

In Review

Dissecting Deregulation

Reviewed by Paul Teske

DEREGULATION OF NETWORK INDUSTRIES: What's Next?

Edited by Sam Peltzman and Clifford Winston
199 pp., Washington, D.C.: AEI-Brookings Joint Center for Regulatory Studies, 2000

WHO PAYS FOR UNIVERSAL SERVICE? When Telephone Subsidies Become Transparent

By Robert Crandall and Leonard Waverman
199 pp., Washington, D.C.: Brookings Institution Press, 2000

It may seem like a (scholastic) lifetime to those of us who study deregulation, but most people may be surprised to learn that deregulation began more than a quarter-century ago. The intervening years have given us a great deal of information about what has worked, particularly in the area of networked industries such as airlines, electricity, telecommunications, and railroads. Analyzing that information reveals the existence of substantial benefits from deregulation, showing that it is one of the more clear-cut cases of public policy success.

But some elements of American society have experienced (or at least believe they have experienced) negative consequences from deregulation and its associated policies. Representatives of

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those groups have been active politically, pressing for changes, or even reversals, in deregulatory policies. Some events catalyze more widespread political opposition to deregulation. Surveys taken several years after the AT&T divestiture showed that a majority of citizens did not approve of the changes, despite their enhanced market choices. Perhaps the most important negative deregulatory event to many citizens was the savings and loan failures of the 1980s, even though deregulation was only partly at fault. Most recently, electricity deregulation has taken a lot of the blame for the power shortages and high prices in California. Thus, it is valuable for scholars to take stock of what has happened and what else needs to be done in those industries.

That analysis has been undertaken in a pair of books published in 2000, one an edited group project from the AEI-Brookings Joint Center for Regulatory Studies and the other from the Brookings Institution. While the authors mostly focus on the economic effects of deregulation, they sometimes discuss or speculate about the political-economic issues, as well as the technological changes that sometimes were exogenous and helped to stimulate deregulation and other times were themselves accelerated by deregulatory policy changes.

DEREGULATION OF NETWORK INDUSTRIES

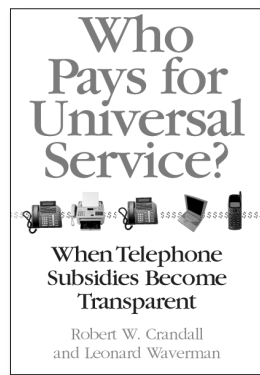
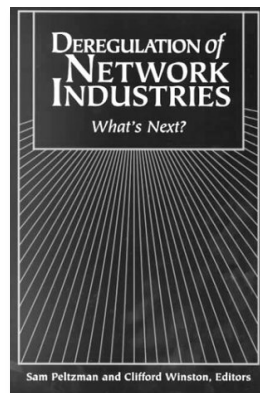
Edited by Sam Peltzman and Clifford Winston, the AEI-Brookings offering *Deregulation of Network Industries: What's Next?* presents updated analyses of four industries: airlines, railroads, telecommunications, and electricity. The two chapters devoted to airlines and railroads note that those industries are fairly close to being fully deregulated, but may require a few more steps to see the

process through. The chapters on telecommunications and electricity present a different story.

Airlines Winston and Steven Morrison analyze airline deregulation, the poster child for the deregulation movement. Interestingly (and validating common sense for those who observe airfares closely around the nation), they demonstrate econometrically that about 40 percent of the fare reductions are due to the competitive pressure from a single airline, Southwest.

Still, despite lower fares, deregulation critics have persisted in trying to tie current airline service complaints to deregulation. Winston and Morrison

show that such service complaints probably have more to do with fuller airplanes (an average of 71 percent of airplane seats are filled now, compared to 62 percent in 1988), which naturally slows down boarding and deplaning times, and provides a perception of lower quality service by reducing empty space. The authors use an impressive collection of data to demonstrate that other problems passengers may expe-



rience are likely due to airport congestion, and not such things as mergers, non-competitive predation, or the hub systems that have emerged.

