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# Growth, Not Taxes, Key To Balanced Budget

by Paul Craig Roberts

The Reagan Administration's projections of large multi-year budget deficits have proved a boon to the President's political opponents. President Reagan's advisers on the budget and the Council of Economic Advisors (CEA) added to his discomfiture by incorrectly attributing the deficits to his tax cuts and defense build-up. The constant assertion of this 'fact' seriously threatens the success of Reagan's attempt to rebuild American economic and military prowess. A detailed and factual look at the origin and source of the budget deficits provides a useful background for evaluating the debate on economic policy.

It is widely believed that the Administration's original economic projections in March 1981 were responsible for under-estimating the deficits by overestimating future GNP growth in a 'rosy' forecast. This belief is unfounded. When the Administration issued its original projections major private forecasters, such as Chase Econometrics and Data Resources Inc., were predicting equal or higher GNP growth (Table 1). The mix between the real and inflation components was different, with private forecasters predicting more inflation and less real growth than the Administration, but since nominal GNP is the tax base, tax revenues are determined primarily by the level of nominal GNP. Another misconception is that the administration based its deficit projections on the Laffer curve, predicting that cutting tax rates would raise revenues. Herbert Stein, a former Chairman of the CEA, has just published a book that is based entirely on this misconception. The Reagan Administration never based any economic forecast or deficit projection on the Laffer curve. This assertion can be easily established from official Administration forecasts and statements of goals. The Administration projected that revenues would decline to 19.3% of GNP in 1984, which is why it defined its budget goal in terms of reducing government spending to 19.3% of GNP by 1984.

The Administration was able to project in its original forecast a balanced budget by 1984 only because the Office of Management and Budget (OMB) projected additional spending reductions that it was not prepared to identify in March of 1981. When these 'additional savings to be proposed' (which OMB failed to deliver) are taken out of the Administration's original budget projections, the Administration's deficits fall between those of Chase and DRI (Table 2). Clearly, the Administra-

(Cont. on p. 3)

**Table 1**
**Forecast of Nominal GNP Growth Rates (%)**
**(4th quarter over 4th quarter)**

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|---|
| Administration (3/81) | 11.0 | 13.3 | 11.8 | 10.1 | 9.6 | 9.1 |
| DRI (1/81) | 10.8 | 13.6 | 12.7 | 12.0 | 13.4 | 11.6 |
| Chase (1/81) | 10.8 | 12.7 | 11.9 | 11.4 | 10.1 | 9.6 |

**Paul Craig Roberts, formerly Assistant Secretary to the Treasury, is professor of economics at Georgetown University's Center for Strategic and International Studies. This article originally appeared in *Economic Affairs*, and is reprinted with permission.**

## In This Issue



# Indexing Repeal Criticized

Repeal of income tax indexing, as suggested by Walter Mondale and some members of Congress, would mean large tax increases over the next five years, with the burden falling most heavily on lower-income people, according to a new Cato Policy Analysis.

Economists Michael R. Baye and Dan A. Black of the University of Kentucky write that a family with $20,000 in taxable income would see its taxes rise 17.7 percent in five years if indexing were repealed and inflation averaged only 5 percent. A family with only $5,000 in taxable income would suffer a 49.9 percent tax increase.

Until tax indexing was passed as part of the 1981 Economic Recovery Tax Act, inflation continually pushed Americans into higher tax brackets. The average American family needed 48.1 percent more income in 1980 than in 1958 just to pay the inflation tax.

If inflation averaged 10 percent from

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# Helping the Grace Commission Help Congress

When President Reagan appointed J. Peter Grace, chief executive officer of W. R. Grace and Co., to head a commission whose mission it was to find ways to eliminate waste, fat, and fraud from the federal budget, I have to admit to having been a bit skeptical. After all, waste is *inherent* in government bureaucracy and, as others have pointed out, there is no line item in the budget for "fat and fraud."

Nevertheless, the mountain of material that the Commission produced is impressive due to its sheer volume (taking up half a wall here at Cato), not to mention exposing major substantive programs and procedures that could be eliminated, saving tens of billions of dollars. In fact, Peter Grace, in a recent television interview, argued that we could save $103 billion over the next three years were it not for "the oversight committees of the 535 clowns that you have in Congress." He then amended (generously, in my view) his statement to say, "two-thirds of them are clowns."

Indeed, perhaps the most interesting of all the Grace Commission reports was one entitled, "The Cost of Congressional Encroachment," written by two investigative journalists, Randall Fitzgerald and Gerald Lipson. The report is a devastating indictment of the unprincipled process of Congressional logrolling, detailing unjustified expenditures on everything from military commissaries to water resource projects.

Congressmen may be "clowns" but they apparently had sufficient clout to convince the Grace Commission to delete all (more than 100) of their names in the report when it was published. Fitzgerald and Lipson retained the rights to the original study, however, and the Cato Institute was pleased to have an opportunity to publish the manuscript in an updated and expanded version entitled, *Porkbarrel: The Unexpurgated Grace Commission Study of Congressional Profligacy.* The names have not been changed to protect the innocent.

In a recent luncheon address Cato Adjunct Scholar Rick Stroup went into some detail as to how the porkbarrel process actually works in Congress. Stroup argues that a truly principled congressman is at a disadvantage because few will work with him, lobby him, or offer financial support. His vote on any issue, being based on principle, is predictable and, hence, taken for granted. Thus, what we end up with are congressmen who willingly "trade" votes for projects they know are not justified in order to get unprincipled votes for their own boondoggles.

