POLICY REPORT

Volume III Number 4 | A PUBLICATION OF THE CATO INSTITUTE | April 1981

Will the Reagan Economic Program Work?

by Richard M. Ebeling

Moments after taking the presidential oath on 20 January, Ronald Reagan warned the nation that "these United States are confronted with an economic affliction of great proportions." Ever-increasing prices were evaporating the people's purchasing power. The skilled and strong were standing helpless before the locked doors of idled factories. And crushing taxation was sapping the strength and incentives of the citizenry. He forthrightly declared: "In this present crisis, government is not the solution to our problem; government is the problem. . . . For decades we have piled deficit upon deficit, mortgaging our future and our children's future for the temporary convenience of the present. To continue this long trend is to guarantee tremendous social, political, and economic upheavals." In a resolute voice President Reagan assured his listeners that it was his "intention to curb the size and influence of the Federal establishment and to demand recognition of the distinction between the powers granted to the Federal Government and those reserved to the states or to the people. . . . And let there be no misunderstanding—we're going to begin to act beginning today."

Seemingly true to his word, within hours of taking on the mantle of the Presidency, Reagan announced a freeze on federal job hiring. Two days later he announced cuts in permitted federal employee travel, furniture procurements, and outside consulting services, projected to save $300 million. On 28 January, the last remaining federal price and allocation controls on domestic oil and gasoline production and distribution were lifted. And on 29 January, at his first news conference, President Reagan announced the elimination of the Council on Wage and Price Stability and a 60-day freeze on pending federal regulations that were set in motion during the last days of the Carter administration. He declared: "I want the American people to know that we have begun."

"All hope of any significant reduction in the size of government spending evaporated on 10 February when seven major programs were declared immune to budget cuts."

Less well publicized was the fact that the Carter administration had already planned most of these actions: A cutback in federal hiring had been planned, the Wage and Price Council had intentionally been made impotent for months, and the gasoline price controls were to be lifted automatically in September. (The early removal of the controls assured the new administration an additional $6 to $10 billion in oil-related taxes during the year, much of it due to the "windfall profits" tax that Republicans had so vehemently opposed.) In private, Reagan advisers admitted that there was nothing momentous in these early acts. They were meant only to create the impression of "momentum."

The Search for Budget Cuts

The real substance of the Reagan assault on the "problem" of government was to be contained in his address to Congress on 18 February, when he would disclose proposals for federal tax and expenditure cuts. Each cabinet member was given orders to search out fat, waste, and fraud in his department. David Stockman, the new Director of the Office of Management and Budget, was to oversee the wielding of the budget-cutting axe. "Hit lists" began to circulate, marking off the areas and the extent of the proposed cuts.

However, even before January had become February, federal bureaucrats began to object as they saw their vested interests threatened. Grumbles began to be heard in Congress and from the many groups whose livelihood flows partly or totally from Washington's horn of plenty. For example, the State Department leaked that Stockman was planning to slice $2.6 billion from the foreign-aid budget. Newly appointed Secretary of State Alexander Haig warned darkly that America might not be able to meet its commitments to various foreign nations and lending institutions. Behind closed doors Stockman and Haig compromised, and the foreign-aid cut was lowered to a $1.8 billion, still leaving a hefty aid program of $5.4 billion.

On the evening of 5 February, President Reagan went before the country on national television in an attempt to sell his budget-cutting message. He held up a dollar bill and declared that a dollar earned in 1960 was worth only the 36¢ he then held out in his hand. As in his inaugural address, he once again warned of the cancerous effects of inflation, the suffocating consequences of regulation, and the dangerous "built-in tendency" for government to grow.

His address also contained two points that were important for the actual shape

(Cont. on p. 3)

Richard M. Ebeling is on the economics faculty of Rutgers University.

EDITORIAL

The Education Crisis

Education in America is in crisis. SAT scores have been falling for the past 17 years at a rate of about 1% a year. At the Berkeley campus of the University of California, where entering freshmen come from the top one-eighth of high-school graduates, a significant percentage of them need remedial English courses.

Many businesses are finding it increasingly difficult to hire employees with basic reading, writing, and mathematical skills. A spokesman for JLG Industries of Pennsylvania says, "Poorly educated workers are our number one problem, the main factor slowing our growth." At Mutual of New York, an estimated 70% of all correspondence must be corrected and retyped because typists working from dictation machines don't know how to spell and punctuate.

As a result, many companies are starting remedial education programs in order to develop enough qualified employees. These classes are working well, making it clear that the source of the educational crisis does not lie with the students but with the quality of education offered to them.

The education establishment replies in its own defense that not enough money is being spent on education or that student-teacher ratios are too high. But the facts just don't back up these claims. The cost of government education per pupil has risen from $920 to $1,500 over the past 20 years—*after* adjusting for inflation. In the last decade alone the consumer price index rose 69% while per-pupil education costs rose 155%. And the ratio of teachers to students rose from 1 to 25 in 1960 to 1 to 18 in 1975. The number of administrative personnel rose even faster.

The schools are also becoming places of conflict, both physical and political. The National Institute of Education reported in 1978 that in a given month some 2.4 million secondary-school students are robbed and 282,000 are attacked. Many schools have guards patrolling the halls, and children are afraid to go to class.

But the political conflicts are almost as severe. Parents, teachers, education bureaucrats, and special interest groups outside the schools wrangle over what will be taught in the public schools. Some want sex education, others don't. Some want a prayer every morning, others regard school prayers as a violation of the First Amendment. Some parents want to exclude gay teachers, while others believe the schools have an obligation to speak positively about every lifestyle. Some people want "back to basics" and the teaching of creation theory, while other groups want an unstructured curriculum and strict reliance on accepted scientific findings.

The problem is that all these desires are legitimate. Parents *should* be able to choose the kind of education they want for their children. Economist Walter Williams, who grew up in Philadelphia's black ghetto and has taught recently at Temple University, has written:

> A state monopoly in the production of a good or service enhances the potential for conflict through requiring uniformity; that is, its production requires a *collective* decision on many attributes of the product, and once produced, everybody has to consume the identical product whether he agrees with all the attributes or not. State monopolies in the production of education enhance the potential for conflict by requiring conformity on issues of importance to many people. For instance, prayers in school, ethnic history, saluting the flag, and educational tracking are highly controversial issues which have received considerable court attention and have resulted in street fighting and heightened racial tensions.