To address those problems, Morrison and Winston advocate further deregulation, particularly at the airport level. They argue for improved access to landing slots at airports (perhaps through airport privatization) and for privatizing air traffic control to better manage the increased volumes (a recommendation that may no longer be feasible in the aftermath of September 11). Thus, Morrison and Winston demonstrate that airline deregulation has been a success, and that additional deregulatory policies may further the gains.

Railroads In their chapter, Winston and Curtis Grimm argue that railroad deregulation differed from all other forms of deregulation in that it was aimed at improving the financial condition of bankrupt and financially troubled carriers, rather than breaking up cartels protected by government-established entry barriers. With deregulation and government-monitored consolidation, the carriers improved their finances, leading to an overall decline in rates.

Captive shippers and their political representatives, however, continue to worry that the gains are coming at their expense. To some extent, Grimm and Winston demonstrate that captive shippers have not received comparable rate reductions. They argue that the problem can be mitigated, in part by eliminating the Surface Transportation Board in the U.S. Department of Transportation, and by allowing the U.S. Department of Justice to handle any railroad pricing concerns with appropriate antitrust approaches.

Telecommunications For the telecommunications chapter, Robert Crandall and Jerry Hausman present considerable evidence of successful gains, but also note several areas in which little has changed since the 1996 Federal Telecommunications Act (FTA). They argue that the act was only partly deregulatory, as it added substantially more issues for the FCC and the states

to regulate. They lament, "The result has been four years of protracted regulatory disputes and litigation that show little sign of abating, as well as continuing welfare losses from distorted prices" (p. 75). In particular, they are concerned that preventing the "Baby Bells" from entering the long-distance market (only Verizon in New York had passed the FTA's Section 271 process at the time of their writing) has caused less competition in long distance, leading to welfare losses at a level of 25 percent of long-distance costs.

In a more positive vein, Crandall and Hausman demonstrate that there has been some improvement in local competition because of the FTA, if only because it has increased the number of states that allow entrants to serve dispersed residential and small business customers. Gains in local service markets by competitors are still quite small, however, from one percent of lines in 1997 to 3.4 percent in 1999. The competitive revenue picture has grown from 2.7 percent in 1997 to 6.3 percent by 1999, because competitors are more likely to serve larger business customers. That still leaves nearly 94 percent of local revenues in the former local monopolists' hands. Here and elsewhere, Crandall and Hausman contrast the heavily regulated local service segment of the industry with the far-less-regulated wireless communications market, where competition has spurred growth and new services over the same time period.

In terms of regulatory process, Crandall and Hausman argue that the FCC's emphasis on developing detailed cost models has led to long and often fruitless debates. Instead, they advocate a price cap mechanism that would ensure protection of more captive customers while allowing other transactions to occur. Still, they find that local rates held fairly steady from 1993 to 1999, even without such protections.

While Crandall and Hausman recognize, and often bemoan, the politics of telecommunications deregulation, they do not provide readers with a clear enough picture that the FTA was itself a political compromise more than a decade in the making. It involved important quid pro quo compromises, allow-

ing certain kinds of providers into others' markets only after opening their own markets to some degree of competition. It may not have been possible politically to pass a version of the FTA in 1996 that would have more quickly and easily deregulated more markets.

Electricity Electricity is probably the most complex of the four industries examined in the book, and as a consequence, Paul Joskow's chapter is quite detailed and difficult, but ultimately rewarding. Written before the 2000-2001 winter price spikes, the author did not predict the California crisis. But readers cannot help but look to the chapter for explanations, especially because California is Joskow's central case study. He does argue that "creating a competitive electricity market is a fairly complex and challenging undertaking" (p. 158) and admits that, unlike other areas of deregulation that largely involve removing government barriers, electricity deregulation requires the successful development of appropriate institutions to handle industry coordination.

Joskow notes that, at the time he wrote the chapter, deregulation had not yet yielded lower prices in California and was not likely to do so soon, but it might lead to lower prices in the long run. He also points out some of the different elements that can be part of the partially deregulated electricity market, including stranded costs, service unbundling, valuation of generating assets, and regulatory incentives (p. 141). And he describes how other deregulatory states, like Pennsylvania and Massachusetts, developed different policy mixes than California. In some states, he argues that retail deregulation has sometimes moved faster than wholesale and transmission reforms, leading to mismatch problems. Thus, despite not predicting the possibility of large price increases in California, Joskow demonstrates that the short-run transition to a more competitive environment would not necessarily go smoothly, and his explanations hold up pretty well in hindsight.