The pork-barrel phenomenon is one that virtually all congressmen condemn but feel (so they say) helpless to do anything about. Perhaps a balanced budget amendment would provide them with sufficient fortitude to say "no" to their constituents. After reading *Porkbarrel* I think you'll agree that things could hardly get worse.

It's unfortunate, too, that it is often the so-called champions of free enterprise, the business community, that is most vocal in supporting boondoggles. It is rare, indeed, for a local Chamber of Commerce to lobby against a local dam project, water project, military base, or whatever, regardless of its merits. Too many of us favor limited government on a macro, or conceptual level, only to embrace big government on a micro, or self-interested, basis. With the federal government alone now accounting for a quarter of our GNP, it is a very shortsighted self-interest that motivates such support.

I'm pleased to note that Catherine England, formerly of The Heritage Foundation, has joined the Institute as Senior Policy Analyst effective September 1st. On a less happy note, that date also marks Janet Nelson's move to pursue her career in Chicago. Janet has been Director of Public Affairs for Cato since we moved to Washington in 1981 and her professionalism and dedication merit a large share of the credit for our increased presence on the public policy scene. We will sorely miss her at Cato and wish her well in her new endeavors.

I would also like to add a personal note of thanks to the hundreds of Cato Sponsors who have renewed their support in 1984. The Sponsor's Program serves both to help us disseminate the findings of our research and provide much-needed funds for our on-going program. I hope this issue of *Cato Policy Report*, which highlights several new studies we are issuing this Fall, is further evidence of the importance of Cato's role in America's policy debate.

Ed Crane

—Ed Crane

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## Deficit (Cont. from p. 1)

tion's economic projections were in line with major private forecasters, and it did not cover up deficits with a rosy economic growth forecast. Indeed, in 1981 when the Administration was accused of rosy forecasting, the charge was based on the belief that the tax cuts would cause *more inflation* than the Administration was projecting. Had this charge been true, the deficits would never have materialized, since higher inflation would have raised tax revenues.

The deficit dilemma arose because the recession caught almost every forecaster by surprise, including the Federal Reserve. During 1981 the Fed was convinced by 'mainstream' economists that the Administration's fiscal policy was too expansionary and would result in higher inflation no matter how hard the Fed applied the monetary brakes. The expansionary force of the tax cut was considerably overestimated by the Administration's critics, causing the Fed to ignore the Treasury's warnings during the latter half of 1981 that the money supply was dangerously below target and leading the economy into recession.

The recession, together with the promised spending cuts that OMB failed to deliver account for more than three-fourths of the traumatic increase in the deficits between the original Administration projections and the latest (February 1984) official forecast (Table 3).

It is indisputable that the economic recession together with the additional budget cuts that failed to materialize account for the bulk of the increase in the deficit since the Administration's original projections in 1981. The sharp decline in the growth of the money supply during 1981 caused both real GNP and inflation to decline dramatically relative to all forecasts. The unexpected collapse in real GNP and inflation resulted in substantially lower federal revenues and caused interest payments on the debt to rise sharply. The OMB's empty promise of 'additional savings to be proposed' is the largest single addition to outlays since the Administration's original budget proposals in March 1981.

In an attempt to shift the burden of balancing the budget from spending control to higher taxes, David Stockman, the Director of the OMB, and Martin Feldstein, then Chairman of the CEA, have claimed success in curbing discretionary spending (total spending excluding defense, social security, medicare and interest on the debt). These claims are inconsistent with the OMB's budget numbers (Table 4).

**Table 2**
**Deficit Projections ($ billion)**

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|---|
| Administration (March, 1981) | 54.9 | 45.0 | 52.6 | 43.7 | 37.9 | 14.5 |
| DRI (January, 1981) | 43.1 | 57.9 | 53.7 | 79.4 | 64.1 | 74.1 |
| Chase (January, 1981) | 66.7 | 64.9 | 37.5 | 28.1 | 15.7 | 27.6 |

**Table 3**
**Effects of Recession and Unidentified Spending Cuts on Deficits ($ billion)**

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|---|
| Deficit forecast (March 1981) | 54.9 | 45.0 | 22.8 | +0.5 | +5.8 | +28.2 |
| Revenue shortfall due to recession | 3.0 | 34.9 | 87.8 | 105.5 | 110.0 | 119.8 |
| Higher interest payments due to revenue shortfall | 0.1 | 2.5 | 7.4 | 16.6 | 25.7 | 34.5 |
| Promised spending cuts | | | 29.8 | 44.2 | 43.7 | 42.7 |
| Total effect on deficit | 3.1 | 37.4 | 125.0 | 166.3 | 179.4 | 197.0 |
| Deficit forecast (February, 1984) | 58.0 | 110.6 | 195.4 | 187.5 | 207.6 | 215.8 |
| Increase in deficit forecast from March 1981 February 1984 | 3.1 | 65.6 | 172.6 | 188.0 | 213.4 | 244.0 |
| Increase in deficit due to revenue effects of recession and unidentified spending cuts | 100 % | 57 % | 72 % | 88 % | 84 % | 81 % |

