for example, duty rates averaged 11.5 percent in the United States, 11 percent in the European Community, and 16 percent in Japan. Cutting those rates another 5 to 10 percentage points over the following three decades is not exactly breathtaking progress.

The GATT has always allowed major exceptions to free-trade principles. Trade in agriculture and services has never been subject to GATT discipline. Countries have always been allowed to use "escape clause" laws to block imports that are "seriously injuring" a domestic industry (that is, imports that are actively promoting beneficial industrial restructuring). Likewise, the original GATT charter authorizes countries to impose antidumping duties on imports with "unfairly" low prices. Developing countries were given permission to indulge in import-substitution policies in the name of preserving their balance of payments. All of those loopholes remain today. While the escape clauses and balance-of-payments restrictions are used rather less than they once were, antidumping laws have enjoyed an enormous surge in popularity over the past decade.

Meanwhile, new forms of protectionism have arisen. Beginning in the early 1960s trade in textiles and clothing was removed from the GATT process and subjected, under what came to be known as the Multifiber Arrangement, to an ever-expanding and more complex web of import quotas. The 1970s saw the rise in the United States and the European Community of so-called voluntary export restraints; since foreign exporters "voluntarily" agreed to limit their shipments, the restrictions technically fell outside the GATT ban on government-imposed quotas. Voluntary export restraints have limited trade in, among other things, color televisions, automobiles, steel products, and machine tools. And in the 1980s the United States began using its section 301 law to circumvent GATT dispute-settlement procedures by threatening sanctions against countries that did not measure up to U.S.-determined standards of "fairness."

On balance, it is hard to avoid the conclusion that the world—the developed world at least—is more protectionist now than it was thirty years ago. The Uruguay round was supposed to reverse that trend and revitalize the GATT process. Of course, the Tokyo round of the late 1970s was supposed to do exactly the same thing. The Tokyo round, despite an unprecedently broad agenda covering government subsidies, antidumping, government procurement, and "technical" nontariff trade barriers, failed in its rescue attempt.

The Uruguay round's agenda was even more ambitious: among other things, it sought to extend GATT discipline to agriculture, services, and intellectual property protection and to phase out the

Multifiber Arrangement. Even the most fervent supporters of the round now acknowledge that if an agreement can be reached, its reforms will be much more modest and incremental than originally envisioned. And whether an agreement is even attainable remains a big if: agriculture is by no means the only obstacle to the talks' completion. Meanwhile, at least another seven years will have slipped by.

The GATT has failed in the past and will continue to fail in the future for the simple reason that it is playing a losing game. The GATT seeks to lead mercantilist governments to become free traders for mercantilist reasons. It will never work. As long as policymakers believe that exports are good and imports are bad, negotiations may lead to a shifting mix of trade barriers—as countries variously duck and feint and backfill and sneak around—but the talks will never lead to substantial elimination of protectionist policies.

The only sure path to real reform is to take on the mercantilist mindset head on. Supporters of free trade in this country should give up on the false promise of GATT negotiations and devote their time and energies instead to an agenda of unilateral liberalization: progressive elimination of U.S. protectionist barriers as a matter of national economic policy, without regard to the policies or conditions of other countries.

Adoption of such a strategy would have the immediate benefit of putting the cause of free trade on the intellectual offensive. The focus of the policy debate over trade negotiations is on the misconduct of other countries (for example, the European Community's agriculture subsidies, Japan's ban on rice imports), which puts free traders in the rhetorically unenviable position of being apologists for foreign abuses. Furthermore, trade negotiations deflect criticism of U.S. protectionist policies because of their near-sacrosanct status as "bargaining chips." By contrast, the focus of debate over a unilateral free-trade agenda would be squarely on the costs and benefits of existing U.S. trade barriers. Framing the issue that way moves protectionists to the moral low ground of explaining why protected industries deserve their special treatment.

Moreover, a unilateralist strategy would extricate the cause of free trade from the escalating diversionary squabbles over environmental and health and safety issues. The "green" attack on free trade has arisen in response to efforts—in the GATT and the North American Free Trade Agreement—to harmonize nations' environmental and health and safety regulations and to subject the trade-distorting effects of those regulations to international discipline. A unilateralist approach would divorce reduction of trade barriers from international regulatory harmonization; accordingly, the case for the former would no longer get bogged down in questions over the latter.

Support for unilateral free trade is typically dismissed as naive or politically impossible. It is nice in theory, the line goes, but the only real supporters for such a program are a few idealists and economists. The fact is, though, that there are significant and growing business interests with a direct stake in open import markets—import-using industries, distributors and retailers of imported merchandise, U.S. corporations with international production operations, and foreign corporations with U.S. production operations. Those business interests, plus the consumers' general interest in lower prices, could be combined into a potent political force. Admittedly, any attempt to remove protectionist barriers would meet stiff resistance, but politicians committed to a free-trade agenda could flex plenty of muscle themselves. And as to naivete, what could be more naive than continuing to place one's trust in GATT negotiations that decade after decade have delivered almost nothing of value?

What about the rest of the world? Significant unilateral liberalization by the United States would do more to undermine foreign trade barriers than any number of further GATT rounds ever could. Today, our self-righteous carping that other nations should do as we say and not as we do is rightly dismissed around the world as so much hot air. If, however, the United States actually went forward with removal of its trade barriers, other countries would at last be forced to take us seriously. Our ability to exert diplomatic pressure would be enormously enhanced.

More important, U.S. liberalization would give foreign governments a real, practical incentive to reform their own trade policies: keeping up with the Joneses. In the past decade or so a number of countries around the world have managed to make sweeping reductions in trade barriers—among them Australia, New Zealand, Mexico, Chile, Argentina, and India. They did so not because of any negotiating breakthrough at the GATT, or under threat of U.S. sanctions, but because their political leaders came to the realization that isolation from the world economy was

causing economic stagnation. Likewise, the member states of the European Community committed themselves to the ambitious EC 1992 initiatives to jolt their economies out of "Eurosclerosis."

In other words, countries will liberalize their trade policies—not just tinker at the margins, but institute thoroughgoing reforms—if their leaders think such a move is necessary to maintain international "competitiveness." If the United States opened its markets and prospered accordingly, other countries would feel the pressure to fall in line or fall behind.

At this late stage it would be a mistake to give up on the Uruguay round. An agreement would impose some useful constraints on protectionist-minded governments, and it would be a shame to get nothing in return for of all this time and effort. The United States should seek to wrap up the talks as quickly as possible—in effect, declare victory and go home. After that, supporters of free trade should seriously rethink their strategy before launching any more negotiations. It is time to move the battleground for freer trade from Geneva to Washington.

B.L.

"That? It means our 'No Smoking' policy doesn't apply here at corporate headquarters."

Tobacco Smoke and Statistical Mirrors

The Environmental Protection Agency recently concluded that environmental tobacco smoke is a "Group A" carcinogen that may cause 3,000 cases of lung cancer a year. That "finding" will not have any direct regulatory effect, because EPA has no authority to regulate indoor air. The EPA report, however, may lead the Occupational Safety and Health Administration and state and local governments to increase the regulation of smoking in the workplace and other private facilities.

There are two serious problems with this development. First, the EPA report is based on what is best described as "political science," rather than on objective statistical analysis. The problems with the analysis are legion. For example, the studies reviewed by EPA are based on the relative incidence of lung cancer among the nonsmoking wives of smokers and nonsmokers. Most of those studies do not control for other types of lung cancer risks to which either group may be exposed. In addition, of the thirty studies the EPA reviewed, twenty-four report no statistically significant increase in risk. The EPA has based its conclusion on a "meta-analysis" that is not easy to replicate and on a looser standard of statistical confidence than the general scientific standard that it previously used. Further, the EPA review did not include the most recent study, based on an unusually large sample, that found no significant increase in risk. Finally, the EPA review did not include the large number of studies of exposure in the workplace and exposure by males and children, most of which found no significant increase in risk.

One can only conclude that the EPA changed its own prior guidelines and selected from the available evidence to meet a "politically correct" conclusion. At most, environmental tobacco smoke may be a trivial health risk, probably less than from the chlorides and fluorides released by one's morning shower.

The second problem with the EPA report is that the government has no business regulating the relations among people in a contract (home, work, shopping) setting. The people involved have much better information and incentives to develop rules for their interaction than does the government. And there is no reason to expect that one set of rules is optimal in all such relations.

The primary problem of passive tobacco smoke, however trivial its health risks, is that it is offensive to many people. Employers, restaurants, and stores have responded to this concern by several means, including segregation, increased ventilation, and only rarely by a complete ban. The government can provide a valuable public good to

assist those private choices by providing an efficient and *unbiased* summary of the best available evidence on the health effects of passive smoke. But biased information is a public bad. And the government compounds the problem by "one size fits all" regulations based on such weak evidence.