Joskow also examines why electricity deregulation emerged when and how it did. While congressional and Federal Energy Regulatory Commission (FERC)

policies in the early- and mid-1990s facilitated state action, he writes that electricity is “unusual in that the stimulus for most radical reform has come from the states rather than the federal government” (p.114). He explains some of the politics of state deregulation as a function of how legislators and regulators prodded utility firms to favor, or at least not oppose, deregulation, by allowing savings on huge stranded costs they would otherwise face. He also speculates from the sequence of state actions that states with high prices were more likely to deregulate more rapidly.

WHO PAYS FOR UNIVERSAL SERVICE?

Readers fascinated by Crandall and Hausman’s chapter in *Deregulation of Network Industries* will want to pick up Crandall and Leonard Waverman’s Brookings book *Who Pays for Universal Service?* In it, the authors offer a journey through the world of “universal service” — the government-directed effort to have every household subscribe to the telephone network.

That goal largely had been achieved (over 90 percent) prior to the deregulation of AT&T in 1982, but the coverage came at a price: Because of the enormous cost of providing phone service to remote customers, the uniform service rates meant that less-costly-to-serve customers subsidized their remote

brethren. Politicians and analysts feared that, under deregulation, those cross-subsidies would unravel, thus threatening universal service.

Crandall and Waverman point out that, historically, local telephone companies often have argued that universal service requires subsidized local prices, particularly when the companies face possible competition. Furthermore, as the Internet developed, some politicians (notably Al Gore) and observers claimed that our society needs to expand its vision of universal service to include access to the information superhighway in libraries and schools, particularly in low-income areas.

Other subsidies? Chapter by chapter, Crandall and Waverman examine telephone pricing and the incidence of costs and benefits for different segments of American society. They also compare U.S. data to that from other developed countries, which provides them a rich comparative database for telephone and other essential services. The data offer some quite fascinating information that challenges a number of income and expenditure notions. For example, Americans across a wide range of income and geographic categories spend virtually the same amount for cable television service — an amount that often exceeds local telephone expenditures.

The authors question why telephone access appears so deserving of subsidies while interest groups and politicians rarely (if ever) make a similar case for subsidizing such things as television, radio, and plumbing. Except for rural electricity subsidies, Crandall and Waverman show that most other regulated network industries do not embrace a widespread concept of universal service subsidies. They show that telephone service, while important, is one of several services upon which consumers spend their incomes, and they do not spend all that much on it, compared to other regulated and unregulated services and products that mostly do not provide explicit or implicit subsidies to the basic access element.

Is there a need? Crandall and Waverman try to demonstrate that most Americans can afford local telephone service without a subsidy. The cost of that service is a very small percentage of most Americans’ budgets, usually less than one percent (and only about two percent for Americans earning \$5,000 a year or less). The authors present several studies (both their own and others’) showing that consumers who are not connected to local service are not disenfranchised by its price, but rather by unpaid long distance bills, initial hook-up charges, or because they are moving from one place to another. Demand for

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local service is very inelastic, and that is why it is efficient policy to “load” joint and common costs upon the service, despite the network externalities. Argue Crandall and Waverman, “The sensitivity of telephone penetration to the recurring monthly price is so small that it is increasingly difficult to detect in modern studies” (p. 104).

As they synthesize all of the impressive data, Crandall and Waverman convincingly argue that subsidized rates for telephone access are no longer needed, if they ever were. They also cite Milton Mueller’s 1997 AEI/MIT Press book *Universal Service*, which argues that historical competition was far more responsible for expanded universal service in the United States than cross-subsidies under the AT&T monopoly. (See “Universal Access in Hindsight,” *Regulation*, Vol. 20, No. 4.)

The Internet Crandall and Waverman are even more skeptical of the “new” post-1996 Federal Telecommunications Act universal service “e-rate” subsidy for Internet access to schools, libraries, and rural health facilities. The subsidy now costs \$ 2.65 billion per year, more than federal support for traditional universal service subsidies. While other advanced countries also tend to price local telephone access below cost, those countries have not advocated subsidies for Internet access.