**Table 4**
**Discretionary Spending ($ billion)**

| | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|
| Mid-session 1983 | 283.3 | 276.3 | 286.0 | 295.4 |
| March 1981 | 215.2 | 205.8 | 72.8 | 224.1 |
| Increase | 68.1 | 70.5 | 72.8 | 71.3 |
| Percent increase | 31.6% | 34.3% | 34.1% | 31.8% |

The only progress the Administration made in reducing federal spending was the 1981 Reconciliation Bill. Since 1981 nothing else has been achieved, and some of the reductions achieved in that Bill have since been given back. Entitlements, such as Social Security, have not been touched. Last year's Social Security rescue plan was another 'quick fix' solution that is not likely to last beyond the next recession, when payroll tax revenues again fall. Furthermore, it was a 'quick fix' based on left-wing principles that President Reagan had disavowed: the conservative taboo against using general revenues to finance the system was broken, and the equivalent of a means test was introduced by taxing the benefits of recipients with a median income or higher. The Treasury Department could not get the Administration to give a hearing to its carefully designed politically feasible long-run solution.[1] Consequently, the growth path of social security and medicare benefits implies a rise over time in the payroll tax from 15% to 25%, with devastating long-run implications for employment and the competitiveness of labor.

About the only thing in the budget that has not gone up since the 1981 budget projections is defense spending (Table 5). By the mid-session review of July 1983, defense expenditure for

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## Deficit (Cont. from p. 3)

1983-86 had been cut $59.3 billion below the Administration's original requests. The latest budget (February 1984) shows an additional $38.3 billion reduction in defense spending for the 1983-86 period since the July 1983 budget review.

Basically, the budget deficits are the cost of the rapid decline in inflation. It was not the policy of the Reagan Administration to collapse the inflation rate so quickly. The Treasury believed that too many economic decisions had been made on the basis of expectations of rising prices. The plan was to reduce inflation more gradually in order to avoid causing a domestic and international liquidity crisis that, in turn, would lead to a new burst of money creation and keep the inflationary cycle going. The Administration's policy was simply ignored by the central bank, the Fed, which substituted its own.

The debate over what should be done about the deficits has been adversely affected by misinformation spread by Administration officials and 'mainstream' economists seeking to take the policy initiative away from Reagan's supply-siders. One of the main arguments of the Budget Director and CEA Chairman has been that the deficits are 'structural' and will not decline with economic recovery. Like other predictions they made, this one also proved incorrect. A comparison of last year's budget with this year's shows that the OMB's estimate of the 'current services' deficits for the 1983-88 period declined by $419.4 billion or 25% (Table 6). Part of this reduction is due to revenues from the Social Security rescue package, but most of it is due to the 1983 economic recovery. The 1983 budget was based on the CEA Chairman's prediction that the deficits would cause high interest rates and prevent economic recovery.

### Has Reagan lost control?

The only way that the budget deficit can be reduced is by encouraging the growth of the economy while curtailing the growth of government expenditures. But this approach has been foreclosed by Reagan's own appointees: the President lost control over budget policy the day his Budget Director and CEA Chairman publicly blamed the deficits on the tax cuts and defense build-up. Since both remained in office, Congress concluded that Reagan was strong on rhetoric but weak on commitment to his program. He accepted a large tax increase in 1982, and another is likely.

Sustained economic growth also seems ruled out by the Federal Reserve Chairman, Paul Volcker, who believes that sustained growth is *ipso facto* inflationary. The Fed Chairman's beliefs are supported by those of his academic consultants, such as Stanley Fischer of MIT, who have told him that continued progress against inflation requires another recession close on the heels of the last one. This, of course, means larger deficits. Whatever the Fed's intentions, the empirical data show that there was a sharp deceleration in money growth in the Spring of 1983 that continued through that year and that the Fed used open market operations to keep interest rates up. Messrs Stockman and Feldstein have protected the Fed from presidential criticism by blaming the budget deficits for interest rates.

Empirical evidence suggests that it is the volume of government spending that crowds out the private sector, not how that spending is financed. To reduce a deficit by reducing spending would reduce government pressures on the economy, but to reduce a deficit by raising taxes leaves the same amount of real resources in the government's hands. Moreover, higher taxes have additional adverse effects on the economy. There is no evidence that the adverse effects of higher taxes are less than those of additional borrowing. Conservatives, however, have had years to build-up frustrations over budget deficits. With daily statements from people in authority adding to 'deficit hysteria,' many conservatives have been maneuvered into a frame of mind in which they see higher taxes as a 'free lunch' solution to a deficit crisis.

President Reagan's economic policy is being eclipsed by that of the Chairman of the Fed. The current direction of policy is to restrain economic growth with restrictive monetary policy and to deal with the deficits that result by raising taxes. Reagan's supply-siders intended to balance the budget with economic growth and control over government spending, but they are being shoved aside by the advocates of private-sector austerity. Ronald Reagan is a great speech-maker, but he and his California team are being out-maneuvered by the seasoned forces of the Washington establishment. ■

**Table 5**
**Defense Spending ($ billion)**

| | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|
| March 1981 budget | 226.0 | 255.6 | 303.9 | 342.7 |
| Mid-session 1983 | 214.8 | 245.4 | 285.5 | 323.2 |
| Reduction | 11.2 | 10.2 | 18.4 | 19.5 |
| Percent reduction | 5.0% | 4.0% | 6.1% | 6.0% |

**Table 6**
**Current Services Deficit ($ billion)***

| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|---|
| 1983 budget | 225.4 | 248.5 | 267.3 | 284.4 | 308.1 | 315.4 |
| 1984 budget | 195.4 | 187.5 | 207.6 | 215.8 | 220.4 | 203.0 |
| Difference | 30.0 | 61.0 | 59.7 | 68.6 | 87.7 | 112.4 |

*The current services deficit is not a policy deficit. It assumes no tax increase or spending reductions.