In this case, the government has used a questionable public health rationale to cater to the "new puritans" who are offended by the recognition that other people enjoy a practice that the puritans disapprove. What is next? Regulations on fatty foods, skiing, and sex? Ease off!

GOVERNMENT WARNING

The author of this note enjoys smoking a pipe in his large closed office.

The Cato Institute receives some support from a major tobacco company.

W.N.

FDICIA: One Year Later

FDICIA, the Federal Deposit Insurance Corporation Improvement Act of 1991, took effect on December 19, 1991. Driven by a perceived need to protect the American taxpayer from a second deposit insurance bailout, FDICIA was and still is hailed by many as a major step forward in preventing another S&L crisis. That attitude perversely misses FDICIA's main impact.

Three factors in addition to the S&L crisis drove FDICIA's enactment: bad data, a confusion between cause and effect, and congressional distrust of regulators. Underlying those factors, and least understood of all, is a resurgence of bankerphobia, stemming from the belief that bankers are the root cause of whatever ails the economy. Bankerphobia, which is comparable to racism, sexism, or anti-Semitism, is evidenced by comments such as "all banks do this" or "bankers do that."

Like all bad legislation, where undesirable and unintended consequences (perhaps intended in the minds of some) swamp the intended consequences, FDICIA increasingly harms the economy. Although attempts are being made to fine-tune FDICIA, its harm can be reversed only by privatizing deposit insurance.

Bad Data

Money was the locomotive that drove FDICIA into the statute books. But bad data fueled that locomotive. Specifically, FDICIA raised to $30 billion, from $5 billion, the amount the Federal Deposit Insurance Corporation could borrow at the Treasury to cover any deficit in the Bank Insurance Fund, the fund that protects bank depositors. Borrowings under that line of credit are supposed to be repaid from future deposit insurance assessments. Additionally, the FDIC was empowered to borrow working capital from the Federal Financing Bank, up to 90 percent of the Bank Insurance Fund's nonliquid assets.

Providing those two lines of credit, which in and of itself was not imprudent, set off a wave of congressional and media hysteria about conditions in the banking industry that fueled FDICIA's regulatory lynching of *all* bankers. By page count, the financing provisions account for less than 3 percent of the bill; indiscriminate regulatory overkill accounts for most of the rest. And all because of bad data.

Members of Congress understandably do not want to suffer another deposit insurance bailout, especially since more congressmen have lost their jobs over the Federal Savings and Loan Insurance Corporation's bailout than have regulators. Starting in 1990, the FDIC, the Office of Management and Budget, the Congressional Budget Office, and the General Accounting Office, pursuing their own agendas, began fanning fears that commercial banks were going the way of S&Ls, which, if true, would force a taxpayer bailout of the Bank Insurance Fund.

Loss estimates of $30 billion, $40 billion, $50 billion, or more were tossed about. Those numbers gave cover for "politically correct" private analysts to develop even more alarming estimates. Surely, it seemed, a crisis was at hand. This collective hysteria about a problem that never was fathered FDICIA and its economic drag on the economy.

But a crisis was not about to erupt because all estimates of Bank Insurance Fund losses, except one, were inordinately high. In May 1991 Ely & Company began publishing detailed projections demonstrating that the deposit insurance premium banks began paying in mid-1991 (23¢ per $100 of deposits) would more than cover *all* Bank Insurance Fund losses and would rebuild the mythical Bank Insurance Fund (that is another story) to a supposedly safe balance. History has borne out the accuracy of our projections. Our data show that commercial banking's problems were regional and sequential in nature. At no time was the entire banking system at risk, as it was during the 1933 banking crisis.

All was for nought, though. Ely & Company's predictions were ignored because Washington only wanted to hear bad news about banks as bankerphobia intensified. Interestingly, our projections, if anything, overstated somewhat the Bank Insurance Fund's future losses in failed banks. *The FDIC has not and will not need to borrow for the Bank Insurance Fund a single dollar of its $30 billion line of credit at the Treasury.*

Confusion between Cause and Effect

Most public policy analysts are as skilled as eighteenth century medical pathologists. They repeatedly diagnose symptoms and consequences as the cause of problems and thus prescribe cures worse than the affliction. Bankerphobia further distorts the diagnosis. Few analysts understand that numerous deliberate federal policies manufactured financially unsound S&Ls, a fiasco that will cost taxpayers almost $200 billion. Even fewer analysts understand that because commercial banks are not like S&Ls, bank failures will be much less costly.

Commercial bank insolvency losses over the past twelve years have been highly concentrated geographically, reflecting the regional nature of the asset deflations that largely caused those losses. Half of the losses in failed commercial banks have occurred in Texas, and 91 percent of the losses have occurred in just fifteen states, located primarily in the Southwest and the Northeast. Yet FDICIA attacked the Bank Insurance Fund's losses as if individual bankers could prevent regional deflations and bankers everywhere are incompetent and potential crooks. There is absolutely no link between the premises on which FDICIA was built and the deflationary forces that sparked the Bank Insurance Fund's losses.

Congressional Distrust of Regulators

FDICIA also reflects the widespread and well-deserved congressional distrust of S&L and bank regulators. The roots of that distrust lie in the gross ineptitude S&L regulators displayed during the 1980s, albeit aided and abetted by Congress. Banking regulators, though, have not gloried themselves, as they first underreacted and then overreacted to banking's regional problems.

Specifically, members of Congress believe, with some justification, that S&L and later bank regulators abused their traditional regulatory discretion by forbearing too frequently for too long in dealing with failing banks and S&Ls. The evidence of S&L forbearance is overwhelming; except for S&L-like savings banks, however, the evidence of forbearance by bank regulators is less clear. Consequently, FDICIA contains numerous new rules, specifically "prompt corrective action," designed to sharply curb regulatory discretion.

FDICIA's dictate that regulators quickly close clearly weak banks and thrifts unable or unwilling to save themselves is a good feature of the bill. It also sent a wake-up call to bank regulators. The requirement already has materially reduced banking's dregs. Unfortunately, FDICIA did not stop there.

Instead, FDICIA imposed stringent one-size-must-fit-all "safety-and-soundness" standards on all banks. Such stringency has sharply impaired the competitiveness of banks, prolonged the credit crunch regulators themselves had previously triggered, fostered an increasingly *inefficient* financial

system, and increased taxpayer risk posed by nonbanking channels of credit intermediation. Talk about unintended consequences!

A few examples from FDICIA's 161 pages of small type and the 60-odd sets of regulations it spawned will illustrate. In addition to stating that regulators must deal aggressively with "critically undercapitalized" banks (fair enough), FDICIA set a standard for "well-capitalized" banks that significantly exceeds international bank capital standards. Consequently, FDICIA overkill has impaired the ability of U.S. chartered banks to profitably compete *inside* the United States against foreign-owned banks and domestic nonbanks. That discrimination makes about as much sense as requiring cars made in the United States by the Big Three to be equipped with catalytic converters while Hondas manufactured in Ohio are not.

No one should be surprised to learn that business lending by foreign banks inside the United States increased by $28 billion in 1991 and 1992 while U.S. banks trimmed their business lending by $74 billion.

Ironically, capital is a *lagging* measure of banking risk, yet escalating uniform capital standards have made it difficult for banks to profitably own low-risk assets. Consequently, higher capital standards are driving lower-risk assets off bank balance sheets. That explains why regulatorily favored nonbank channels of credit intermediation, such as the money market mutual funds and asset securitization, have grown at banking's expense. A massive regulatory arbitrage is now reshaping the American financial system in ways few, if any, intended. Research Ely & Company conducted last year suggests that nonbank credit intermediation in the main actually is less efficient than bank intermediation of credit.

But FDICIA did not stop at boosting capital standards for already sound and well-managed banks. It also directed regulators to develop detailed yet uniform "operational and management," "asset quality, earnings, and stock valuation," and "compensation" standards, to name a few—issues formerly left to the discretion of bankers and regulators. In effect, those standards presume incompetent bank management, a presumption neither proven nor true.

Space does not permit the comprehensive dissection FDICIA warrants. But the former Soviet Union and Eastern Europe amply demonstrated that central planning and government micromanagement of individual enterprises cause economic rot. That lesson escaped Congress and its staff when it drafted FDICIA out of a misplaced fear that commercial banking was in crisis.

FDICIA's Consequences

FDICIA is delivering its predictable yet supposedly unintended consequences. In inflation-adjusted terms, the total assets of all banks and thrifts have shrunk 15 percent over the past four years as these institutions have steadily lost market share to their less-taxed and less-regulated competitors. Although commercial banks have been buying thrift institutions, the inflation-adjusted assets of banks have shrunk 4 percent over the past three years. Bank and thrift deposits, the feedstock of bank lending and investing, have plunged to modern lows relative to GDP. At the same time, banks are getting safer, and perhaps too safe, as bankers, increasingly fearful that they will lose their bank because of regulatory caprice, hunker down.