Ironically, Crandall and Waverman note that Internet access is already implicitly subsidized because most Americans receive access to it through their (subsidized) local telephone connection. They argue against that Internet subsidy, but they suggest that, if it is politically important, it should be explicit and should come from general revenues, not from inefficiently priced telephone services.

Considerations Overall, while their accumulation of evidence makes for a strong argument, I was less impressed with Crandall and Waverman’s specific discussions of telephone network externalities, which I did not think were clear enough. They note that network externalities exist in theory but, in making their broader argument, they dismiss them and quickly argue that con-

sumers do not “need” to be subsidized onto the telephone network. Still, there is a positive external benefit, and a few empirical measures have been offered, one of which they later employ in their re-pricing analysis (p. 115).

By not being clearer, and by conflating real network externalities with “social externalities” that might be provided by other modern (and unsubsidized) services like plumbing and sewerage, they almost encourage confusion. There are social externalities in telephone usage equivalent to sewerage: You are better off because your neighbor has a telephone that he can use to call the police or hospital if you are robbed or fall ill.

But, unlike electricity, gas, water, and sewer services, telephone subscribers get value from being linked to each other, not just to a central facility. There are network externalities in telephone networks, and that is a real difference that Crandall and Waverman must consider, even if the price inelasticity of local access leads to recovery of much of network joint and common costs from higher local access prices. Their later analysis using three different empirical cost and pricing models suggests that some measurement issues about local costs remain unresolved.

Still, they make the case that universal service subsidies are inefficient and probably not necessary to maintain high levels of telephone connectivity, even for low-income consumers. If the political process insists upon maintaining subsidies, they should be funded from general revenues rather than higher rates on telecom usage.

Ultimately, in many ways, the most important subsidies are to rural residents. The authors allude to that point themselves (p. 167), but they underemphasize the point about the political potency of rural interests. The largest telecommunications subsidies are to rural consumers, rural electric customers still receive substantial subsidies (though Crandall and Waverman take pains to show that they are being reduced), rural customers have always received an implicit subsidy from averaged first-class postal mail rates, and (of course) some of the largest rural subsidies are for production (or sometimes for non-produc-

tion) of agricultural products. Perhaps the issue of telecommunications subsidies is really a subset of a larger issue about rural subsidies that exist even after federal and state legislatures were reformed to represent geographic groups more fairly.

While Crandall and Waverman generally assess economic issues well, given all of their data (broken down by income, geography, and other groupings), they do not take enough advantage of their resources to provide the political background for a complete policy analysis of universal service. For re-pricing, they do note that, while the average consumer will gain from their proposals, the median voter may not (p. 125), and that may drive the political process. Their conclusion that the needed price changes are not too large (except perhaps for some rural residents), but the median voter/consumer will experience losses while average telecommunication users will gain, is parallel to what I demonstrated with data from the 1980s. (See my *After Divestiture: The Political Economy of State Telecommunications Regulation*, SUNY Press, 1990.) Clearly, as they did right after divestiture, politicians and regulators continue to move incrementally with re-pricing policies that will provide substantial aggregate welfare gains, to test if consumer perceptions of the changes will prompt any serious political backlash.

CONCLUSION

In the end, for telecommunications and other network industries (with the jury perhaps still out on electricity), deregulation has been successful and further deregulation of those industries can yield still more gains. But the final elements of deregulation may be the hardest to achieve because the most-subsidized and protected interests remain, and the core values of their political representatives may be threatened by further deregulation.