**"Ronald Reagan is a great speech-maker, but he is being out-maneuvered by the seasoned forces of the Washington establishment."**

[1]Paul Craig Roberts, *The Supply-Side Revolution: An Insider's Account of Policymaking in Washington*, Harvard University Press, 1984, pp. 259-283.



*Free Enterprise the Loser*

# Kwitny Criticizes Foreign Intervention

Jonathan Kwitny, a reporter for the *Wall Street Journal* and author of the recent book *Endless Enemies*, addressed a Cato Policy Forum in June. Kwitny discussed how American foreign policy helps promote anti-Americanism and socialism in the Third World, and the role of the press in distorting facts about conflicts in the Third World. Kwitny was particularly scathing in his remarks about the role that a *New York Times* reporter, Kennet Love, played in overthrowing the head of the Iranian government, Mohammed Mossadegh, in the 1953 coup that installed the late Shah. Love helped direct the coup while at the same time reporting two different versions of events: one to the readers of the *Times* in his dispatches, and quite another version in a report submitted to Allen Dulles at the CIA.

**Jonathan Kwitny is questioned by Juliana Geran Pilon of the Heritage Foundation after his Policy Forum talk.**

In *Endless Enemies*, Kwitny reports on case after case where American intervention has undermined free enterprise and promoted socialism and anti-Americanism in the Third World. He maintains that where the U.S. has intervened, the outcome of events has often been hostile to American interests, while in many cases where it did not intervene, the outcome proved to be quite positive. Kwitny's book is unique in its approach, because while hostile to an interventionist foreign policy, it is also supportive of capitalism, pointing out with many case studies the obvious superiority of the free market over socialism. In a chapter entitled "On Capitalism, Communism, and Freedom," there is a withering indictment of the influence of the late Algerian writer Frantz Fanon, whose book *The Wretched of the Earth* represented his most influential attempt to adapt Marxism to the Third World. Fanon was an advocate of a planned economy, implacably hostile toward free markets, and Kwitny observes that his ideas were widely accepted and implemented by Third World leaders, with disastrous consequences. *Endless Enemies* also argues that in many countries Marxist socialism is adopted in reaction against American interference in their affairs and in an attempt to achieve independence from the U.S.

## Cato News

Commenting on Kwitny, Stephen Rosenfeld, deputy editorial page editor of the *Washington Post* and the author of a regular column on foreign affairs, praised *Endless Enemies* and said that Kwitny "sets a standard for journalism which is noble, romantic, crazy, unhumble . . . but I do believe it's unrealistic." Rosenfeld pointed out that journalists are human and can be guilty of both honest mistakes and bad judgment. He also emphasized that government control of information, both here and abroad, often hinders the attempts of journalists to report accurately on events. On substantive issues, he indicated that Kwitny might be overly optimistic about how benevolent rule by deposed leaders such as Iran's Mossedegh would in fact have been, and offered several anecdotes to illustrate why he thought that Kwitny overstated the role of U.S. intervention in promoting Third World repression.

While applauding Kwitny's basic support for the free market over socialism, and his noninterventionist views on foreign policy, several libertarians in the audience were critical of some of Kwitny's remarks about Fidel Castro. Kwitny seemed to praise Castro because his rule has not been as oppressive as those of many other regimes, both communist and noncommunist, and because standards of living in Cuba are higher than in many other Third World nations. Kwitny responded that he thought Cuba was indeed a repressive police state, but that conditions there were better than in many other nations. *Endless Enemies* presents a similar ambivalence, when Kwitny reports on a visit to Cuba in which he failed to find much fundamental dissatisfaction with Castro, but also analyzes the influence Castro has had on other Third World dissidents and revolutionaries: "The intellectual disregard that these Third World students express for individual liberty is absolutely chilling . . . The worst features of the Cuban revolution—its intolerance of political dissent, and its ruthless disregard for personal privacy in seeking to eliminate all deviation from prescribed norms—have become their model."

Both Kwitny's remarks and his book proved to be very controversial, which was amply illustrated by the vigorous exchange between Kwitny and the audience in the question-and-answer session. ■

# Cato Conference Focuses on Classical Liberalism

*Every summer the Cato Institute holds its Summer Seminar in Political Economy. This year's seminar featured some 80 participants from across the United States and 11 foreign countries, including Germany, England, Nigeria, Venezuela, and Guatemala. In this column, nationally syndicated by Copley News Service, Cato Senior Fellow Doug Bandow reflects on the week's discussions.*

**Hanover, N.H.**—It's hard to be sanguine about the future these days.

What with the Democrats in favor of $100 billion or more in new federal spending programs and the Republican administration discussing another year of "temporary" limits on Japanese auto imports. With Congress passing the vindictive Simpson-Mazzoli Bill, which will inaugurate a national worker ID system. And the Supreme Court gutting the Exclusionary Rule, which protects our Fourth Amendment rights.

It is in this environment that the Cato Institute held a seminar on political economy at Dartmouth University.