Whether or not they understand the economic and political issues involved, many parents realize that the public schools are failing. Recently 4 Chicago parents were arrested after they and 30 other parents occupied a school principal's office because they said there is "something wrong with a system that turns out students who can't read and write." Other parents in Chicago have turned to Marva Collins's Westside Prep, a one-room private school that has achieved extraordinary results with poor black students who had been judged failures by the public school system. In New York thousands of black parents have turned to black-run private schools for their children. In Los Angeles parents fed up with the public schools decided to build their own. Columnist Richard Reeves said they repeatedly told him, "We took control of our own lives!"

Why don't more parents choose private schools for their children? The obvious reason is cost. Taxed to pay for the public schools, most low- and middle-income parents can't afford to pay extra for private education.

The single most important thing to be done about education in America is to give parents and students more choice, to let them become real consumers of education. The easiest way to accomplish this would be to implement a broad program of tax credits, giving parents a credit against their income taxes for all the money they spend on their children's education. Because many lower-income children, who need private schools the most, would not be benefited by a straight tax credit, the credit could be made available to *any* taxpayer—individual or corporate—who paid for the education of any child, whether a relative or not. Then the public schools would face a real market decision on whether their product was worth purchasing.

The most scandalous aspect of the education crisis is the almost total silence on the issue by politicians. *Our children are being forced to attend schools that do not teach them.* What failure of public policy could be more shameful? It is an outrage that nothing has been done.

Reagan's Economics (Cont. from p. 1)

his economic program would take. First, he emphasized that budget cuts did not mean that government spending would be less this year than last: "The budgets will increase as our population increases, and each year we'll see spending increases to match that growth." Second, he said that the "spending cuts will not be at the expense of the truly needy." The consequences of these statements were to become evident during the following two weeks.

Reagan and his advisers began to give soothing assurances of "equitable" and "fair" belt-tightening. All hope of any significant reduction in the size of government spending evaporated on 10 February when the news was released that seven major social programs—social security, Medicare, the Veterans Administration, supplemental security income, school lunch and breakfast programs, Head Start and Summer Youth Jobs—costing a total of $210 billion were immune from the budgetary scalpel. Protecting the 80 million beneficiaries of these seven programs —equivalent to almost one-third of the entire population—was declared to be President Reagan's way of taking care of the "truly needy."

The Reagan administration also announced that rather than eliminate major programs it would propose to shift control of them from Washington to the states via block grants, after making some cuts; would ask Congress not to make the proposed 1981 cut in income tax rates retroactive to 1 January; and would reduce the tax break to be given to upper-income groups. Furthermore, a $7.2 billion *increase* in defense spending over the Carter projections of $181.5 billion was also introduced.

When one added the budgets of the seven immune programs to the military budget and the required payment of interest on the national debt, it became clear that nearly two-thirds of the entire federal budget had been sheltered from attack by the time President Reagan went before the Congress and the nation on 18 February to ask support for his proposals for "massive" cuts in federal spending and taxation.

In fact, Reagan asked for a 30% cut in income tax rates spread over three years and a *decrease* in the previously projected rate of increase of federal expenditures over the next four years.

Federal tax revenues would be lowered by $8.9 billion in fiscal 1981, by $53.9 billion in fiscal 1982, and by $100 billion in fiscal 1983. On the expenditure side, Reagan proposed a budget cut of $4.8 billion in fiscal 1981, $41.8 billion in fiscal 1982, and $79.7 billion in fiscal 1983. However, in each instance these are cuts from projected *increases* in revenues and expenditures made by the Carter administration. And in each instance, the cuts still leave the Reagan budgets larger in relation to each previous year. Thus federal spending will *increase* by 6.2% in 1982; over the entire period from fiscal 1981 through fiscal 1984, federal spending will increase at an average annual rate of 5.6%. (Admittedly, this rate of increase will be an improvement over the period from fiscal 1979 to 1981, when federal spending increased at an average annual rate of 15.9%.)

Furthermore, the decline in tax revenues, combined with the *actual increases* in government expenditure, will generate budget deficits of $54.5 billion in fiscal 1981, $45 billion in fiscal 1982, and $22.9 billion in fiscal 1983. Not until fiscal 1984 does the Reagan administration project a surplus, and then of only $500 million.

Supply-Side Assumptions

The 1984 projected surplus is dependent on assumptions about investment stimuli that are supposed to result from the tax reductions. These assumptions form the basis of the supply-side economic theories the administration has adopted.[1] In simple terms, if marginal tax rates are lowered, thereby increasing the incremental take-home wage-income or investment-return at every level of income, incentives will be created for additional savings and investment that will generate new and greater wealth and output in the economy.

It may well be true that lower tax rates would generate such an expansion of incentives that tax revenues in excess of the tax

(Cont. on p. 4)

In This Issue

Will the Reagan Economic Program Work?	1
The Education Crisis (Editorial)	2
Politics and the Decontrol of Oil	6
Briefs	5
Regulatory Watch/The Freeze	7
Washington Update	8
Government Receipts Monitor	10
PR Reviews	11
"To be governed . . ."	12

POLICY REPORT

Published by the Cato Institute, *Policy Report* is a monthly review that provides in-depth evaluations of public policies and discusses appropriate solutions to current economic problems.

David Boaz . . . . Executive Editor
Richard H. Fink . . . . Managing Editor
Tyler Cowen, Daniel Klein . . . . Research

EDITORIAL BOARD

Yale Brozen . . . . University of Chicago
Karl Brunner . . . . University of Rochester
Friedrich A. Hayek . . . . University of Freiburg
M. Bruce Johnson . . . . University of California at Santa Barbara
Israel M. Kirzner . . New York University
Gerald P. O'Driscoll, Jr. . . . . New York University
Edwin G. West . . . . . Carleton University
Leland B. Yeager . . . . University of Virginia

Subscriptions and correspondence should be addressed to: *Policy Report*, P.O. Box 693, Englewood, CO 80151. The annual subscription rate is $15.00 (12 issues). Single issues are $2.00 per copy. *Policy Report* is published monthly by the Cato Institute, 747 Front St., San Francisco, CA 94111. Second-class postage paid at San Francisco, CA. POSTMASTER: Send address corrections to P.O. Box 693, Englewood, CO 80151.