While the economic policy prescriptions in both books are predictable to those familiar with the literature, the impressive data that the authors gather to demonstrate deregulatory gains will prove helpful to policymakers who want to sustain the forward momentum of deregulation. **R**

The Costs of Natural Gas Regulation

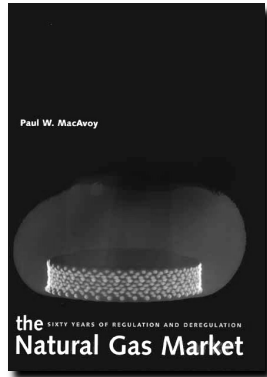
Reviewed by William F. Hederman

THE NATURAL GAS MARKET: Sixty Years of Regulation and Deregulation

By Paul W. MacAvoy

176 pp., New Haven, Conn.: Yale University Press, 2001

In this brief book, Yale management professor Paul MacAvoy evaluates the history of natural gas price regulation in the United States. He provides a quick glance and assessment of the difficult topic that is far more insightful than other books that have attempted such a synthesis. MacAvoy concludes that the regulations benefited neither consumers, nor producers, nor pipelines. All three groups received some benefits at different times from the regulations, but the economic losses they experienced greatly exceeded any benefits. Across three regulatory eras (from 1968 to 1994), he estimates that the total economic losses from natural gas regulation exceed \$130 billion. In my assessment, that figure is probably a conservative lower limit.



DETERMINING THE LOSSES

The first period MacAvoy examines is 1968 to 1977, the era of wellhead price regulation during which serious natural gas shortages developed. MacAvoy estimates \$59 billion in net losses in that period, based on his simulation model runs (not discounting the stream of gains and losses). The net economic cost includes \$39 billion in gains to customers

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who received actual production at lower regulated prices and an offsetting loss for producers who supplied gas at the lower-than-market prices. There were also \$52 billion in losses for consumers who were unable to procure gas because of shortages and \$7 billion in losses to producers through lowered production.

The second period, from 1978 to 1984, began with the passage of the Natural Gas Policy Act of 1978 (NGPA). The act instituted the gradual deregulation of wellhead gas prices, which unleashed the market forces that still affect the natural gas industry today. For that time period, MacAvoy estimates some \$45 billion in gains to producers for selling gas at “weighted-average cost of gas” (WACOG) prices above market-clearing prices. He further estimates some \$41 billion in gains to consumers who purchased gas

below market-clearing prices, with those gains coming from the sell-off of excess gas supplies in the new spot market. MacAvoy estimates losses in the same period of \$45 billion to consumers in an offset to the producers’ gains mentioned above. Producers lost \$90 billion because of sell-offs at prices below WACOG levels. (I think the losses should probably be relative to market-clearing levels rather than WACOG levels.) Thus, MacAvoy determines a net loss for the period of \$49 billion.

The final period that he analyzes is 1985 to 1994, when gas transportation was partially deregulated in response to the market pressures unleashed by the NGPA. The regulatory changes also helped create a single North American natural gas market. MacAvoy estimates gains for pipelines for 1985-1994 of \$55 billion from providing service at regulated rates above market-clearing levels. But the gains are offset by losses to consumers who paid some \$55 billion

in excess rates for gas transport. He also estimates \$12 billion for consumers who used less because of higher delivered prices, and losses to pipelines of \$62 billion due to reduced throughput. Those figures yield a net loss for the period of \$74 billion.

Natural gas regulation had additional negative effects not included in those calculations. Among the effects:

- **Bureaucratic growth:** The Federal Power Commission instituted elaborate procedures for establishing the cost-of-service for all the gas wells. MacAvoy reports “thousands of wellhead sales contracts” placed in suspension in the United States. (That behavior illustrates an agency developing methods of implementing a public policy that require budget growth.)
- **Industrial dislocation:** As price caps created a shortfall between the quantities of gas demanded and the quantities supplied to the interstate market, industries dependent on large reliable gas supplies moved major production facilities to the intrastate market, where wellhead price caps had not discouraged production.
- **Discrimination against new consumers:** Both residential and industrial customers who sought new natural gas service were severely harmed by price caps. They were denied access because of a lack of supply.

The extent of that damage is particularly interesting when we consider that Congress appeared more focused on pipeline market power when it passed the Natural Gas Act of 1938. How did we get wellhead price regulation if Congress did not intend it? In 1954, the Supreme Court interpreted the Natural Gas Act to require the regulation of prices at the wellhead (*Phillips Petroleum Company vs. Wisconsin*). Shortly thereafter, legislation exempting independent producers from such regulation passed both the House and Senate. But before President Eisenhower could sign it, Senator Francis Higbee Case announced that he had been offered a bribe for his favorable vote and Eisen-

hower vetoed the legislation to avoid a scandal. Exemption bills were introduced in subsequent Congresses but never received committee approval.