The government-induced contraction of the nation's depository institutions is destroying billions of dollars of bank franchise value as employees are laid off, banks merged, and branches closed. FDICIA and its legislative antecedents are needlessly manufacturing overcapacity in banking that cost-cutting and industry consolidation must then eliminate.

What few realize is that FDICIA has not yet hit its full stride. One senior regulator estimated that it will take three years for the full impact of FDICIA, and all of the regulations it has spawned, to fully clobber the banking system and the economy.

Perhaps FDICIA's greatest irony lies outside the banking system. Nonbank channels of credit intermediation have no mechanism comparable to federal deposit insurance for levying on surviving firms the losses the federal government incurs in protecting the creditors of failed financial firms. The Federal Reserve will incur those losses to protect the stability of the entire financial system. Since the Fed, in a financial sense, is merely an appendage of the U.S. Treasury, the general taxpayer will bear those losses.

The Clinton administration has expressed great interest in easing FDICIA's indiscriminate regulatory overkill. That will be very difficult, however, for two reasons. First, FDICIA has many fans on Capitol Hill, in the regulatory community, and

among academics, where bankerphobia is especially virulent. They will not easily cede back to the marketplace the power over banking they have fought so hard to gain.

Second, regulatory personnel, particularly the bank examiners, overreacted several years ago to certain regional real estate problems. They did not back off despite the pleadings of senior regulators and Bush administration officials. The old saying, that it is much easier to unleash the dogs than to call them off, also may hold true for the Clinton administration.

What can be done about or to FDICIA? One former senior bank regulator recently suggested that the best way to correct FDICIA is to repeal it and start all over again. That is a wonderful idea, especially since the hysteria about conditions in the banking industry is subsiding. But that will not happen, for two reasons.

First, FDICIA's economic damage has not yet manifested itself sufficiently to overcome the deeply felt congressional guilt over the FSLIC fiasco and the fear of a second deposit insurance bailout. Second, the political process is not yet willing to surrender its greatly increased control over $4.5 *trillion* of bank and thrift assets. Americans have not yet begun to demand perestroika for banking.

Consequently, FDICIA will inflict increasing damage on the economy. That is a gloomy prognosis, but I hope that this strangling eventually will build sufficient pressure to cut the noose, not merely loosen it.

There is only one way to cut the noose, and that is to privatize the management of deposit insurance, and all of the government safety-and-soundness regulation that accompanies it, while eliminating *all* taxpayer risk posed by deposit insurance. As in any other sphere of economic activity, a properly structured marketplace will deliver far superior outcomes than can government micromanagement.

Rep. Tom Petri will reintroduce legislation this spring to privatize deposit insurance, using the 100 percent cross-guarantee concept. That industry self-insurance mechanism would permit the marketplace to tailor capital requirements, lending standards, and so forth to the risks and management strategies of individual banks and thrifts. Only through 100 percent cross guarantees can FDICIA's damage to the economy be repealed.

Some argue that it is politically impossible to radically alter banking regulation by privatizing it. The alternative, though, is a shrinking banking industry, an increasingly risky and inefficient nonbank segment of the financial system, and sluggish economic performance. When the hurt gets bad enough, change will occur. FDICIA is providing that hurt. From that perspective, maybe we should be grateful for what the apparatchiks have wrought.

Bert Ely
Ely & Company

Financing Infrastructure Investment by Taxing Foreign Corporations

By all accounts, President Clinton will introduce legislation that will provide for, among other economic measures, the immediate investment of $16 billion per year over the next four to five years to improve and enhance the nation's infrastructure. During the campaign and in its economic platform, the Clinton team repeatedly asserted that a major source of funding for that investment would be substantial new tax revenues from foreign subsidiary corporations operating in the United States. The amounts mentioned were initially in the $20 billion to $25 billion range per year, although more recent statements by the Clinton team talk about $45 billion to $50 billion over four years.

Given the Clinton administration's need to achieve positive accomplishments in its initial endeavors, it is incumbent upon it to effectively explore both the complete ramifications and the likelihood of success in attempting to generate that additional level of revenue in a relatively short period of time—let alone on a sustained basis.

For a number of reasons, those significant revenue goals do not appear to be attainable, and their aggressive pursuit would likely prove counterproductive. First, the tax revenue estimates on which the Clinton advisers relied are vastly inflated because the methodologies applied to generate them are fundamentally flawed by the lack of precision in comparing U.S. and foreign firms and in establishing rate-of-return criteria. Second, a tax policy that is directed specifically toward foreign corporations in a discriminatory manner will have

diplomatic, commercial, and financial repercussions that will both impede growth and be self-defeating in their outcome.

The Clinton administration can, however, have its "tax cake" and eat it too if it indeed has the courage to drastically alter the current structure of international taxation so that its revenue goals are achieved in a multilateral context.

Source of the Inflated Revenue Estimate

Clinton's advisers made no independent assessment of tax revenues from foreign-controlled subsidiaries operating in the United States. Instead, they used estimates from earlier studies that inappropriately compared U.S. and foreign firms in attempting to establish rate-of-return criteria to project the firms' taxable income. For example, in general, U.S. overseas subsidiaries are much older with more established asset bases, traditional customers, and diverse investment patterns than foreign subsidiaries in the United States. Thus, U.S. subsidiaries overseas are likely to earn a higher return on assets and sales than foreign-controlled affiliates here. The much closer relationship between the book value of assets and total sales of U.S. subsidiaries bears this out. Even more critical is the fact that many of the foreign subsidiaries in the United States are primarily engaged in distribution as opposed to manufacturing. Particularly in the case of the Japanese distributors, it is widely acknowledged that market share growth, as opposed to profitability, has been their primary objective. Thus, their return on sales is very likely to be substantially below that of U.S. subsidiaries.

The result of using such fundamentally flawed methodologies to project tax revenue from foreign-owned subsidiaries operating in the United States has been a gross overestimate of that revenue. When formal IRS settlements have been announced in the press, as in the automobile and consumer electronics industries, the U.S. government has settled on a taxable income figure based on a return on sales ranging from 2 to 2.5 percent. If, indeed, that range is reasonable, at 1989 levels foreign subsidiaries operating in the United States would have approximately $19 billion to $26 billion in taxable income, which would generate tax revenue of $5 billion to $9 billion annually.

Unlikelihood of Revenue Enhancement

Just as critical as the amount of tax revenue being raised is the temporal issue of how quickly that revenue might be enhanced and what the repercussions might be for acceleration. Germane to this is a report by a Bureau of National Affairs newsletter that indicated that Clinton's advisers believe that no fundamental changes are required in current or proposed U.S. transfer pricing regulations to achieve their revenue goals. If, in fact, no immediate significant changes are contemplated other than those the Treasury proposed in January of this year, which seems plausible since changing those regulations would be both complex and time consuming, there is little likelihood of any rapid increase in tax revenue from those firms.

Tax revenues are unlikely to increase because economic recession has hit foreign subsidiaries—generally in consumer durables, consumer electronics, or high technology—particularly hard. In addition, the IRS continues to pursue adjustments that are so aggressive that they preclude any reasonable settlements and lead to an ever-growing backlog of cases. Moreover, the ultimate adjudication process is both lengthy and complex. It involves not only the IRS appeals process but also the option to go to trial in Tax Court. Those parties can also request a government-to-government resolution in a tax treaty process known as competent authority. Overall, it is not unusual for a final resolution to take seven to ten years. Finally, the relevant regulations themselves are both arcane and subject to varying interpretation. Thus, they lead to inefficient administration.

The regulations, which are ultimately the main culprit, are primarily intended to determine the reasonable allocation of income between the parent and its subsidiary. Unfortunately, the mechanism chosen is one in which one is supposed to first determine an acceptable price for the transferred good and then have that price determine income allocations. The standard of an acceptable transfer price is that of a firm negotiating with an independent party at "arm's length." Since transfer prices in general are not market prices, however, there are virtually no objective standards.

For example, a VCR that is sold by a foreign-controlled subsidiary to a department store for $300 wholesale may have $100 in advertising, warranty, and other distribution costs associated with its sale. If the foreign manufacturing parent charges $175 for each unit, the subsidiary earns a substantial profit of $25 or 8.3 percent of sales. If the transfer price to the subsidiary is raised to $195 and there is no change in the final selling price, the profit is reduced to $5 or 1.7 percent of sales. Since virtually all VCRs are now sold through controlled distributors, there is no open

"If only we could get Japanese executives to spend as much time in meetings as we do!"

market price that can be used as a benchmark. That forces the IRS and the taxpayer into a second-best solution, which is to determine what a "fair" or reasonable level of profit ought to be for a foreign distributor. Unfortunately, the search for a comparable distributor can be as quixotic as that for a "fair" price. The disparity created by the interpretation of a "comparable" firm is what creates the enormous delays in the adjudication and settlement process.

Therefore, under the current regime, it is highly unlikely that any substantial revenue enhancements will be forthcoming from foreign affiliates until the economic recovery is fully under way and a more effective process is developed for dealing with the complexities and ambiguities of our current transfer pricing regulations.