Nestled in peaceful rural New Hampshire, Dartmouth provided an appropriate site for the convergence of more than 80 students, businessmen, journalists, scholars and lecturers from across the United States and the world. The theme of the conference was political liberty; the issues discussed ranged from basic philosophical principles to current foreign policy crises.

The status of individual freedom today is our most important issue. We live in a nation born of revolution against arbitrary state power, but much of what was won in the conflict that united 13 disparate Colonies two centuries ago has been lost.

The philosophy that gave rise to the United States was classical liberalism, which swept Europe in the 18th and 19th centuries. It arose in the midst of absolute monarchies, like that of Louis XIV, the "sun king," around whom all of France revolved, and helped impose constitutional government to protect the governed.

Classical liberalism emerged from an economic system of mercantilism, in which the government ran the economy to benefit political and economic elites the resulting doctrine of laissez-faire freed both consumers and producers from greedy state economic regulation. And classical liberalism spread across a continent racked by imperial wars, opposing a system in which the peasants provided the cannon fodder for national and royal aggrandizement.

But as quickly as the philosophy spread, it faded in the late 1800s and 1900s. Historian Ralph Raico cites opposition from traditionalists and Marxists, and the onset of world wars and government-created economic calamities, as contributing to the death of classical liberalism and the creation of the perpetual welfare/warfare state.

Indeed, 208 years after the declaration of U.S. independence, we find ourselves back where our forefathers started: an unresponsive ruling establishment, a neomercantilist economic system and constant foreign conflicts designed to enhance the government's influence, not our freedom.

The Cato Seminar left no doubt as to the importance of restoring our philosophical heritage. Father James Sadowsky, a professor of philosophy at Fordham University, pointed to the moral imperative of individual freedom—economic as well as civil.

And freedom is desirable economically, as well. Though businessmen seeking guaranteed profits routinely rail against "chaotic competition," the market spontaneously creates order, a beneficial form of order based on the sophisticated interaction of the desires of consumers and producers throughout our society.

The chief threat to our freedom these days does not come from the most obviously malevolent purveyors of human slavery. Marxism, full of inherent contradictions and falsified by both experience and history, exists only through military force.

In contrast, the modern seekers of economic privilege, the heirs of the socialist tradition, offer seductive proposals for central planning, industrial policy, economic democracy and the like. All of them are bound to fail economically, and all threaten, in George Mason University Professor Don Lavoie's words, a "dangerous degeneration to fascism" by wielding enormous economic and political power over the rest of us.

What are the prospects for liberty? Despite the day-to-day buildup of government power, Cato Institute analyst Roy Childs, at least, thinks there is hope. For as people have lived through—and died from—the lack of freedom around the globe, the price of liberty has become clear.

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Cato president Ed Crane responds to question from Larry Butler, host of the nationally syndicated television program, "Ask Washington." Crane was the featured guest on the U.S. Chamber of Commerce-sponsored program August 7, discussing the findings of various Institute studies.



Cato's newest Adjunct Scholar, Svetozar Pejovich, visited the Institute in July and discussed his academic activities with president Ed Crane. Dr. Pejovich, one of the nation's leading free market economists, is Director of the Center for Education and Research in Free Enterprise at Texas A&M University.

*Fear of Freedom*

# Cable Regulation a Threat

The cable television bills that were before Congress this summer won't solve the real problems with cable regulation, says a telecommunications expert in a recent Cato Policy Analysis.

Senate Bill 66 was passed by the Senate in 1983. H.R. 4103, a compromise bill worked out by the National Cable Television Association and the National League of Cities (consumers were not present at the negotiations), was passed by the House Commerce Committee in mid-summer.

William E. Lee of the University of Georgia writes, "Today's municipal regulation of cable limits the information the public receives, and the two bills currently before Congress won't remedy this. If cable is to fulfill its potential as a means of information, it must be freed from all regulations that are not narrowly tailored to protect public safety."

Lee charges that "the truly animating force in municipal cable policy is a fear of freedom."

Arguing that current cable regulation violates First Amendment rights, Lee points out that the two bills would allow franchise agreements to outlaw certain kinds of content. Neither bill, he says, "will eliminate entirely the backroom deals between local governments and cable operators that affect cable content. Some cable operators will not challenge such illegal deals for fear of reprisals at renewal time. Perhaps most important, neither bill eliminates the chilling effect created by rate regulation."

Rate regulation, Lee points out, "is inexorably tied to control of content because regulation of rates without some reference to the quality of the product being offered is meaningless."

Besides criticizing current municipal regulations and the House and Senate bills, Lee offers his own outline of an "open entry" policy under which cities would not be able to condition franchises on the nature of an applicant's programming.

Lee's study, "The First Amendment versus Municipal Regulation of Cable Television," is available from the Cato Institute for $2.00.

# Political Spectrum Reassessed

The terms liberal and conservative have become inadequate for describing the political views of Americans.

That's the message of *Beyond Liberal and Conservative: Reassessing the Political Spectrum* by William S. Maddox and Stuart A. Lilie, just published by the Cato Institute. The book goes a long way toward explaining such recent political phenomena as the decline in voting turnout, the surprising success of Gary Hart, the emergence of the "yuppies," and the apparently contradictory results of elections and opinion polls.

Traditionally political scientists have divided the electorate into two groups: liberals, who favor government intervention into the economy and expansion of civil liberties, and conservatives, who oppose economic intervention and expanded civil liberties. But two sets of issues with two answers each, Maddox and Lilie say, yield four categories.