WHAT MACAVOY OVERLOOKS

MacAvoy's estimate of the damage caused by natural gas regulation has provided a useful service to regulatory policymakers and analysts. But his brief book does miss much, and is ultimately frustrating to someone familiar with how the natural gas market place actually works.

First, as the reader should know, the fundamental problem of price caps is that shortages are an inherent, unavoidable result of any cap that actually holds down prices to less than they would be in a free market. MacAvoy's book does not emphasize that basic insight.

Second, natural gas policy generally has been subjected to intense and complex political forces. The public choice insights regarding regulation and legislative compromise are essential to understanding the compromises in the 60 years of regulated natural gas markets. I noted earlier the power of a public choice budget-maximizing model to understanding the Federal Power Commission's behavior. The NGPA was an extremely complex legislative compromise among multiple interest groups. The many paths to price decontrol resulted from the many compromises achieved. The NGPA unleashed market forces that undermined the role of the commission in regulating natural gas prices, but the goal of the NGPA was more narrow: to limit the windfall profits of producers with low production costs, but let prices be determined by a free market for marginal high-cost supplies. (That was the same intellectual motivation of the crude-oil pricing policies enacted in the 1970s.)

Third, MacAvoy discusses the Federal Energy Regulatory Commission (successor to the Federal Power Commission) as if it were directing the market's evolution. That was not the case; the commission was constantly working to catch up to developments in the marketplace unleashed by the NGPA. It was also under intense pressure from

the courts to restructure the system. The D.C. Circuit Court repeatedly remanded decisions back to the commission with rather specific directions about what it needed to do. The *Maryland People's Counsel* decision (U.S. Supreme Court, 1985) really unleashed open access for the interstate pipeline system. Order No. 436 was part of the commission's response to the court finding of undue discrimination regarding the commission-approved Industrial Sales Program (ISP) (*Maryland People's Counsel vs. F.E.R.C.*, 761 F. 2d 768 (DC Cir. 1985)). ISPs had allowed industrial customers access to low cost spot gas supplies, but had denied the benefits of access to small customers. The pipelines had sought special marketing programs for industrial customers to keep them from switching away from gas. When the Maryland People's Counsel challenged the rule, the court found the practice to be unduly discriminatory.

Fourth, MacAvoy's book basically ignores one of the most important dynamics of economic regulation: the Averch-Johnson (A-J) effect, which the author mentions in one footnote. The A-J effect refers to the tendency of rate-of-return-regulated industries to increase their costs and investment beyond efficient levels. It was a major explanatory factor of pipeline behavior until recently, when pipelines began competing in earnest for business.

An example illustrates that point: A pipeline company recently attacked the size of its inventory of spare parts as part of its new cost discipline initiative. The inventory had grown because the purchases became part of the rate base and thus earned profits as it grew. When, under competition, inventory and inventory-carrying expenses became costs, the pipeline found it had more of certain parts for a compressor in its inventory than the manufacturer of the compressor had in its global inventory. Such is the power of perverse incentives.

Fifth, MacAvoy ignores the "take-or-pay" contracts that threatened the financial viability of some pipelines during the 1980s. As a response to price control-induced shortages, pipelines

made contractual commitments to pay the maximum price allowed by regulation and to guarantee consumption (take) at very high levels (e.g., 90 percent of the maximum contract capacity) regardless of actual consumer demand. Such contracts with high take-or-pay provisions were an inefficient means to circumvent price caps. (If you pay \$1 per unit for 90 units but only take 60 units, what did you pay per unit?)

Finally, MacAvoy does not address the important and thriving "gray market" that has been fundamental to the functioning of natural gas markets for years. He mentions the price caps on the resale of releases of pipeline capacity. What is not mentioned is that a marketer can offer gas at point A for one price and downstream at point B for another price. The prices are deregulated. Thus, the downstream price can exceed the upstream price by more than the regulated price for transporting the gas in the pipeline between the two points.

The commission prevents pipelines or their distribution company customers from charging more than the cost at point A plus a regulated transportation tariff. But it does not prevent marketers from making profits on the same transaction. The gray market has become so important to understanding the value of transmission capacity that pipelines have established price desks to gather information on gas prices at specified points on their systems.