The Danger of Discriminatory Tax Codes

There is a danger that the Clinton administration, having staked out its own optimistic and aggressive political position on revenue enhancement from taxing foreign subsidiaries in the United States, will be tempted to speedily enact discriminatory tax code provisions directed specifically at foreign subsidiaries. To do so would clearly generate significant foreign policy frictions that might catch the administration completely off guard and thereby seriously damage its initial relations with Japan, Korea, Canada, Germany, Great Britain, France, and even Mexico. The reason that the administration might be caught off guard is that successive U.S. administrations have generally failed to appreciate the close nationalistic linkages that exist between a country's major multinational enterprises and its government on issues of broad policy involving the guarantee of equal treatment for its commercial and political representatives. Moreover, any attempts to discriminate against foreign-controlled subsidiaries in the United States will be met with immediate retaliation against U.S. controlled subsidiaries overseas, which will engender a counterproductive cycle and additional diplomatic confrontations. That would indeed be a tragedy that would have broad repercussions far beyond its commercial implications.

Constructive Steps to Stimulate the U.S. Economy

If substantial new tax revenues are not going to be generated under current and proposed policy and if attempts to alter U.S. regulations that are clearly discriminatory are ultimately counterproductive, what constructive, timely steps might the Clinton administration undertake?

At a minimum, the first step ought to be the reaffirmation of U.S. traditional foreign policy: the United States should reassert that it intends to treat all corporations under its jurisdiction and protection, independent of where their ownership or control ultimately lies, in a similar, nondiscriminatory manner. It expects and demands the identical behavior from all its commercial partners with respect to U.S. controlled affiliates.

Next, in the area of tax administration, the United States should create a temporary "safe harbor" provision allowing corporations to settle all outstanding assessments at a taxable income minimum of 2 to 3 percent of sales. The IRS commissioner currently has that authority and can make exceptions where required. That step would eliminate much of the current backlog and likely generate an immediate additional $10 billion to $11 billion for fiscal year 1992-93 on a one-time basis.

In addition, the United States should take the lead in reducing the administrative complexities of the current system. It could do this by offering to split—on a 50-50 basis—with the firm's home country the taxable consolidated income from all foreign corporations operating in the United States. Then each jurisdiction could tax the income at its respective tax rate. Such a measure is consistent with our tax treaties with those countries and would eliminate all the problems of defining taxable income within a particular jurisdiction. For example, in practice that would mean estimating the consolidated net income of a foreign distributor operating in the United States and of its parent in Japan for product lines sold in the United States. Assuming that this was $100 million, based on sales of $1 billion over a three-year period, 1986 to 1989, the United States would have allocated $50 million to the subsidiary and $50 million to the Japanese parent. The United States would tax the income at 34 percent, and Japan would tax the income at Japan's respective rate.

Finally, the United States should no longer tax the income (dividends) U.S.-based multinational enterprises receive from their overseas subsidiaries. In addition, the United States should recommend the same treatment by its major commercial allies so that foreign-source income, other than royalties, would no longer be taxed.

Those recommendations are based on the obvious premise that the Clinton administration's primary goal is to increase the real growth of the U.S. economy. Since 1982, the major source of sustained growth in the U.S. economy has come from export growth, which is primarily linked to its multinational enterprises and related firms. Those firms are most in need of an open and fair trading environment and of a tax environment that is both fair and transparent in its impacts. Thus, the United States would have to take the same bold leadership in the tax area that it has historically taken in the trade area.

Although radical to some, and certainly not a traditional Democratic approach, these proposals would greatly simplify the current system, ultimately eliminate whatever incentives there are to manipulate prices and profits to minimize taxes, avoid the complexities of the foreign tax credit calculation, and produce immediate revenues for the IRS and the Treasury without a prolonged and costly adjudication process.

For those who argue that not taxing repatriated foreign dividends reduces tax revenues, the response is twofold. First, that revenue will ultimately be taxed at the individual level as dividends or capital gains, depending on the disposition of the proceeds. Second, taxing repatriated foreign dividends is completely consistent with the Treasury's proposals for integration of the corporate tax system in the case of dividend payouts to individuals.

Conclusion

The Clinton administration will not be able to generate substantial new tax revenues on an ongoing basis from foreign-controlled subsidiaries operating in the United States under current policies because the taxable income is simply not available. The tax regulatory system that is charged with collecting those revenues is arcane, ambiguous, and extremely lengthy in its processes and thus precludes any obvious increase in receipts. To increase tax receipts in a progrowth environment, the current system needs to be simplified, modified, and restructured to engender the proper economic motivations. If the United States attempts to discriminate against foreign-controlled corporations, it will create severe diplomatic problems with its major allies far beyond the commercial implications. In addition, it will invite retaliation against U.S.-controlled subsidiaries. The United States can both gain immediate revenue and take the lead in innovation if it has the courage to "change" the current gridlock that afflicts the system of taxing foreign corporations.

Michael E. Granfield
University of California at Los Angeles

Defense Conversion

The idea of converting defense companies to civilian production is a tantalizing prospect. It produces a civilian payoff for the scientific and technological advances developed in the course of designing new weapon systems, and it provides employment for the many scientists, engineers, and skilled craftsmen who are losing their jobs as a result of the cutbacks in military spending. Not

too surprisingly, President Clinton advocated an ambitious program of defense industry conversion in the recent election campaign. Congress could not wait and appropriated over $1 billion for that purpose last year.

So what is the problem? The trouble is that governmental decisionmakers often overlook the experiences of the past before enacting additional legislation. It is a lot more fun to tout one's brainstorm as a new idea. Conversion is not a new idea, and there is a track record to be considered. Sadly, those past experiences of defense companies' trying to diversify into commercial markets are not very good.

The Dismal Track Record

Ever since the end of World War II, the large, specialized military contractors—Lockheed, Northrop, General Dynamics, Grumman, McDonnell Douglas, and Boeing—have repeatedly tried to penetrate civilian markets outside aviation and aerospace. The results have been dismal. Most of those ventures have been abandoned or sold off. The remainder generally operate at marginal levels. In the words of a study for the U.S. Arms Control and Disarmament Agency, "[t]here is a discouraging history of failure in commercial diversification efforts by defense firms."

Boeing—the most successful builder of commercial jet airliners—tried to use some of the surplus resources of its helicopter division to build subway cars. After encountering all sorts of grief in dealing with the Department of Transportation, several municipal governments, and a host of union restrictions, it left the business. Ditto for commercial hydrofoil vessels. Like its competitors, Boeing kept trying to diversify in the 1980s. The result was a cumulative deficit in its nonaerospace, nongovernmental sales for the decade.

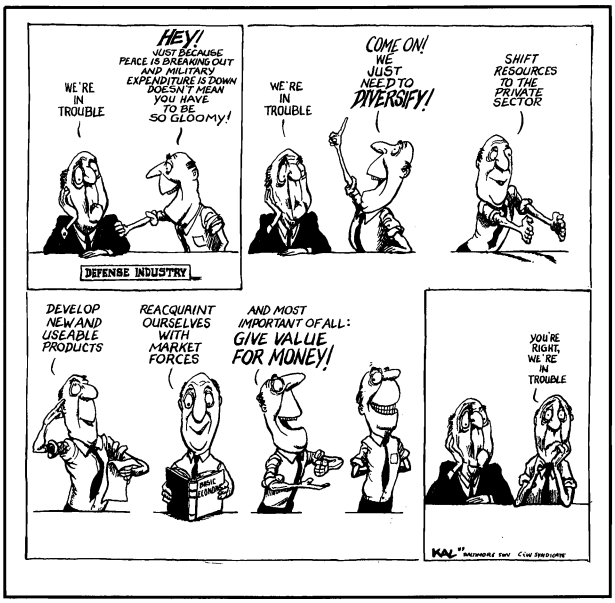
After similar adverse experiences, General Dynamics announced in 1989 that it would stick to defense business. Since then, it has sold off Cessna, the subsidiary producing small aircraft for the commercial market as well as several of its military-oriented divisions.

Curtiss-Wright provides the most extreme example of the conversion approach. The pioneering aviation company built more aircraft during World War II than any other U.S. manufacturer. It diversified out of the military market and into a host of industrial product areas. While its former competitors now enjoy annual sales of aircraft, missiles, and space vehicles measured in billions of dollars, Curtiss-Wright's annual revenues are down to about $200 million.

Why conversion has failed is no secret. The major defense companies are highly specialized. They are set up to design and produce state-of-the-art aircraft and closely related high-tech products. They are very good at the tasks they are set up to do. Companies that specialize in defense work, or their military-oriented divisions, have been successful in diversifying into a few large but very narrowly defined markets. The expansion from aircraft to missiles was a natural progression. Similarly, they quite successfully extended their capabilities to the design and production of space systems—both military and civilian (NASA). Several large aerospace companies also have designed and produced substantial numbers of civilian passenger aircraft, but, except for Boeing, profitability has been illusive.