To the traditional groups they add two more ideological types: populists, who favor economic intervention and oppose civil liberties, and libertarians, who oppose government involvement in the economy and support expansion of civil liberties.

When they re-examined survey data from recent years, they found that by the 1970s substantial numbers of Americans actually fell into the two "new" categories. Using Center for Political Studies data for 1980, they found the public divided into 24 percent liberals, 17 percent conservatives, 26 percent populists, and 18 percent libertarians (with 15 percent still not classifiable).

An earlier version of this analysis received widespread attention, with political analyst Kevin Phillips calling it "a fascinating study. . . . It produces a major clarification of voter opinion and philosophy." The Cato Institute expects major coverage for this completed study.

*Beyond Liberal and Conservative* is available from the Cato Institute for $18.00 (cloth, 220 pages).

## Heading in the Right Direction

# Antitrust and the FTC

*Every month the Cato Institute sponsors a Policy Forum at its Washington headquarters where distinguished analysts discuss their views with an audience drawn from government, the public policy community, and the media. A recent forum featured Timothy J. Muris, the Director of the Bureau of Competition at the Federal Trade Commission (FTC), discussing recent trends in antitrust enforcement. Commenting on his remarks was D. T. Armentano, professor of economics at the University of Hartford and author of* Antitrust and Monopoly: Anatomy of a Policy Failure.

**Timothy Muris:** Today I would like to discuss a positive program for antitrust at the FTC. Much of it involves the problems and distortions that government has created. There have been many problems historically with antitrust. I will just list a couple, as examples, and refer you to books such as Robert Bork's *The Antitrust Paradox*. Once, when merger cases were evaluated, it was regarded as a bad thing if the merger was going to lower cost and therefore prices. "Monopolization" cases provide a second example. Until very recently, the law had a tendency to turn on firms because they were successful. But in the last ten years, we have seen an evolution in antitrust law away from an attack on efficiency toward promoting competition and efficient practices. With this change, the Commission has faced a special problem. Probably 40% of the Commission's resources involve merger activity, and review of mergers will continue.

The more interesting aspect of the Commission is what to do with the other 60% of the resources.

Before 1970, those resources were spent primarily on enforcing the Robinson-Patman Act.

After severe legal and scholarly attacks, the Commission abandoned massive enforcement of the Act nearly fifteen years ago. The question was—although there are Robinson-Patman Act cases that continue to this day—what should that Act be replaced with? What should the Commission do instead? The solution that was tried in the 1970s was to rely on the simple version of the so-called "Market Concentration Doctrine," which held that there is a direct correlation between the number of firms in an industry and the state of competition. In the 1960s and 1970s many scholars, including Dom Armentano, showed that that simple view was wrong. Nevertheless, the Commission spent a lot of money and research on that effort, but accomplished virtually nothing except enriching lawyers.

Conglomerates were another area of attention in the 70s. There was a view that conglomerate mergers were often bad. Whatever one's views of conglomerate mergers (I think they are rarely anti-competitive) it is clear that one can win few, if any, conglomerate merger cases in court. The record of the Antitrust Division the FTC is indeed abysmal in conglomerate merger cases. Long before 1980, they had abandoned bringing many of them.

Some have suggested that the FTC emphasize vertical cases. Here again, vertical practices are generally pro-competitive and, in any event, they have never comprised a major part of the FTC's efforts. Private parties do most of the work in the vertical area.

Given that all these options are not available for a variety of reasons—either policy, political or practice—the question is, "What should the Commission do?" One thing that we thought should be done is reduce its size. Indeed, that view was shared by Congress, and the Commission is now about 30% smaller than it was five years ago.

In terms of a positive agenda, let me discuss a couple of success stories that began at the FTC in the mid-70s. The first idea is for the FTC to be heavily involved in health care. Health care shares a common theme of many of the activities I will discuss—namely that the government has distorted the market. The Commission has become a leading advocate—both through its cases and through advocacy in Congress, before HHS, and in state legislatures—of a more competitive marketplace.

Timothy Muris: "A positive and market-oriented antitrust program."

The Commission has repeatedly brought cases designed to encourage new competition, advertising, etc.—and thus reduce health care costs through new competitive techniques. In the last year and a half, we have tried to emulate that success in health care not only by increasing our resources in activities involving doctors, but becoming involved with other professions. We have begun investigations of pharmacists, lawyers, accountants, funeral directors, surveyors—of a great many people who have relied in the past on government or quasi-government activities to protect them from competition.

For example, many of our investigations now involve activities of state boards in three areas: first of all, many state boards prevent or limit advertising, even though there is a constitutional right to advertise. The favorite guise to prevent advertising is that one cannot advertise in a self-laudatory manner. It is pretty hard to advertise in a manner that is not self-laudatory.

A second kind of professional activity we are investigating involves restraints on price discounts. Many people are prohibited from discount



pricing unless certain overly stringent circumstances are met.

A third activity, one that is becoming more and more prominent in this professional area, is restrictions on branching. For example, North Carolina prohibits branch offices in accounting. Branch offices in many professions can be an efficient way to provide services to consumers.