CONCLUSION

MacAvoy has provided a genuine service in explaining and estimating the costs that gas regulation has extracted from the American economy. Those lessons are important today, as energy markets and energy policymakers continue to respond to California's chaos and prepare to respond to future disruptions and other unexpected developments as the nation addresses the latest crisis.

The industry must continue to wait for a book that tells the full story of the complex market, technological, and policy forces that have formed it. I wish I had the time to write it. R

The Coming Investor Revolution

Reviewed by Chris Edwards and Tad DeHaven

INVESTOR POLITICS: The New Force That Will Transform American Business, Government, and Politics in the Twenty-First Century

By John Hood

308 pp., Philadelphia, Pa.: Templeton Foundation Press, 2000

The non-stop expansion of the welfare state during the twentieth century could finally be unraveling under a new force in the twenty-first century. That force is investor politics, according to John Hood, president of the John Locke Foundation, a North Carolina think tank. In his new book appropriately entitled *Investor Politics*, Hood predicts that the expansion of individual savings accounts to fund not just retirement, but also health care, education, unemployment, and other big government spending areas will liberate Americans from dependence on Washington.

Over half of Americans now own corporate stocks through 401(k)s, Individual Retirement Accounts (IRAs), and other channels. This rising investor class, claims Hood, is the starting point for changing the politics of the welfare state.

THE HISTORY OF BIG GOVERNMENT

Hood's book describes the historical growth of a remarkably broad range of federal programs, including Social Security, Medicare, Medicaid, housing programs, education programs, unemployment insurance, and others. Hood does an excellent job of synthesizing a tremendous amount of fact and detail on so many programs, and his book is

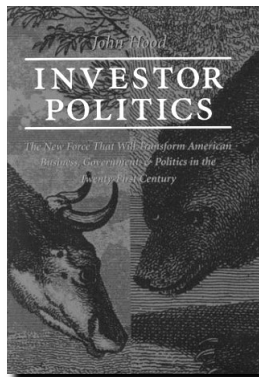
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well worth a read just for his summaries of the purpose and functioning of those programs.

The author ties each program into his broader theme of the relationship between savings, investment, and the welfare state. While many of those federal spending programs began in the New Deal, Hood digs further back in history, even prehistory, for the foundations of big government and the centrality of saving to the modern economic system.

Although much of the structure of the modern welfare state was laid in the 1930s, Hood notes that the seeds actually were planted in the late nineteenth century with politicians such as Bismarck



In the new century, the expansion of the investor class will liberate Americans from their dependence on Washington.

seeking a "third way" between socialism and capitalism. Populists and progressives, whose ideas infiltrated both major American political parties, nurtured those seeds in the years prior to the New Deal. In parallel to those developments, the United States was becoming industrialized with the rise of large corporations helping to foster the development of new and innovative financial instruments, and a huge widening and deepening of the publicly traded securities markets.

BEYOND WELFARE

An important theme woven throughout Hood's discussion of programs for retirement, health, education, housing, and other areas is the distinction between investment and consumption. Government should not penalize investment, as it frequently does under the current

income tax. The author notes that, to the extent that each activity represents investment, individuals should be able to take a tax deduction for it and build up assets for the future in a tax-deferred account. Basically, individuals would accumulate an alphabet soup collection of IRA-type

accounts to substitute for the current alphabet soup of big government spending programs.

Americans, who have partly built their lives around federal entitlements, could return to self-sufficiency with this new financial investment strategy. And the strategy is not just good economics, writes Hood, but

good politics because it will be more effective in undermining the welfare state than the frontal assaults that have been attempted by conservatives and libertarians in recent years. Laying siege to the welfare state and penetrating it from different angles with new savings accounts will work far better than calling for an immediate replacement of the income

tax with a flat tax or national retail sales tax, according to the author.

Too dangerous? In making that argument, Hood raises important issues with regard to political strategy. But complicating the tax code with a slew of

new program-specific savings accounts could backfire. Anyone who has struggled with complicated rules on an MSA or IRA will question whether the American public would have the patience to juggle half a dozen such vehicles, each with different income limits, contribution limits, and withdrawal restrictions.