ISSN 0190-325X

Copyright © 1981 by the Cato Institute

Reagan's Economics (Cont. from p. 3)

cut would emerge, but they would emerge only at some future point. Investment and production take time. The immediate consequence of the tax cut is lowered government revenues in the face of increased government expenditures. The new additional investment demand of the private sector (generated by the tax cut) will run head-on into the increased level of government spending. The finite resources of the marketplace will have to be allocated between the alternatives of private and government use.

If the government attempts to recoup the lost revenue by borrowing in the private sector, it will inevitably raise interest rates and crowd out the additional private investment demand created by the tax cut. Alternatively, if the government decides to make up the revenue loss through money creation, it shifts the required resources to the public sector via inflation. There is no third choice other than to raise taxes again, which would nullify the very incentives the tax cut was meant to enhance. Regardless of the method chosen to finance the deficit, then, the anticipated capital formation and growth will most likely be thwarted.

It is quite true that present tax structures act as disincentives to savings and investment. Twenty years of increasingly larger budget deficits have depressed capital formation and produced inflationary expectations sufficient to modify the country's consumption/savings ratio in favor of consumption. The proposed 30% cut in income tax rates over three years could have spurred greater private investment and activity—but only if the requisite expenditure cuts were made to free the necessary resources for private sector use. Also, as Milton Friedman suggested recently, "If the tax cut threatens bigger deficits, the political appeal of balancing the budget [could have been] harnessed to reducing government spending rather than raising taxes." But for the tax cut stimulus to do its work in the economy, government expenditures would have to be severely cut, either as much as or, preferably, in excess of the tax cut itself.

Yet this is precisely what the Reagan administration seems determined to avoid. The lure of supply-side economics is that it seems to offer a way to stimulate and expand private sector activity—to "restore the freedom of all men and women to excel and create" as Reagan expressed it—without having to jeopardize the incomes of the almost 100 million Americans who receive some privilege, benefit, or transfer payment from the government. The hope of supply-side advocates is that tax cuts can stimulate production enough that the private sector can expand without having to fight with special interest groups over any really significant cut in the public sector. Supply-siders want to decrease the relative size of the government not by decreasing government expenditures but by increasing the output of the whole economy relative to government expenditures.

> **"The Reagan people have chosen to emphasize the elimination of 'excessive' regulation. But how does one define 'excessive'?"**

Why Government Will Still Grow

This attempt is bound to fail. Even if the supply-side program were to work (which is questionable without the appropriate expenditure cuts), an incentive structure would still exist encouraging special interests to lobby for an expansion of their particular programs—programs whose benefits accrue only to themselves while the tax burden is diffused throughout the economy.[2]

The reluctance of the Reagan administration to do battle against the prevailing system of privilege is quite evident in its decision not to cut certain social programs but instead to transfer them from Washington to the states via block grants. The end result will be both a shifting and an expansion of the public troughs from which the special interests feed, from the banks of the Potomac to the state capitals. There the special interest groups will fight over the relative distribution of the block grants. This move will not assure increased local discipline over the programs. As mere distributors of "gifts" from Washington, the state legislators will feel free to offer and promise larger and more expensive programs to their constituents without having themselves to raise the taxes necessary to pay for the programs. The state legislators will merely join the established special interests in Washington and lobby for larger block grants. And, most assuredly, decision making will not have been returned to the people, for the taxes will still be collected in Washington; only the dispensing of the funds will have shifted to the 50 state capitals. This may be a gain for state's rights but certainly not for individual freedom of choice.

The same unwillingness to resist special interest groups is visible in the evolving administration attitude toward government regulation. The Reagan people have chosen not to question government regulation per se but rather to emphasize the elimination of "excessive" regulation. The problem with this attitude is how one defines "excessive." On 17 February, Reagan signed an executive order requiring that in weighing the methods for implementing a regulation or standard, the alternative money costs of one approach over another should be compared. The one with the lowest money costs, given the goal desired, is to be considered the "nonexcessive" regulation.

Now while economists may frequently refer to money outlays as an analytical shorthand for costs, consistent economic theory would dictate that the true cost of doing something is the next best alternative or opportunity that has to be forgone, and this can never be known to anyone except perhaps the decision maker who must select from the various alternatives before him. A criterion of money costs thus fails completely as an objective standard. Furthermore, it sidesteps the question of whether there should be regulations at all and focuses attention on the secondary question of implementation.

The Fundamental Problem

To say that resisting or eliminating special interest politics is a difficult task is certainly to say nothing new. Indeed, it was understood clearly in 1821 by Jean-Baptiste Say, the originator of Say's law:

> I know that certain governments, corrupted and corrupting, stand in need of monopolies, and of custom duties, to pay for the votes of the honourable majorities which pretend to represent nations: I am not so unreasonable as to expect them to govern so entirely according to the general interest, as to be able to obtain votes without paying for them; but, at the same time, why should I be astonished that such vicious systems have deplorable consequences?[3]

Even if the Reagan administration is able to gain passage of most or all of its program through Congress—which is far from certain—it will not have rooted out the fundamental question that lies behind the sickness of the American and Western European economies: What is the proper relationship between the individual and the State? Is an individual to be secure in his life and property, or is he to be open, against his will and at his expense, to the arbitrary seizures and interventions of government that have as their purpose the bestowing of benefits and privileges on others?

Although they speak of the need to reestablish America's past greatness and prosperity, Ronald Reagan and his administration seem unwilling to define that greatness, as it should defined, in terms of individual liberty that stands squarely in opposition to those who want to use the power of the State as a vehicle for private gain. By following the course he seems to have marked out for his administration, President Reagan has assured that long after he's gone the corrupting hand of the Interventionist State will still be with us.

[1]See Richard M. Ebeling, "Some Thoughts on Supply-Side Economics," *Libertarian Forum* (May–June 1980); and Tyler Cowen, "Supply-Side Economics: Another View," *Policy Report* (August 1980).

[2]See Jean-Baptiste Say, *A Treatise on Political Economy* (1821); Nassau W. Senior, *Three Lectures on the Transmission of the Precious Metals from Country to Country and the Mercantile Theory of Wealth* (1828); and Oskar Morgenstern, *The Limits of Economics* (1937).