On the other hand, the major defense contractors in general are woefully ignorant of the basis of commercial business. They have little experience and limited capability for producing in large quantity at low unit costs or in using tried-and-true, low-tech production methods or designs or in marketing and distributing their products to broad consumer markets.

Compared with commercially oriented companies, defense contractors have relatively low capitalization, a large administrative structure geared to the unique reporting and control requirements of the governmental customer, and little if any



commercial marketing know-how. Clearly, the type of company that can successfully design and build a new multibillion dollar ICBM network has a very different set of capabilities from that of the soap, steel, toy, or other typical cost-conscious but low-tech company operating in the commercial economy.

Grumman provides a cogent case in point. The firm developed and tried to sell a minivan years before Chrysler popularized the vehicle. Grumman failed at making the project a commercial success because it lacked a broad-based distribution network. That experience illustrates a more general point that is widely understood in defense industry circles. Commercial markets are already fully served with strong, knowledgeable, established competitors.

Given the substantial cutbacks that have been made in the military market and the great likelihood of a downward trend's continuing in defense procurement, the most sensible response on the part of the contractors in the private sector is to reduce the scope of their operations—to slow down, consolidate, and cut back. Most of the companies are doing just that as they respond to the growing excessive capacity in the defense industry.

All that has not prevented enthusiasts for defense "conversion" from continuing to beat the drums for a more formal government program in that area. Indeed, the fiscal year 1993 Department of Defense appropriation bill allocated $1.8 billion for defense conversion, including $575 million for research and development to help defense contractors retool for commercial products and $306 million for research and development into dual-use technologies.

In his election campaign document, *Putting People First,* President Bill Clinton proposed a new program of loans and grants to help defense companies convert to civilian pursuits. His infrastructure programs specify the use of defense production facilities. He also wants to develop an inventory of national defense jobs. All that sounds as if the recent congressional action on defense conversion is the beginning, not the end, of federal involvement in that aspect of private business.

There is a particularly ironic aspect to the subject of defense conversion. So much of the enthusiastic support for such expansion of federal activity comes from the same people who, all through the cold war period, bitterly criticized the companies in the "military-industrial complex" for being economic dinosaurs with a wasteful, cost-plus mentality—and worse. It would seem that those critics would welcome the opportunity to slim down that "inefficient" sector of the American economy and to transfer its resources to other, supposedly more productive sectors of the economy. After all, as conversion guru Seymour Melman asserted, "[t]hese fellows couldn't produce anything for Sears & Roebuck to save their lives."

In any event, the United States is not facing a disarmament situation. A substantial budget for defense R&D and procurement is likely for the foreseeable future. That requires a significant defense industrial capability. That design and production base is more likely to be available without federal subsidy if the major defense contractors are allowed to consolidate, close down unneeded facilities, and, in general, cut down the size of their current operations. The alternative—which would be brought about by yielding to the demands for defense "conversion"—would be an array of weak, financially unstable firms that could not adequately compete for the weapons and equipment that the Department of Defense will need in the years ahead.

Large-scale federal subsidies for defense conversion would be a waste of government money at a time when deficit reduction is a high priority. Yet, on reflection, such outlays would be more pernicious than that. An examination of the conversion bills that are already in the congressional hopper reveals that the enactment would be a large step toward increased governmental control of private business. One of the more enthusiastic supporters, the Worldwatch Institute, asserts: "Conversion goes beyond a mere reshuffling of people and money. It involves a political institutional transformation."

Conclusion

The enthusiasts for subsidized conversion of defense companies forget that, in a private enterprise economy, the basic responsibility for adjusting to unemployment or reduced sales falls on the individual worker or firm. The optimum approach to national economic policy during a period of defense cutbacks is for the government to focus on the important responsibilities that are uniquely its own—developing sensible macroeconomic monetary and fiscal policies and minimizing tax and regulatory obstacles to economic activity.

Erecting that appropriate economic framework is challenging enough. It creates the conditions that make it possible to achieve a truly meaningful peace dividend—which will occur when individuals and companies successfully shift from military to civilian activity. Once government succeeds in combining reduced military spending with that revised macroeconomic policy geared to a growing economy, it should then get out of the way!

Murray Weidenbaum
Center for the Study of American Business

Not Quite Free Wheeling: The Energy Policy Act of 1992

In 1978 Congress enacted the Public Utility Regulatory Policies Act (PURPA) to foster industrial cogenerators and other small power plants not owned by utilities. The act unexpectedly set in motion competitive forces that are reshaping all of electricity. Nonutility generation grew from only 2.5 percent of U.S. capacity in 1983 to provide 9 percent of all power in 1991. By the end of 1991, 4,091 nonutility power plants were in operation. Between 1991 and 1994 nonutilities will build over 50 percent of all new capacity.

PURPA mandated much of the growth by compelling corporate utilities to purchase power from "qualifying facilities" located in their service areas. It required state regulators to set the price at the "avoided cost" of the utility-produced power being replaced. Initially, long-term contracts with liberal payments spurred cogeneration in a number of states. Today, payments are usually lower, but PURPA still requires utilities to purchase the power. Owners of some PURPA facilities want to sell their power elsewhere, and some utilities wish to avoid paying for power that is of little value to them.

Since the act was passed, a majority of state regulators have decreed that utilities must put new generation up for competitive bids. Bidding has encouraged both PURPA facilities and independent power producers whose plants do not qualify for PURPA treatment. But other federal laws have inhibited competitive procurement by keeping some efficient producers out of the bidding and by restricting the geographic scope of power markets.

Passed by large majorities in both houses, the Comprehensive National Energy Policy Act of 1992 lowers but does not entirely remove those barriers to competition. It eliminates some of the restrictions on power production and sales imposed by the Public Utility Holding Company Act of 1935 (PUHCA) and expands the hitherto limited ability of the Federal Energy Regulatory Commission to order utilities to transmit power ("wheel") for others.

PUHCA Reform

Enacted to control depression-era regulatory evasions, PUHCA subjected the activities of electric holding companies to oversight by the Securities and Exchange Commission and forced them to restructure themselves into geographically contiguous entities, frequently by divestiture. Today's nine "registered holding companies" include such giants as American Electric Power and Entergy Corporation. Over 100 other utilities are "exempt intrastate holding companies," which avoid PUHCA to the extent that they restrict their nonutility operations geographically and financially. If PUHCA is triggered, the SEC can regulate utility activities not otherwise under its jurisdiction. Some large independent power producers, such as Southern California Edison affiliate Mission Energy, are inhibited from entering new markets because they are units of exempt holding companies. Other major independents are units of firms that are not electric utilities, such as Dow Chemical's Destec subsidiary and Enron Corporation's Enron Power. Before today, PUHCA would have applied to both their electric and nonelectric operations.

The 1992 act allows the owner of a power plant to request that FERC certify the plant as an "exempt wholesale generator" that is not subject to PUHCA. The act does little to change the nature of competition, which will still take place primarily in procuring long-term power supply. Short-term auction markets for power are seldom desirable or even feasible in today's industry. Exempt wholesale generators can sell only to utilities, rather than to ultimate users. Both federal and state regulation will remain pervasive. FERC regulates the rates and terms of the transaction and has jurisdiction over transmission of the power, even if both parties are in the same state. State regulators approve the utility's plans for acquiring the power and control the rates the utility charges

"For God's sake! Can't you ever do something without first finding out what the federal guidelines are?"

its ultimate customers. The new act also facilitates international competition by exempting some foreign operations of American utilities from PUHCA if state regulators approve.

Unless owned by a municipal or cooperative utility, an exempt wholesale generator cannot sell power to final users and cannot have a franchised service territory. What the act gives exempt wholesale generators is a wider choice of utilities to buy their power. A regulated utility that wishes to compete for off-system sales can convert a plant into an exempt wholesale generator. The utility must delete it from the "rate base" (capital entitled to a regulated return), and state regulators must determine that the conversion benefits consumers. Self-dealing between utility affiliates and exempt wholesale generators is only allowed with state regulatory approval. In November 1992 FERC licensed the first exempt wholesale generator, a 310-megawatt peaking facility in Chesapeake, Virginia, owned by a joint venture of Mission and Destec.

Orders to Wheel

An exempt wholesale generator requires transmission if it is to sell at a distance. In most service areas nearly all transmission is owned by the franchised utility. Before the 1992 act a power producer seeking transmission service had little regulatory or legal recourse if the owner refused. FERC had few legal grounds on which it could order wheeling, although in 1988 the commission found that it could condition utility mergers and power marketing plans on commitments to wheel. The 1992 act allows a utility, a PURPA facility, an exempt wholesale generator, or a federal power marketing agency to request wheeling service from a transmission owner. If the owner refuses or does not respond within sixty days, the requestor may ask FERC for a wheeling order. FERC will issue the order if it does not adversely affect reliability. The act also allows FERC to order the enlargement of capacity-constrained lines to accommodate a transaction, again subject to reliability considerations.