As each particular account gains a political constituency, it will become more difficult to enact overall reforms and simplification of the tax code. And surely the new vehicles would give Congress more power to play favorites with important political groups, each claiming that its activity should be classified as an "investment" deserving of a special savings account. Savings accounts for zero-emissions electric cars, anyone?

Perhaps a better solution would be

to have a single tax-favored account with very liberal rules. Such accounts would not only be simpler, but their greater flexibility would encourage more savings.

CONCLUSION

Hood has delivered a thoughtful and very engaging text that will help move the debate from the last century's entitlement-dependent view of society to the country's Jeffersonian roots of self-reliance. In this

century, as the author notes, growing financial sophistication converging with an impending demographic crisis caused by retirement of the baby boomers is offering us a way to avoid the looming train wreck of Social Security. We should look at that convergence as an opportunity to create Social Security private accounts and continue expanding the investor class by further reductions in the tax penalty on saving. **R**

what that person gets during retirement is just an accident.

McLachlan's straight talk also discusses the federal budgetary accounting for Social Security that often causes confusion. He describes the difference between "on-budget" and "off-budget" federal accounting in layman's terms, noting that while off-budget Social Security is in surplus in recent years, it has essentially been used as a slush fund for politicians for on-budget general purpose spending.

McLachlan does go astray in his opposition to the use of the "unified" budget concept that melds Social Security together with the rest of the budget. In our view, Social Security under current law is a federal tax-and-spend transfer program, and not a real pension system. As such, it should be grouped together with other federal funds and not strictly separated out as McLachlan proposes.

A new system The author then moves on to the primary reform being considered for Social Security, which is full or partial privatization. He reviews the experience of other countries that pursued such reforms, led by Chile's successful transition to private accounts begun two decades ago. For the United States, McLachlan provides us with a detailed list of options designed around his plan for personal accounts funded by a 10-percent payroll contribution. The new accounts would be mandatory for younger workers, optional for older workers, and would

provide substantial flexibility with regards to withdrawals and other features. He also recommends a variety of structural changes to ease the financial transition to a new system.

His larger message is that procrastination and half-baked compromises will not cut it. McLachlan's book is low on technical jargon, high on understandable fact, and a welcome addition in the struggle to empower Americans through greater private retirement savings. **R**

Straight Talk on Social Security

Reviewed by Chris Edwards and Tad DeHaven

SAVING SOCIAL SECURITY (FROM CONGRESS)

By Bert McLachlan

257 pp., Leawood, Kansas: Leathers

Publishing, 2001

The combination of a pay-as-you-go financial structure and the expected rapid growth in the number of retirees has created a near consensus that Social Security will be in major trouble in the coming years. There is no similar consensus, yet, regarding what to do about it. But there is broad support for moving toward advance funding of Social Security with new individual retirement savings accounts.

While polls show that a majority of the public already supports private Social Security accounts, fresh and entertaining discussions of reform aimed at the layman are always useful. That is what Bert McLachlan provides in his new book, *Saving Social Security (From Congress)*. The author, a retired corporate comptroller who has self-published the book in the hope of adding to the Social Security debate, offers an easy-to-understand volume, complete with newspaper comic strips, that illustrates the bankruptcy of the current system and the need to move to a privatized approach.

Straight talk The author tackles both

the politics and economics of Social Security reform. On the politics, McLachlan stresses that average citizens need to be informed about the current system's mess in order to propel reform forward. He rightly notes that politicians and Social Security administrators have made citizen understanding difficult by using inaccurate or nonsense words such as "trust fund" and "insurance" to describe the program. He points out that such "lies" and "malarky" have confused the American public about the workings of Social Security.

On the program's economics, McLachlan's "straight talk" does an able job of detailing the problems with the current system. The author points to the baby boomers' impending retirement, the falling worker-to-retiree ratio, and the costs of not pursuing any reforms. He notes that Social Security is an unsustainable wealth transfer and not a real pension system:

It is more accurate to say that it is a retirement income welfare program. Those who work pay bills, and those who are retired get benefits, and any relationship between what any individual pays in over a lifetime and