[3]Jean-Baptiste Say, *Letters to Mr. Malthus* (1821).

Briefs

☐ Thousands of General Motors employees in Michigan are refusing to file income tax returns and are falsifying withholding forms as part of a concerted effort to avoid paying income taxes. The workers have argued that income taxes are a violation of rights in several ways; for example, they may force an individual to incriminate himself against his will. Many of the protesters are simply not filing returns, while others have even directed their employers to change their filing status in order to escape the federal withholding tax. Others have claimed enough dependents so that no tax is withheld—up to 99 dependents have been claimed in some cases.

Although the IRS is threatening to crush the burgeoning revolt, they have admitted that the large number of protesters will make such a task difficult, if not impossible. So far, only five cases have been referred for possible prosecution.

☐ The federal government currently has 470,400 buildings under either ownership or lease, whose floor space totals 2,864,000,000 square feet. It would take 300 buildings the size of the twin towers of New York's World Trade Center to accommodate this space.

☐ The Pentagon has recently reported that the total cost of 47 of its major weapons programs rose by $47.6 billion in the last three months of 1980. This increase brought the price tag of these projects to $310.2 billion. Previously, the single largest leap in weapons costs in a quarter was $28.8 billion in the last three months of 1979.

☐ Because of ex-President Carter's civil service reform act, U.S. agencies planning a cut in staff can offer early retirements either to employees with 25 years of service or to anyone 50 or over with 20 years of service. The General Accounting Office has estimated that several federal agencies have allowed hundreds of early retirements each, at a total cost of $109 million for fiscal 1980. All early retirements to date have added more than $600 million to the unfunded liability of the federal pension program.

☐ Audit reports by the General Services Administration and the Department of Health and Human Services have estimated that the government could save $790,000 a year in just four federal buildings by implementing such basic steps as using lower-wattage lighting in hallways and eliminating heat in the garages. Furthermore, some federal officials have failed to verify the accuracy of their utility meters, in one case resulting in an agency's being overbilled an additional $50,000 a month.

☐ Thomas Sowell, the outspoken free-market economist, is forming a national black organization intended to ". . . put forth my [Sowell's] vision of the world and offer a forum for other views of the world." The new group, entitled Black Alternatives Association Inc., plans to have established six chapters by March. Sources close to Sowell say that Sowell has already raised $100,000 for the project.

☐ A recent General Accounting Office investigation of the Small Business Administration has discovered widespread fraud and waste. For instance, SBA officials would often allow contracts to be selected by minority firms, merely to be rubber-stamped by the federal agency. In another case, one contract was awarded to a firm that did not perform the kind of work called for, so the firm was granted an additional $1.2 million for purposes of retooling.

☐ June Gibbs Brown, formerly an inspector general with the Interior Department, recently discovered that a youth camp director in Missouri ordered 1,072 pairs of leg chaps, 3,736 pairs of work gloves, 112 stepladders, and 1,509 desk calendars with federal funds, all for a camp with only 136 enrolled youngsters. Ms. Brown was recently dismissed by the Reagan administration. ■

Politics and the Decontrol of Oil

by Joe Cobb

On 28 January 1981 President Reagan signed an executive order that decontrolled crude-oil prices in the United States. For those who understand the free-market issues in the energy business, this was V-E Day—the day the Moral Equivalent of War ended. Yet many people in the petroleum industry are unhappy about the prospect of a free market and they are regrouping for a counterattack. An array of antimarket politicians and lobbyists—Ted Kennedy, Toby Moffett, Howard Metzenbaum, et al.—filed challenges in court to decontrol and introduced bills that would reimpose controls.

Although the opponents of decontrol have failed, they have made the symbolic gestures that their constituencies expected, and they have signaled to the administration that any unpleasant or unexpected developments in the petroleum market will be met with a wave of antimarket legislation. Meanwhile, behind the scenes, an effort is being made to subsidize petroleum refiners who have lost their privileges under price and allocation controls and to legislate restrictions on the ownership of service stations by refiners. Moreover, with federal law out of the picture, lobbyists are turning to various state legislators to pass legislation to control the industry. It would appear that the moral equivalent of guerrilla warfare has begun. The petroleum industry has been so tied up in political action since World War I that no one should expect its operations to be left to the free market just because the President has endorsed this policy.

The executive order signed by the President moved the date of decontrol from 30 September 1981 to 31 March for various allocations, including mass transportation and the set-aside programs managed by state governors. The administrative orders under the buy/sell program, which require some companies to deliver petroleum to others, were left intact to expire under their own terms—usually within 60 days—but there will be no new buy/sell orders. The reporting and record-keeping systems under the Emergency Petroleum Allocation Act are to continue in effect unless the Secretary of Energy cancels them, although the EPAA itself expires on 30 September. The part of the order that took effect immediately was the elimination of price controls on the 15% of crude oil that had not already been decontrolled under the terms of Carter's executive order of June 1979, which had started the process of phased decontrol.

> "The oil companies had enough flexibility to raise prices before the President's action because they had not been charging the maximum allowable for petroleum products."

The Outcry against Decontrol

Since the impact of President Reagan's executive order is so small, why was there an immediate outcry? Why was there a sudden jump in prices, causing a raft of news reports about how "inflationary" the action was? The explanation has to do with politics, not with economics. The news media were responding to a spurious correlation between the increase in the world-market price of crude, following the December OPEC meeting in Bali, and the exploratory price increases by some major oil companies testing the strength of consumer demand.

Even before the President's action the oil companies had more than enough flexibility to raise prices because they had not been charging the maximum allowable for petroleum products. Under the rules, if a company did not charge the maximum allowable in some prior month, the difference was credited to a "cost bank" and could be added to the price limit in a subsequent month. The fact that these cost banks carried large balances during most of the period of price controls is evidence that consumer demand was always the determining factor in setting prices, not the price controls on refiner and dealer markups. Further evidence that American motorists were paying world-market prices and not really enjoying benefits from price controls is that during the entire period of controls the United States imported some refined products. Importers would have been reluctant to do business in the United States if they had had to sell their products to domestic consumers at a controlled, below the world-market price.