Nearly all states place high barriers in the path of an industrial user that requests wheeling service from its local utility. It is, however, possible that FERC would issue an order if the user is in a state that allows it. Such retail wheeling raises reliability concerns, since imports of low-quality power by a single customer can put a wide area at risk of blackout. It also raises questions of the utility's obligation to invest in costly plants to serve wheeling customers who might choose to return to service from the utility. Retail wheeling carries political consequences that few regulators want to face. A utility that loses industrial customers to retail wheeling must either extract payments for idle plants from captive customers or impose the loss on shareholders.

Transmission Pricing and Access

Wheeling will only be efficient if the price of transmission compels all parties, including the owner, to recognize its scarcity value. On that issue the 1992 act is vague. FERC has often set wheeling rates at a prorated fraction of the capital and operating costs of the transmission used, a so-called embedded cost standard. Embedded cost rates are reflections of historical cost rather than economic value. They do not account for the transmission owner's lost opportunities if wheeling causes it to forego transactions that might benefit its own customers.

Opportunity costs only appear obliquely in the act. Entities that would be primarily wheeling customers, such as small municipal utilities and exempt wholesale generators, understandably wanted historical cost language. Transmission owners wanted explicit mention of opportunity costs. Neither got what they wanted. This most important detail is left to FERC under the act's

charge that wheeling rates must recover "all legitimate, verifiable economic costs incurred in connection with the transmission services," but also be "just and reasonable and not unduly discriminatory or preferential."

In a 1992 docket (now in the U.S. Court of Appeals), Pennsylvania Electric (Penelec) has agreed to wheel an industrial cogenerator's output to nearby Niagara Mohawk Power Corporation. Penelec's wheeling rates would have recovered the sum of its embedded and opportunity costs, with the latter capped at the cost of constructing new capacity. Rather than accept that negotiated agreement (the cogenerator had alternatives to Penelec), FERC ruled that Penelec could recover no more than the higher of the two costs. FERC said that opportunity costs were "real," but not "just like other variable costs of providing transmission service." Whatever the equity consequences, FERC believes that the "higher of" standard leaves Penelec's other customers as well off as if the lines had not been used for wheeling. Although Penelec's contract was arrived at by negotiation, FERC will probably impose caps when they are unwanted, possibly as the outcome of a rulemaking. When a cap is binding because imported power is cheap, wheeling users will gain at the expense of the transmission owner's customers. In effect, those who have a more valuable use for the line will not be able to bid it away from whoever is on it.

The act is silent on how transmission will be allocated when regulators set price at a level too low to do the job. Tucson Electric Power Company's president, Charles Bayless, writing in *Public Utilities Fortnightly*, perceptively noted the schizophrenia: "FERC has wrestled with the problem of how to integrate the free market and regulated systems. It has selected open access from the free market system, and pricing from the regulated system. It doesn't work." Former FERC advisor Reinier Lock recently referred to FERC's pricing policy as "knee-jerk bottleneckism." Perhaps too optimistic, he expects future rulemakings that will produce more rational pricing. Such pricing must not only allocate transmission efficiently in the short term, but also provide indications of where new construction is warranted.

FERC has often invoked concerns about monopoly to rationalize its insistence on historical costs and price caps. Bayless argues that if monopoly is really the problem, that is a job for the antitrust courts. The 1992 act says that it "shall not be construed to modify, impair, or supersede the Antitrust Laws." Antitrust rulings on transmission, however, are moving toward a rule of reason that may conflict with the act's goals of increasing the number of market participants. In 1992 the U.S. Court of Appeals for the Ninth Circuit ruled on two suits in which municipal utilities alleged that Southern California Edison monopolistically restricted their transmission access. The court found that the utility often used the lines to capacity for the benefit of all its customers, including municipals. It ruled that the company had a legitimate business interest in keeping rates to its own customers low, and that its offer of interruptible service to plaintiffs was sufficient.

FERC may have unstated rationales for insisting on shortage prices and administered access. John Jurewitz of Southern California Edison has noted that inexpensive transmission renders FERC more likely to reach its goal of expanded power markets. Wheeling users will agree with FERC, since most of them will manage to gain access. Jurewitz believes that the policy will lead to a slightly overbuilt transmission system. Others believe that it might produce a chronic shortage. State regulators hold authority over the siting of transmission and determine the need for it. FERC cannot supersede their orders. States are increasingly averse to new construction because of environmentalist pressure, noneconomic conservation goals, and health issues related to electric fields. If FERC imposes shortage prices, it will be encouraging transmission users to put pressure on state regulators to certify construction they would otherwise veto.

Retail and Franchise Competition

The act brings new competition to bulk power markets but explicitly prohibits wheeling for retail customers. Depending on the expert one asks, retail wheeling will be a reality in two to ten years. Something that resembles it will emerge through loopholes in the act. John Anderson, chairman of ELCON, a trade group of industrial users, has noted that if state regulators approve, the act permits wholesale transactions by a utility that are earmarked for an industrial customer rather than for its entire system. State regulators might be willing to give an industrial customer a price break if the alternative is a bypass that contributes no revenue to the utility.

On the other side, Public Service Company of New Mexico has responded to widespread customer dissatisfaction with its rates by pledging to find ways to implement retail wheeling. The state legislature is currently entertaining a bill that will allow it. Believing that the future of the industry is competition, PNM has become the first major utility to break ranks with its industry's position. According to the company's chief financial officer, retail wheeling "appears inevitable."

The act prohibits "sham" transactions to disguise retail wheeling but allows the formation of new municipal utilities that might be shells for industrial customers who want it. There are potential conflicts with existing FERC policy. In 1992 the commission approved an open access transmission plan formulated by Entergy Services, Inc., in connection with a power marketing program. Stating that Entergy had valid concerns about disguised retail wheeling, FERC allowed the company to exclude transmission access to new municipals that would serve former customers of the Entergy companies. In another politically important area the act may enhance the subsidy to municipal utilities that comes from their legal priority to underpriced "preference power" produced at federal hydroelectric sites. The act probably allows FERC to order wheeling of preference power to a distant municipal.

Beyond any sham transactions, the act will encourage the formation of new municipal utilities. The incentive will be stronger because it adds transmission access to the existing lures of tax-exempt financing and possible allocations of preference power. Most municipals will be in smaller cities and will be dependent on the surrounding corporate utility for transmission. Others, such as Los Angeles and other California cities, own transmission that extends hundreds of miles from their limits. Municipals that own transmission facilities will have a new role. Unlike before, FERC can now order them to wheel.

Jurewitz notes other factors encouraging new municipals. In most states they are exempt from regulations on rates, generation planning, and transmission siting that apply to corporate utilities. The latter now face extensive state micromanagement of power supply decisions, as regulators attempt to direct their investments in ways that do not provide the lowest-cost delivered power for consumers. Transmission access mandated under the 1992 act allows a new municipal utility to escape those exactions. In states where municipals are exempt from regulatory approval of new transmission, they might become entrepreneurs. They will build lines in lieu of those that regulators do not allow corporate utilities to construct. In California state regulators recently excluded corporate utilities from participation in a joint corporate-municipal intertie to the northwest on grounds that demand management programs would be more cost-effective. The municipals, exempt from that regulation, now own the entire line.

State-Federal Relations

Although many provisions of the 1992 act defer to the states, in reality the act puts an increasing fraction of electricity under federal regulation. In important ways that is desirable, since it facilitates the development of markets that extend over entire regions and discourages some state-level efforts to balkanize them. Before the 1992 act, FERC controlled virtually all aspects of high-voltage transmission except for construction. Now it will have jurisdiction over a new and increasingly important set of costs—those paid by utilities to exempt wholesale generators. The prices paid for power produced in PURPA facilities will remain under state jurisdiction as will the requirement that utilities purchase that power.

The Supreme Court's 1988 *Mississippi Power and Light* decision will probably apply to exempt wholesale generator purchases. That decision precludes state regulators from investigating the prudence of federally approved costs when they determine a utility's retail rates. Although there were initiatives to do so, the 1992 act did not codify the *Pike County* doctrine, which allows state regulators to review the prudence of certain other wholesale power purchases by utilities. In effect, according to Michigan regulator Ronald Russell, states are giving FERC control over their retail rates. Russell says that "state commissions who encourage utilities to buy rather than build are, to some extent, digging [their] own graves."

There is little evidence that most state regulators have any interest in liberalizing access to transmission or in pricing it rationally, since doing so would upset a long history of cross subsidies. (Exceptions include California, Wisconsin, and Michigan.) Whatever has happened in other industries, the metaphor that the states are fifty

regulatory laboratories seems inapplicable to electricity. There are important access and pricing issues—not even resolved as economic theory—about which states have had little to say. As one example, outgoing FERC chairman Martin Allday recently discussed the increasing urgency that the commission determine how to compensate a transmission owner for electrical flows through its lines that result from the transactions of others. In light of the way FERC currently sets transmission prices, the big worry is that the commission will not set appropriate compensation levels either.