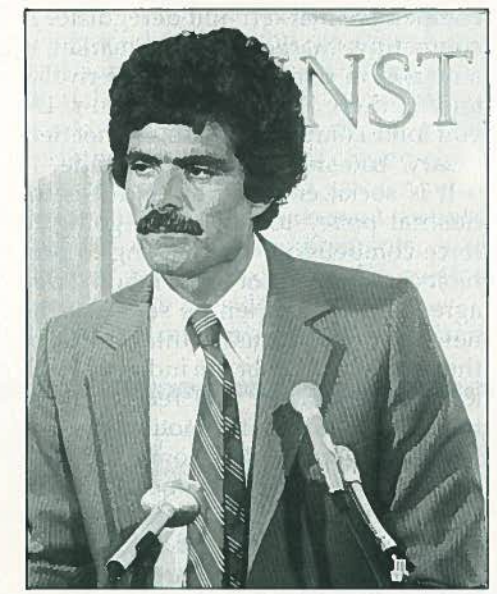
Another area related closely to this theme of problems caused by the government is what we call the intervention or the advocacy program. Antitrust agencies have had a very useful role in communicating to other government agencies and to other levels of government the importance of competition. The role of the Justice Department and the Federal Trade Commission in educating the public about the problems of the Civil Aeronautics Board, for instance, cannot be understated. This was one of the factors, along with hearings by Sen. Kennedy and the role of the Ford administration, in beginning the effort that resulted in the demise of the CAB.

Currently, this role of being an advocate or watchdog for competition is extremely important in two ways. One involves foreign competition. The FTC is one of the few agencies that has forcefully advocated the case for a market economy in trying to stop restrictions on imports. We have gone to the International Trade Commission, for example, and argued the case for competition. And, for the first time in our history, we are having some impact. Our view of how these statutes ought to be applied has been adopted to a considerable degree by two of the Commissioners there. Moreover, the costs that we have found from import restrictions are being reported widely.

There is another area where the presence of the mentality of antitrust—which more and more is a mentality that is competition oriented—is useful. And that is in the whole debate over industrial policy. Industrial policy is anti-antitrust. Industrial policy is all about "rationalizing industries." What we need to do, its advocates say, is get people together in a room and figure out how much capacity we ought to have for that industry, for example. Now that is a clear antitrust violation. People in antitrust are intuitively hostile to that sort of government planning.

That hostility carries across the political spectrum. Mike Pertschuk, who was a liberal chairman, and Jim Miller, who is a conservative chairman, agree on these issues. Because there are broad elements of both political parties who are opposed to these competition-oriented ideas and in favor of industrial policy and tariffs and quotas, it is a useful role of the FTC to be an advocate for competition.

Let me talk about some of the other areas we are involved in. One is trade associations. Trade associations are, by and large, beneficial, but members of trade associations can engage in restraints on competition. Trade associations are, in the economists' "all else equal" phrase, not as dangerous as the state boards, usually, because they do not carry the impact of state law. But there are occasions when being a member of a trade association can have a competitive advantage, and there are short term situations in which a trade association's effect can be damaging indeed.



Dom Armentano: "Not enough of a revolution in antitrust theory."

Another area under study at the FTC involves the so-called Noerr-Pennington Doctrine. Under the First Amendment, one has a right to petition his government to exclude his competitors. That is a constitutional right, enshrined in the Noerr and the Pennington cases. But the courts have also said that there is an exception to the Noerr-Pennington Doctrine, called the sham exception. If you have no basis for what you are doing, but you are simply trying to delay or exclude your competitors, then that could be an antitrust violation. And for the first time in the history of the Commission, we sat down last summer and systematically looked to see what we could do in that area. We now have several serious investigations of what we think are abuses of the legal process.

The most recent and most prominent, and the last area I will talk about, involves activities of municipalities. Municipalities can engage in serious antitrust violations. There are not necessarily many current problems, but one can imagine, if cities and municipalities were exempt from the antitrust laws, what they could do.

For example, real estate, professionals, car dealers, supermarkets, retail gas stations, among other industries, could go to their local government and get that government to end competition. For this reason, we oppose a complete exemption from the antitrust laws for cities, although we favor limiting the damages that can be assessed. Thus the Commission filed two complaints, against the cities of New Orleans and Minneapolis, for conspiracies in their taxicab regulations. A recent study for the Department of Transportation found that consumers lose annually $800 million from taxicab regulations, and that there would be 38,000 more jobs if taxicabs were deregulated. We think it is hard to find an example of a market that cries out for new competition more than taxicab regulation in many cities. And indeed, after the filing of our cases, several cities have deregulated; and the Governor of Florida vetoed a bill to exempt his state's taxicab regulation, citing our effort.

There are, of course, days at the Commission that are better than others. I am reminded of when my son was three. We were in Miami, and we were driving past the hospital where Matthew was born. I pointed that out to him, and Matthew looked up at me, smiled and said, "I wouldn't want to do that again!" There are days that I feel that way. But for the most part it has been an exciting time and we have shown that

(Cont. on p. 10)

## Antitrust (Cont. from p. 9)

it is possible to have a positive and market-oriented antitrust program.

**Dom Armentano:** I would commend the Federal Trade Commission for the change in policy, beginning roughly in 1980, but perhaps starting with Wesley Liebeler in the 1970s, to move the FTC away from prosecuting companies like A&P, Morton Salt, and Borden for lowering their prices and expanding their outputs—away from that sort of nonsense to prosecuting real monopolies.

In economics, there are two theories of monopoly. One is that monopoly is a free market problem and that either a firm can have a substantial market share and then be able to control the market, reduce output and raise prices to injure consumers, or that a group of firms can accomplish the same results, which is essentially the rationale for the Sherman Act—that monopoly is a private market problem which has to be dealt with legislatively.