The outcry against decontrol from within the industry came from those who saw a competitive market looming and trembled with fear. The heart of the system of controls on the oil industry was not the price limits but the allocation controls guaranteeing certain companies that they would be supplied with crude oil or refined products. The price controls on domestic crude oil did create an economic premium for those refiners who could get a share of it, but because not every refiner could do so at first, subsequent layers of law and regulations were added. For example, the entitlements system was created to force the redistribution of income among refiners, with the effect of subsidizing the importation of crude oil. The predictable results led to President Carter's panic over the level of oil imports in 1977. Small refiners, some of whom are relatively inefficient, got an economic boost from the "small refiner bias," which paid them money because they were small, and as a result most new refineries built in the last eight years have been small and inefficient. The oil-reselling industry has mushroomed because a reseller could collect a small markup on each barrel of price-controlled oil. The predictable result was the practice of selling and reselling oil through an interlinked series of companies before it reached the refinery. Indeed, one explanation for the failure of crude-oil price controls to be reflected at the gasoline pump is the skimming of the economic premium by these new participants in the industry. Their future is now bleak.

Allocation Controls

The allocation controls were also an important part of the process of moving oil from refiner to consumer. Refiners and marketers were not subject to price controls so much as profit-margin controls establishing fixed amounts that they could charge above the price they had to pay to their suppliers. These controls were usually a weak link in the distribution chain and led to the establishing of cost banks. During the Arab embargo and the Iranian revolution, however, the chain was tautened by consumer demand in certain areas because the allocation controls gave every jobber and dealer a predetermined volume of petroleum products based on their historical sales volume. When motorists decided to postpone trips to rural resort areas during these periods, fuel inventories piled up in gas stations along the interstate highways and in remote locations, but tanks ran dry in the cities. The allocation controls prevented any shifting of supplies to the shortage markets. Indeed, in some markets the local governments made matters worse by limiting maximum sales and imposing other purchase restrictions, which frightened motorists and caused them to buy gas much more often than they otherwise would. During the Iranian revolution many motorists had full tanks and many service stations had empty tanks underground, although under different circumstances the fleet of automobiles in a city might have their tanks half-full.

Now that allocation controls have been abolished, the independent oil jobbers and service stations are fearful that they will lose access to supplies in any future tight market. They believe that the major companies will give preference to their own distribution agents, either by cutting off independent marketers or charging them a higher price. Since it is perfectly logical

(Cont. on p. 8)

Regulatory Watch

THE FREEZE

President Reagan's 60-day freeze on government regulations has put Washington in a frenzy. Within hours of the announcement, regulatory councils were busy drawing up lists of affected rules and appealing for exemptions. The Reagan administration's own list of 119 rules that are "candidates for postponement" has rapidly proved to be both incomplete and overextensive. For instance, the 60-day freeze has made it illegal for manufacturers of drugs, food products, and cosmetics to use the 23 most common coloring additives. The Food and Drug Administration rule permitting these additives was about to expire, and the agency was prepared to issue a routine extension allowing the continued use of such additives. If taken literally, the freeze would ban almost every processed food, lipstick, and vitamin. President Reagan is currently preparing an emergency exemption for the FDA extension.

Two different sets of regulations at the Environmental Protection Agency are likely to escape the freeze because of previous court orders mandating that they go into effect. One set, a series of amendments regulating the transportation of toxic metals and chemicals to local sewage treatment plants, was described by EPA official Steven Schatzow as "one of the most controversial things we ever promulgated," because it was expected to result in the shutting down of 20 percent of all electroplating sewage plants.

The Reagan administration had also hoped the freeze would prevent the issuance of new water pollution standards for the timber industry, but a similar court order dating from 1976 may force the rules through. The American Forest Institute has estimated that the pending regulations will cost the timber industry $1 billion, and it is expected that these rules will serve as a precedent for similar water pollution standards soon to come out for 30 other industries.

Alan Morison, director of Private Citizen, an advocacy group, has threatened President Reagan with a lawsuit if certain labor regulations are not exempted from the freeze. The most important of these rules increases the number of workers in private industry who must receive overtime payments in accordance with federal standards.

Since 1 January 1979 the federal government has regulated the size of bottles in which certain beverages may be sold. For instance, the approved size for wine containers ranges from 3 liters to 100 milliliters (about half a cup). The Bureau of Alcohol, Tobacco and Firearms decided that although the 100-milliliter bottle was suitable for servings of dinner wine, it was slightly too large for such beverages as sherry or Madeira. Regulations were prepared that would allow all forms of wine to be sold in 50-milliliter bottles, but such regulations are being held up by President Reagan's freeze.

The freeze stopped the Farmers Home Administration from extending low-interest loans to middle-income families, and it prevented West Virginia from asking for federal money to help it reclaim strip-mined areas.

Another rule likely to be canceled by the freeze is the Occupational Safety and Health Administration's "walkaround standard," requiring companies to pay employees for time spent accompanying OSHA inspectors on their rounds. Businesses have strongly protested the policy, but OSHA says it is already in effect and thus not subject to the freeze.

✓ Washington Update

✓ Although the White House has frozen federal hiring, guidelines for granting hardship exemptions have recently been announced. President Reagan's executive order, which forbade employment of any civilian hired after 5 November 1980 who was not yet on the job, can be overridden if an employee can show he was ". . . honestly, severely injured" by the order. The Office of Management and Budget is now flooded with thousands of requests for exemptions, but has yet to rule on any of them. Three lawsuits have already been filed against Reagan's freeze.

✓ Education Secretary Terrell Bell has ordered scrapped the controversial set of regulations that would have required schools to teach non-English-speaking students in their own language. Although the bilingual requirement is being replaced by new regulations giving local schools more flexibility, the regulations still insist that any school receiving federal funds "provide equal educational opportunity for . . . children who face language barriers."

✓ The Reagan administration has moved to eliminate the Federal Trade Commission's antitrust enforcement powers by cutting off funds for the agency's Bureau of Competition. This proposal, emanating from the OMB, cuts the FTC's budget to $67.7 million and transfers the FTC's antitrust responsibilities to the Department of Justice. Under the plan, the FTC's budget will fall to $41 million by 1985. Critics of the action allege that it constitutes a de facto repeal of the 1914 Clayton Antitrust Act and the Robinson-Patman Act, which give the FTC the power to attack monopolies and regulate competition.