Robert J. Michaels
California State University, Fullerton

An Inquiry into the Nature and Causes of the Clinton Health Care Reforms

Because of the breach in trust guaranteeing members of the First Lady's Task Force on Health Care Reform anonymity, we believe we are released from our vow of secrecy. We are not vengeful, but since the names were made public, we must explain the substantive issues that otherwise would be concealed.

For the first time, it can be revealed that Hillary Clinton was never in charge of the effort. Tipper Gore was, from the beginning, the intellectual, political, and administrative leader. Tipper Gore would often say, "Who in their right mind would put a lawyer in charge of 14 percent of the GDP? If we did that, it would be resolved like a divorce case—one gets the condo, the other gets the sail boat. We would end up fighting for even smaller pieces of a shrinking pie. They did that in England, and we now call that approach the British Disease. The president now follows my leadership and says that the only way we can get a bigger government is to mandate that business pay the bill so that it is free (or off-budget), and the only way we can afford to pay off all of those who voted for a free national health care system is to fix the prices."

The whole health care regulatory initiative is actually based on Albert Gore's deep understanding of the worldwide energy and pollution situation. It was that understanding of how to solve energy and pollution problems that led to the insightful approach to health care. It was political brilliance to base the plan on critical choices that had been successfully demonstrated in previous administrations—both Democratic and Republican.

Unfortunately, space limitations preclude a full disclosure of how the full-blown Clinton-Gore managed competition plan will work. We can, however, tell you exactly how the emergency price control portion will work. To understand it, you need to understand how the emergency energy system of the 1970s worked. We shall present each part and then show how it will be modified to work in the health care sector.

Nineteen ninety-three will mark the twentieth anniversary of one of the greatest achievements in the legislative history of the United States: the passage of the Emergency Petroleum Allocation Act or EPAA for short. That legislation is recalled fondly as the full-employment benefit act for bureaucrats, lobbyists, and consumer advocates. The grateful Nixon, Ford, and Carter administrations made extensive use of the EPAA to impose an elaborate and extraordinarily beautiful system of price controls on the petroleum industry. All of us fondly recall the new economic concepts created by the regulations. Who can forget old oil, new oil, stripper oil, marginal oil, the base period control level, exempt Alaskan oil, allowable margins, cost banks, base period allocations, controlled fractions, and, of course, entitlements?

Unfortunately, Ronald Reagan rudely terminated price controls on January 28, 1981, a date now marked everywhere as a national day of mourning. Economic activity in the nation's capital slowed with decontrol and has never recovered.

One of the reasons President Clinton can be so sure of the success of health care reform based on the EPPA is the way in which the actual system will be developed. Each of the 500+ members of the task force has been assigned one section of the regulations issued under the oil price controls and has been cautioned to change only the words related to oil to terms associated with the medical sector today. Thus, the administration will be able to introduce a new health care program by May 15 that is designed to treat all individuals equally. Further, the program is guaranteed to be a bureaucratic success because it is built on the model of the nation's great oil price control program.

The new legislation will be called the Emergency Health and Pharmaceutical Allocation Act (EHPAA). To help you understand the opportunity created by the twentieth anniversary of the EPAA, we explain the way that the lessons of EPAA will be applied to the health care system.

Old Doctors. One of the crowning achievements of the Nixon-Ford-Carter energy programs was the creation of old oil. Old oil was oil produced from wells that came into production before August 15, 1971. The price of old oil was initially frozen at $3 per barrel and gradually allowed to increase to $5 per barrel by 1981—at a time when the world price was $40 per barrel. Clearly, the central piece of the EHPAA must be "old doctors." Old doctors will be defined as those doctors who entered practice before May 15, 1993. The fees they charge for each specific service should be frozen at about the same rate—12 percent of the current rate.

Much of the subgroup's discussion concerned reducing physicians' annual income from, say, $175,000 to $21,000. They pointed out that the huge run-up in price for energy was not the same as in health care. One suggestion was to base the price controls on general inflation and to reduce the controlled prices by an excess income or excess profits tax. A much better plan was developed, however.

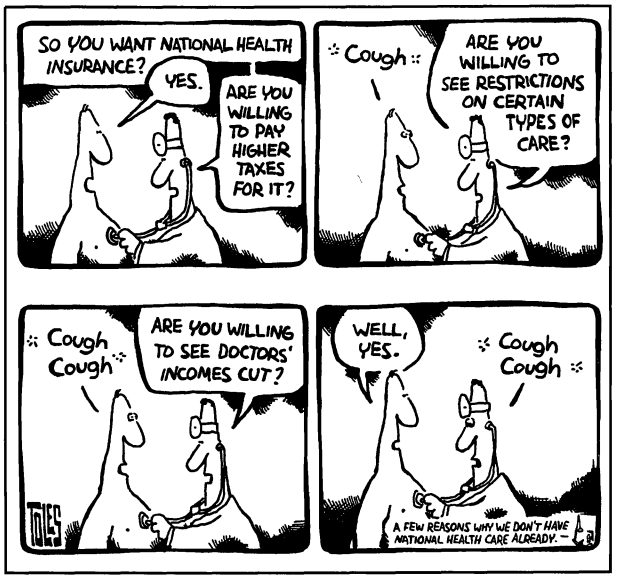
Every academic economist on the task force agreed that no physician was worth more to society than an economist. Every government employee agreed that no physician was worth more than a skilled bureaucrat. Thus, the comparable worth of physicians was born. The system was developed at Harvard and is called the resource-based relative value scale. It computes the number of units of "value" that each physician task contains. Because the system came from Harvard and is derived from the labor theory of value (which determines all true worth), it is now being used in the Medicare system. Since the resource-based relative value scale is now in operation, all we had to do was to recalibrate it so that diagnosticians equalled econometricians.

Those recalibrated units are both the measure of output of the physician sector and the total compensation of the physician. This result is unique and never occurs unless we have a fully operational comparable worth system. Politically, we must separate the two aspects of the measure. That is, the crass private materialism and governmental cost must be separated from the public benefits and social engineering aspects. The output measure is called "medical service units" (MSUs). Of course, we shall need to control the level of MSUs. Each month the number of "old MSUs" will be reported and compared with the pre-May 15, 1993 base level.

New Doctors. A second crowning achievement of the Nixon-Ford-Carter energy program was the introduction of new oil. New oil was production from wells that came into production after 1971 and incremental production from old oil wells that exceeded output levels from old wells during the year before the imposition of price controls. New oil was initially exempt from price controls. But administration officials concluded that the price of new oil was excessively high and subjected it to price controls after 1976. The price of new oil was roughly $12 per barrel.

One of the fundamental insights of the Clinton-Gore plan is that health care is recognized as a bad not a good. That is why we always talk of where the productivity "goes" and never from where is "comes." Thus, 14 percent of our GDP *goes to* health care, and we never hear it said that 14 percent of our GDP *comes from* the production of health care goods and services. So health care is actually like pollution, and generally speaking, the administration wants less of it, not more.

New physicians would be those who enter practice after May 15, 1993. The fees—resource-based relative value scale MSUs—for the services of



those doctors initially will be a fraction of the controlled "old doctor" fees. A plan was proposed to completely exempt new doctors from fee regulations if they worked in socially approved areas such as the inner city, rural locations, or other politically designated areas. That was rejected as being inflationary and adding to the budget deficit. But the chairman (czar) of the new Federal Health Reserve Board will be required to make a determination no later than May 15, 1996, as to whether controls must be further applied or fees further reduced for new doctors.

The argument for creating two classes of doctors is so simple that it barely requires repeating. Doctors completing training today force up health care costs. That process is called supplying induced demand and is formally set out in the target income theory. An important part of the Clinton plan is to reduce utilization and cost via reduced supply.

Following the successful model of the price control program, old doctors will also be able to charge uncontrolled prices for their services to the extent that they perform more services to the poor in some future month than they performed in 1993. That will provide an incentive for old doctors to work harder. Also, young doctors will be receiving less per service, and they too will have to work harder to repay their educational expenses. So everyone will win according to the task force's analyses. The code phrase is "working longer and harder, but producing and receiving less and less."

Base Period Control Level and Cumulative Deficiencies. Energy regulators of the Nixon-Ford-Carter administrations worried that some unscrupulous individuals and companies might attempt to game the oil price control system. Thus, they created a base period control level, which was the level of output from a well during the month before the imposition of controls. Production during the future had to exceed the level achieved during the same month before the imposition of controls to qualify for new oil pricing.

Energy officials worried, however, that producers would deliberately restrict output in one month so that they could achieve a surge in the following month. Thus, they introduced the concept of cumulative deficiencies. Producers were required to show that the cumulative production from a well during the entire period of controls had exceeded the total production that would have occurred had the well matched its base period control level during the entire period. The cumulative deficiency was the aggregate shortfall that had occurred during the period of controls (if any). Producers were required to make up the shortfall—selling production at old oil prices—before any production could be sold as new oil.