✓ A federal judge has ruled that the Food and Drug Administration has the right to prevent the marketing of generic drugs until after the completion of five to ten years of safety testing. The ruling rose out of a suit involving Premo Pharmaceutical Laboratories Inc., which had been marketing proven drugs after the brand-name patents had expired. U.S. District Court Judge Frederick B. Lacey prohibited such marketing on the grounds that there was a substantial difference between the generic and brand-name drugs.

✓ David Stockman's food-stamp reduction proposal calls for a cut of about one-fourth in food-stamp aid to approximately 22 million Americans. Such cuts would save $1.3 billion in fiscal 1981 and $2.5 billion in fiscal 1982. Another suggestion offered in the proposal would count federal energy assistance as part of an individual's income when assessing his eligibility for food stamps. Such a step would save $278 million by fiscal 1982.

✓ President Reagan and his aides have often endorsed legislation that would allow Congress to veto federal regulations, but some administration aides now worry that such legislation might hamper the administration's ability to make sweeping changes in regulations. Nevertheless, the new conservative mood in Congress is likely to encourage backers of the legislative veto.

✓ The Selective Service System reported that only 87% of eligible young men registered for the draft in January. Draft registration opponents charged that the nonregistration rate was even higher than Selective Service officials acknowledged. There has been no word on whether nonregistrants will be prosecuted, and President Reagan has declined to say whether he will keep his campaign promise to end registration.

✓ Despite the decontrol of oil prices, the 1,500 bureaucrats who administered the controls are still in office. They are empowered to continue to investigate possible violations of controls even after the controls have been lifted. The employees of the Economic Regulatory Administration at the Energy Department are reported to be certain that they will not lose their jobs.

✓ President Reagan has been convinced by Secretary of State Alexander Haig to renege on his campaign promise to end the grain embargo against the Soviet Union. Reagan is now considering extending the embargo to cover some technical products such as computers.

✓ Although Congress has received a proposal from President Reagan that would deregulate the wellhead price of natural gas as of 30 September 1981, it is not clear whether complete deregulation, which is being combined with a budget cut for the Federal Regulatory Commission, will be enacted.

✓ Transportation Secretary Drew Lewis is urging that restrictions on imports of Japanese cars be part of the Reagan administration's program to assist the domestic automobile industry. He said a cabinet-level task force he heads is trying to determine just what would be an "appropriate" level of imports. ■

Politics and Decontrol (Cont. from p. 7)

that a major oil company would want to supply its own people first, the National Oil Jobbers Council is pushing a bill sponsored by Representative Berkley Bedell (D-Iowa) to prohibit such favoritism and also force oil refiners that operate their own service stations to sell them (and to subsidize the independent dealers who may buy them). Most people don't realize that the major oil companies do not always operate the service stations that bear their names: They lease them to independent businessmen. Bedell's bill would mostly hurt some regional refining companies, not the major oil marketers; but in Iowa at least he has a following. The major oil companies oppose such divorcement legislation primarily because they want to preserve the right to operate their own stations, not because it would significantly change their current operations.

Another major legislative activity goes under the name of "guaranteed access to crude oil." Those refining companies that either do not have their own domestic sources of supply or do not have long-term contracts with foreign governments argue that they are being frozen out of the market for crude oil. Senator J. Bennett Johnston, Jr. (D-La.) has introduced a bill that would force those companies with crude-oil inventories to supply feedstocks to the refiners who might be cut off in a tight market. His argument, and that of the lobbyists whom he is serving, is that the world crude-oil market is not free—that foreign governments treat American oil companies in a political way and refuse even to entertain contract offers from smaller buyers. During a tight market, of course, companies with long-term contracts would continue to receive oil, and those without such agreements would have to bid against each other in the volatile spot market. Prices in the spot market could easily exceed $50 per barrel if the market tightens up later this year.

For the past several years, however, the value of a long-term contract with a foreign government has been eroding. During the Iranian revolution, for example, the major OPEC suppliers invoked the doctrine of *force majeure* and supplied only a percentage of their contracted amounts of crude oil at the official price. They sold the rest on the spot market, even to the major international companies whom they were shorting on the long-term contracts. The economic principle that you can get any amount of a good you want if you are willing to pay the price for it applies to the major companies as well as to everyone else, and Senator Johnston's claim that the market is not free only begs the question.

The real objective of the "guaranteed access to crude" lobbyists, who have formed an organization to guarantee that access, is more subtle, however. Probably not one person in a thousand understands the difference between the average cost and the marginal cost of a product—and the ratio among congressmen is not much higher. Under the buy/sell regulations of the Emergency Petroleum Allocation Act, the oil company that had to sell its crude supply to another refiner had to price it at the average cost it had paid during a previous base period. Of course, if the oil market were tight, the price of each additional barrel it had recently acquired would be higher than the average price of its entire inventory. The privileged buyer, enjoying a special Department of Energy administrative order, would thus receive an economic benefit.

> **"The decontrol of crude oil has already set off a drilling boom such as hasn't been seen since Spindletop and the East Texas oil rush."**

Ashland Oil Co., which is not a small refiner, went to the Department of Energy early in 1980 for just such a buy/sell order. It had been getting oil from Iran at $21.56 per barrel. When the oil was cut off, it found the opportunity to buy oil from Abu Dhabi at the spot market price of about $40.00 per barrel, but Ashland decided it could get oil from some other U.S. oil company more cheaply—and it did. Ashland Oil Co. is now one of the principals in the Committee for Equitable Access to Crude Oil, seeking to enact Senator Johnston's bill so it will be able to repeat this performance if necessary even after the EPAA expires on 30 September. Of course, the injustice of this proposal should be obvious: The company that may be ordered to share its crude oil inventory at the average price will then have to go into the spot market to replace the oil at the higher marginal prices that would exist during a shortage.

The Threat of Emergency Planning

The prospect of another world oil crisis is the Achilles heel of the Reagan administration's energy policy. In spite of the free-market rhetoric—and the perhaps sincere belief of the President and his Secretary of Energy in the free market "during normal times"—there remains in Congress and the administration an almost universal sentiment that government action will be required during an emergency—complete with allocations, price controls, etc. Secretary Edwards has just reorganized the Department of Energy, creating a new assistant secretary for emergency preparedness. After the executive order decontrolling oil, moreover, the 1,000-odd civil service employees of the Economic Regulatory Administration in DOE are left with little work to do. It is pretty clear that most of them will go to work on emergency planning, and they will take to their new assignments all their experience in petroleum allocations from the past few years. This agency is a loaded gun just waiting to be used against the free market again at a moment's notice.

To make the situation worse, the National Petroleum Council (an advisory group made up of oil company representatives appointed by the Secretary of Energy) is putting the final touches on an emergency preparedness study that calls for a system of controls and allocations in the event of a crisis. The architects of the NPC's study are employed by the major oil companies (the chairman works for Exxon) who stand to lose the most, hypothetically, under such an emergency planning arrangement. One might speculate endlessly about this curious fact. Would the big boys come out ahead in a crisis? Have 60 years of politics so conditioned them to believe that the free market wouldn't be politically realistic in a crisis, that they are proposing their own suicide in the hope of an easier death? Or is it the case that orthodox economic theory, with its doctrine of market failure, simply blinds the energy experts who are working on this study to the fundamental truths of economic adjustment—namely, that at a time of crisis or rapid change in economic conditions the free market is the only way to discover the least costly path to the new supply and demand realities? Certainly the opportunity for the petroleum industry to make its case for the free market during a time of shortage has been squandered.

In spite of their watered-down commitment to the free market, however, the Rea-

gan administration in general and Energy Secretary Edwards in particular represent a major improvement over their predecessors. At hearings before the House of Representatives Subcommittee on Fossil Fuels, held to inquire into the effects of President Reagan's executive order, Representatives Edward J. Markey (D-Mass.) and Toby Moffett (D-Conn.) expressed concern over the effects that increased home heating oil and gasoline prices would have on consumers. Secretary Edwards replied by saying that those problems are the jurisdiction of the Department of Health and Human Services, not the Department of Energy.

The major problem in energy policy has always been the easy confusion between welfare issues—Congress likes to pretend that its main concern is the plight of the needy—and economic issues. Instead of addressing the need to adjust to economic changes that are forced on us by the real world, the politicians concern themselves with redistributing other people's money and helping particular groups at the expense of others. Politicians love this sort of game; it makes them appear valuable to special-interest groups and to the voters.

The Drilling Boom

If the world crude-oil market remains relatively stable for the rest of this year, the political games will remain in the background. Senator Johnston's refiner bail-out and Representative Bedell's retail divorcement proposals may die in congressional committees, and DOE's emergency planning bureaucracy will not get a chance to cripple the U.S. economy. Because of the very large current inventories of crude oil and refined products, the stories about higher prices are mostly fiction. The decontrol of crude oil has already set off a drilling boom such as hasn't been seen since Spindletop and the East Texas oil rush. The Department of the Interior is opening up government lands in the West and permitting increased offshore drilling. New discoveries of natural gas hold out the promise that there will be ample supplies of fuel well into the next century.

None of these optimistic signs, however, means that the real cost of energy will decline. The economic reality is that the relative prices of various energy sources will continue to rise in the future. The free market that President Reagan's executive order has moved us toward is merely the best way we have to cope with changing economic reality.

Jimmy Carter declared the Moral Equivalent of War on the energy problem at the beginning of his administration, and everybody agrees that he lost. President Reagan has now pointed in the direction of the free market and the "energy crisis" has receded. Perhaps history will agree that the free market is the Moral Equivalent of Peace. ■

GOVERNMENT RECEIPTS MONITOR

On a quarterly basis, *Policy Report* presents three monitors of economic activity: "Government Spending," "Government Receipts," and "Inflation." This month, the "Government Receipts Monitor" summarizes the latest levels and sources of the federal government's income.

RECEIPTS (annual rate in millions of $)

	1980 Fourth Quarter	1980 Third Quarter	1980 Second Quarter	Average for Last Year
Total Receipts	508,004	540,604	624,892	533,017
Surplus or Deficit	– 134,220	– 129,348	32,344	– 84,929
Total Individual Income Taxes	266,950	264,944	274,210	252,960
Gross Corporate Income Taxes	46,696	49,548	104,820	63,431
Gross Employment Taxes and Contributions	124,408	143,668	158,064	141,632
Social Insurance Taxes and Contributions	142,412	166,640	189,864	163,860
Unemployment Trust Fund	11,168	15,804	25,272	15,434
Excise Taxes	28,996	32,332	29,072	26,717
Highway Trust Fund	6,192	6,352	6,788	6,463
Estate and Gift Taxes	6,680	7,316	6,336	6,592
Customs Duties	7,328	7,540	6,908	7,158
Miscellaneous	12,984	12,288	13,680	13,311
Holding of Public Debt Securities	910,062	887,553	875,177	882,010
Holding of Agency Securities	6,531	6,670	6,776	6,748
Federal Securities Held by Public	720,461	698,092	683,926	692,755

SOURCES: All data are derived from the *Treasury Bulletin* and the *Final Monthly Treasury Statement of Receipts and Outlays of the United States Government.*

PR Reviews

The Regulation of Medical Care: Is the Price Too High? by John Goodman. Cato Institute, 1980. $5.00.

The crisis in American health care has become so acute and so widely acknowledged that both *Time* and *Newsweek* have devoted cover stories to the crisis, and ABC "World News Tonight" has spent five consecutive nights exploring the problem. Although we are spending more and more of our national income each year on health care, the quality and accessibility of such care is declining, while the price is skyrocketing.

Most public discussion of this problem pins the blame on the market. Physicians, insurance companies, and even consumers are often held accountable. However, John Goodman's finding is quite different: "Most of the problems we encounter in the market for health care arise not because the free market has failed but because it has not been tried."

Goodman's book provides a systematic outline and analysis of the different forms government intervention in the health care market has taken. Among the topics discussed are controls on the numbers of physicians allowed to practice, controls on nurses and paramedics, controls on hospitals, insurance regulations, and restrictions on Health Maintenance Organizations (HMOs).

HMOs are a particularly interesting development in health care that have been discouraged by federal and state laws. Although the HMO, an organization that provides delivery of all health services for a prepaid premium, has been shown to be an effective cost-minimizing device, 20 states either prohibit HMOs outright or have restrictions so severe that HMOs are prevented from operating.