In calculating base period control levels energy officials refused to take account of the fact that output from oil wells will decline over time as reserves are exhausted. Oil producers were told that this was a problem of geophysics that government officials could not address. Instead, they were advised to deal with a higher authority on the issue of declining production.

In health care it is, of course, just the opposite. Technology causes increases in health care utilization. Nevertheless, the EHPAA also incorporates the concept of base period control levels and cumulative superfluities into the new health care system. Old doctors should not be allowed to increase their output of MSUs to needy people in one month and then claim new doctor prices on output in excess of their base period MSUs in the following month. Nor should old doctors be allowed to make adjustments for increasing output. While human knowledge does tend to increase as one becomes older, government health officials should not address the problem of increasing productivity of aging doctors. That problem, too, is an issue for a higher authority.

Unitization. The energy price control program contained special regulations for unitized oil fields. They are properties that contain several oil wells that produce from a common field. To encourage unitization the energy price control officials allowed operators of unitized fields to claim a base period control level equal to the sum of the base period control levels of each well before unitization. On that basis the increased production from the field was treated as new oil and shared among all the unit holders.

Doctors should be encouraged to create similar units. New doctors merging into a single practice will be allowed to aggregate their MSUs and charge old doctor prices for all production in excess of the base period control level. Doctors who are already unitized will be allowed to aggregate their individual MSUs. In the health trade unitized fields are called preferred provider organizations, and some operate outpatient surgery or

primary care centers—the famous "Doc in Box," "Hemorrhoids R Us," and "Mac Doc" national franchise chains.

Entitlements. The creation of entitlements by President Nixon's secretary of treasury represented one of the greatest intellectual achievements by a bureaucrat during the 1970s. Entitlements were created as a means of sharing the benefits of price controls among all consumers. Regulators discovered that some oil companies, such as Marathon, had large supplies of old oil, while others, such as Sohio, depended almost entirely on supplies of uncontrolled oil. They also discovered that the companies having access to low-cost oil would unfairly and unscrupulously refuse to pass the benefits on to consumers, but would instead keep them in the form of profits. Entitlements were created to equalize the costs of crude among all refiners. Each month accountants at the Department of Energy would calculate the average price of oil processed by all refiners. Those refiners whose cost of crude fell below the national average were required to write checks to those whose costs exceeded the average. In that way the economic benefits of old and new oil were redistributed to those according to their need from those according to their ability.

A similar system will be required to make the Clinton health care system work more efficiently. In the absence of a system of medical entitlements, older Americans and large purchasers of health care are likely to have excessive access to old doctors, while younger Americans and small purchasers will be left to deal with the less-experienced, high-volume new doctors. Under a system with similar incentives, German physicians see about 125 patients per *day*, compared with the present volume of about 122 patients per *week* for U.S. physicians.

An entitlement system will resolve that problem. Each month the Clinton Federal Health Reserve Board will compute a national old doctor service ratio (similar to the national old oil ratio computed under price controls). The ratio will represent the number of MSUs performed by old doctors relative to the total number of MSUs performed by all doctors. Doctors and units having an excessive number of MSUs will be required to remit payments to those doctors who have too few MSUs. The health agency will add an adjusting correction to the MSUs by computing an average price for old MSUs (MSUs performed by old doctors) and an average price for new MSUs (MSUs performed by new doctors).

Exempt Uses. The energy price control program exempted certain uses of oil from price controls. For example, crude oil burned directly by utilities or in the field to produce more crude was exempt from controls. That created an exemption that was used by a number of specialized trading firms such as West Texas Marketing and Marc Rich to create new, productive enterprises referred to as tier traders. Those companies actively traded oil back and forth until a socially optimal level of trading had been achieved, at which point the oil was used for some inferior purpose, such as making gasoline or powering a ship.

Under the Clinton health program there will be several exempt uses for old doctors. The first will be "good health care services"—those that have low unit costs. These include tranquilizers, eye glasses, and ambulance rides. In England there are 19.5 million ambulance rides each year—one for every two Brits. They are said to provide glorified taxi rides to pick up prescriptions and visit doctors. Very many voters get these little subsidies. Thus, low-cost caring is exempt. (On the other hand, "bad health services"—those with high unit costs, such as cancer treatment, heart surgery, kidney dialysis, and transplants, which are routinely rationed to patients throughout the world where a national health system is imposed—will not be exempt, but will be covered from day one. Thus, curing will be controlled.) Second, expert witnesses in medical malpractice and personal injury lawsuits will be exempt. Price controls will not apply to activities associated with legal proceedings, and doctors will be encouraged to engage actively in such pursuits. The nation must do nothing to compromise the most productive sector of its economy: litigation. This is so since physicians are seen as working for the government. The only protection the public has is through the legal system. Markets could never produce this level of trust or security.

Stripper Doctors and Marginal Doctors. The energy price control program exempted certain small producers from regulation to maximize the nation's output of oil and gas. For example, wells producing less than ten barrels of oil a day were not subject to price controls. Further, wells that were classified as strippers were permanently

exempted from price controls. Thus, some companies allowed output to decline until they achieved a stripper status and then boosted production.

Although health care is a bad, the task force has social engineering goals. Thus, a similar category must be created for the medical profession (although the name "stripper doctor" is just the task force's working label). Doctors working in rural and poor areas could be placed in the stripper category and exempted from controls. Old doctors moving to rural areas might also be allowed to qualify for the stripper category after a period of time. The Federal Health Reserve Board czar would be allowed to designate up to five specialties experiencing a surplus of doctors as marginal categories of physicians. Their productivity could fall to zero and receive some payment comparable to farm subsidies to not grow food.

Base Period Allocations. An endearing feature of the price control system was the system of allocation controls. Producers of crude oil were required to supply the same volumes of crude to refiners in any month as they supplied during the base month (which was the month before controls became effective). Refiners were required to supply the same volumes of product to buyers as they supplied in the base month. Output had to be allocated proportionally to those customers if production fell short of the amount supplied in the base month. Production in excess of the base period output had to be declared surplus and could be assigned to any buyer by the energy czar. Such assignments were regularly made to new buyers and to "high priority customers."

A similar system of allocation will be used in the EHPAA. Doctors will be required to supply the same number of MSUs to each patient, or group of patients, in any future month as were supplied in the base month. If the former patients do not require that number of MSUs, then the output should be declared surplus. The health czar will then assign the surplus MSUs to new patients according to some list of priorities. Obviously, those individuals who voted Democrat would be at the top of the list, followed by newborn children, who obviously would have no MSUs because they did not exist during the base period. Other individuals such as the sick and Republicans would follow. Of course, the political preference groups would be revised if a change in the party of the president occurred. That not only would guarantee bipartisan support of the program, but also would promote higher campaign contributions as the stakes for being on the winning side became life-and-death issues.

Small Hospital and Small Office Bias. Small refiners were offered special exemptions under the oil price control system because they were believed to be essential to the competitiveness of the nation's oil industry and because they were large political donors to the key members of Congress who created the legislation. The benefit was achieved by allowing those firms to have access to a larger number of barrels of old oil than would have been permitted had all refiners been required to process the same number of barrels of old oil. The extra barrels of old oil were subtracted from the allotment given to large refiners.

Hospitals with fewer than sixty beds and physicians working with six or fewer professionals would be granted extra old MSUs. That would reduce their cost of service and make them more competitive with larger facilities and more technically integrated providers. This will, of course, mean that some folks will have to get their cure in the country. Others will have to get operations where the surgeons are not so practiced as those who routinely perform them. Fortunately, the government has developed diagnosis related groups (DRGs) that classify all hospital treatments. That official government taxonomy also is slated to set one national price for each DRG for all Medicare patients. In a related activity Congress recently established a new organization called the Agency for Health Care Policy and Research (AHCPR). That agency is developing performance standards, output measures, and practice guidelines. In effect, we have a "flat-rate book" via the DRGs, and a how-to-do-it "shop manual" or "cook book" via the AHCPR. So we do not need to be concerned about quality, the government has standardized it.

Space limits preclude a more in-depth and extended explanation of how the price controls, income caps, global budgets, and managed competition programs will be implemented. We have, however, shown how the energy price control program created in the 1970s provided an excellent model for Tipper Gore's leadership of the Health Care Reform Task Force. What better way to celebrate the twentieth anniversary of the passage of EPAA than by enacting EHPAA? It is a stroke of political brilliance since it will have bipartisan support.

We are saddened that we had to disclose some of the behind-the-scenes details. Most readers, however, will understand why we had to do so. We hope that this report will cause others to read Al Gore's forthcoming book, *Health in the Balance: Why Less Health Care Is Better than More.*

Gerald L. Musgrave
Economics America Inc.

Philip K. Verleger, Jr.
Economics Consultant

Fu Ling You
Haavahd University