Goodman explains the role of the AMA and other provider organizations in restricting entry into the health care field and thereby keeping costs high. He warns that as pressures for national health insurance grow, doctors and other providers will try to mold the system to fit their own needs. It can only be hoped that patients will understand the dangers of further government intervention and work toward more competition, not more regulation, in health care. Goodman's research will provide an excellent argument for that position.

Better Government at Half the Cost: Private Production of Public Services by James Bennett and Manuel Johnson. Caroline House Publishers, 1980. $5.95.

Every taxpayer, regardless of his or her political persuasion, should be vitally interested in this powerful and persuasive book. The authors convincingly demonstrate that public services can be produced efficiently and at less cost by the private sector. The book argues that the tax and regulatory burden on the private sector is large and rapidly growing—a theme the authors treat in greater detail in their recently published *The Political Economy of Federal Government Growth* (Texas A&M University Press). Bennett and Johnson show that the public sector cannot produce efficiently: The incentive system in this sector rewards waste and failure, but not cost reduction and efficiency. Numerous case studies of activities performed by the private sector and by local, state, and federal government are compared with regard to expenditure. In every case, the private sector markedly outperforms the public sector by producing comparable services at lower cost. So persuasive is the evidence that the authors propose a "Bureaucratic Rule of Two": The transfer of a service from the private to the public sector doubles its money cost of production. The arguments against contracting out to the private sector are meticulously examined and, the authors reason, the failures from boondoggles, waste, and corruption are the result of failures of the public employee, not the private firm.

This book provides timely and important insights into the role and functioning of government at all levels. It also addresses a critical public policy issue—the need to reduce the tax burden without sacrificing essential services. The clear and unmistakable conclusion that taxes can be cut substantially without adverse effects should be welcomed by all.

Economic Liberties and the Constitution by Bernard Siegan. University of Chicago Press, 1980. $19.50.

In this well-researched and scholarly study that outlines the changing attitudes of the judicial process toward private property and economic freedom, the author argues that one of the major objectives of the framers of the Constitution was to protect and preserve the right of property, and one of their methods of achieving such protection was the institution of judicial review, a power that exists to approve or strike down legislation that may be harmful to economic and civil liberties. The erosion of the desire of the courts to use their judicial review function in order to veto economic regulation is described in detail.

Siegan argues that the Supreme Court under John Marshall was willing to protect property rights even without explicit constitutional authority to do so, and that this is an important precedent for the courts' power to review economic regulation. Even during what is known to legal scholars as the "substantive due process period" (1897–1937), the courts were reasonably effective in safeguarding property rights.

However, in the early 1940s the Supreme Court essentially abandoned judicial review of economic regulation and social legislation. Such laws were invariably upheld unless it could be shown that they interfered with other, noneconomic liberties, such as freedom of speech. As a result, there have been fewer checks on the government's power to interfere with the operation of the free market. Siegan concludes by suggesting that we should uphold the intentions of the writers of the Constitution that private property rights be respected. ■

"To be governed..."

Win some, lose some

In its annual report, the IRS disclosed it audited almost 90,000 fewer tax returns in 1980 than the previous year, but recommended $2.3 billion dollars more in additional tax and penalties.

—*Washington Post*, Feb. 5, 1981

Only a coincidence

Government inspectors have found an interesting conflict of interest at the prestigious National Science Foundation: A scientist was awarded a $180,000 research grant and was then hired by NSF on a temporary basis. He was named director of the program that funded his research project. Not surprisingly, the research program was given a $60,000 "extension" once he left the foundation.

—*Washington Post*, Feb. 13, 1981

Catch-22

No matter where he turned last October, 61-year-old George Smith of Baldwin, L.I., a dealer in supposedly pornographic "European magazines," appeared trapped. The Nassau County District Attorney accused him of fraud for selling through a mail offer six publications that were too "tame" to qualify as pornographic and too small to be called magazines.

"If it had turned out to be hard-core pornography," District Attorney Denis Dillon said, "he would have been in violation of obscenity laws."

—*New York Times*, Jan. 18, 1981

Oh, no! Not that!

Whether or not the Reagan supply-side program works, it is unprecedented in concept and scope, and comes frighteningly close to Reagan's campaign commitments to a lesser role for government.

—Hobart Rowen, *Washington Post*, Feb. 19, 1981

Essential services

For a city still backing gingerly away from the brink of bankruptcy, the ownership of two noncommercial radio stations and a television station may seem profligate....

The stations cost New York City taxpayers $1.4 million last year....

In a city of seven million people, the AM station typically draws only 6,500 listeners.... The TV audience is so small it can't be measured, although officials are sure that somebody out there watches....

The stations, which employ 93 people, are fighting to survive.... "It would be a community and cultural tragedy if the WNYC licenses were disposed of," says George Fox, president of the WNYC Foundation.

—*Wall Street Journal*, Feb. 20, 1981

Chrysler's move to China nixed

China said it spent more than $13.3 billion last year on subsidies but warned that it will stop subsidizing industrial and commercial enterprises that are losing money through poor management.

—*Wall Street Journal*, Feb. 4, 1981

It's strictly free enterprise unless you get a subsidy

Energy Secretary James Edwards said yesterday his agency's revised budget will make deep cuts in nearly all programs except nuclear energy....

Edwards told reporters the nuclear budget will go up....

For energy sources other than heavily subsidized atomic power, he said he favors a free market approach.

—*San Francisco Chronicle*, Feb. 11, 1981

Strange bedfellows?

The traditional foes of budget cutting promise to make this one of the liveliest political brawls Washington has seen in years.

"It will be one of the great menageries of all time," predicts a top Senate Budget Committee staff asssitant.... "It will be like a procession, with bankers in three-piece suits and construction magnates cheek by jowl with welfare recipients from Watts."

—*Wall Street Journal*, Feb. 20, 1981

Anti-family policy

"As an accountant," Bissell says, "I don't hesitate to tell clients what the tax ramifications of marriage are. When I told one client it would cost $2,700 for him to marry, he wanted to hold off his wedding until the following year. But the invitations were already out and the wedding was the next week. His fiancée was ready to kill me."

—*Washington Post*, Jan. 10, 1981

POLICY REPORT
747 Front Street
San Francisco, CA 94111

CATO
INSTITUTE