However, there is an older theory of monopoly that makes much more sense in my view. This is the theory that we can find in the writings of some of the classical economists such as Adam Smith. He specifically talks about government and about *legal* barriers to entry, and there is a very big difference as to whether entry barriers are legal or whether they are nonlegal. I will grant that legal barriers injure consumers and shut-out suppliers, but I will *not* grant that nonlegal barriers do.

Fordham University philosopher Father James Sadowsky lectures on ethics at Cato's Summer Seminar in Political Economy.

I'm on record as favoring the repeal of the antitrust laws, but I realize there's no button that could be pushed that would repeal them. (If there were such a button, I would push it.) We certainly ought to use the law, if we cannot abolish it immediately, against real monopoly: pernicious legal restraint to competition, entry, and trade and exchange. In fact, I would like to think that some of what the antitrust people are doing at the FTC is consistent with deregulation in telecommunications and banking and transportation. How do you create a competitive market? You deregulate. A competitive market, an open market, is a market in which there can be rivalry and/or there can be cooperation. Do you force competition? No, it's not necessary. You simply allow free trade.

It is social engineering and it is industrial policy to say, we're going to force competition, we're going to prohibit certain kinds of cooperation. I disagree with Tim when he said that the new view on antitrust is antagonistic or the opposite of what the industrial policy people believe. Not really. Industrial policy accepts the notion that the federal government is some sort of a social engineer. Well, so does antitrust. Even in the minimal antitrust position with respect to merger guidelines, there's a belief that the antitrust division or the Federal Trade Commission understands what the appropriate market structure is. For obtaining what? For obtaining what they're calling competition.

But I commend Timothy and I commend the Federal Trade Commission for attacking real monopoly, for going after state and local government regulation that restricts competition, that restricts entry, that restricts advertising. I testified at a Joint Economic Committee hearing in November of 1983 and said *if* there's going to be any antitrust policy at all, that is the only rational antitrust policy.

O.K., that's the good news: the movement away from traditional approaches to antitrust. Now let me get to the essential point of my comments. I don't think that the Federal Trade Commission is making a careful distinction between real entry barriers and the rules that the associations adopt. And I think they ought to make such a distinction.

While it is appropriate to attack *legal* restraints and restrictions on entry and competition, I do not think it is appropriate to attack voluntary associations. It's not appropriate to attack the rules and regulations that those associations adopt for their own members. That still leaves market participants free to choose.

So to the extent that the Federal Trade Commission is sliding over the line, and treating trade associations as if they are state boards, I think that is inappropriate. I would make a clear distinction between voluntary associations and their activities and rules, and legal restrictions on competition. After all, we all restrain trade. There's no way that a free society can enforce a prohibition on restraint of trade—it's absolutely absurd to continue to use that term. We've had a near revolution in antitrust policy, but not enough of one, in theory, I'm afraid.

We ought to be trying to create a society in which people can be rivalrous if they choose or be cooperative if they choose. Are we saying that there are no social advantages to be achieved from inter-firm cooperation? We would never say that. Internally, within an organization, it's absolutely essential that people cooperate. That's how efficiency is produced. So while there's been a kind of revolution in antitrust policy (certainly the administration of the antitrust laws), it hasn't been sufficient because we've still got some incorrect theoretical notions.

Most people apparently feel that Adam Smith believed in antitrust laws. He talked about conspiracies, businessmen rarely getting together for merriment and diversion except that they would hatch a conspiracy against the public and so on. Well, what Adam Smith did say in *The Wealth of Nations* is that even though businessmen may do this, we ought not to make a law against it. Why not? Because he couldn't conceive of a law that could be enforced that would be consistent with liberty and justice. Competition is an important value, particularly to the economist, but liberty remains the primary value.



*Naming Names*

# Porkbarrel: The Unexpurgated Grace Report

When the Grace Commission on waste in government released its final report, it accused Congress of blocking attempts to cut billions of dollars from federal spending. Members of Congress, it said, tried to bring water projects, military bases, and federal offices to their districts and to keep them there when agencies wanted to close them. In addition, it charged Congress with interfering in administrative decisions on pay scales, employee reorganizations, and contracting.

However, the Grace Commission lost its nerve and published its final volume, *The Cost of Congressional Encroachment*, with all the names deleted. More than 100 members of Congress breathed a sigh of relief that their porkbarrel efforts would not be exposed to public scrutiny.

Now the complete, unexpurgated report is available to the public from the Cato Institute. Titled *Porkbarrel: The Unexpurgated Grace Commission Story of Congressional Profligacy*, the book contains every name included in the original report along with a new introduction by the authors, journalists Randall Fitzgerald and Gerald Lipson.

This book shows that pork-barreling respects no political or ideological boundaries. Those cited in its pages range from well-known "big spenders" to some of Congress's leading fiscal conservatives.

*Porkbarrel* should be popular reading in an election year. But it was not just published for its sensational value. It makes a serious point about the extent to which our modern mixed-economy democracy is riddled with special-interest politics and log-rolling. Fitzgerald and Lipson offer a few suggestions for reform, including a national council on military base closings, strengthening the role of the public printer to free him from congressional "micro-managing," a government-wide study on contracting out, a sunset bill for reporting requirements, a biannual budget process, and an item veto for the president.

Larger reforms may be required. Read in conjunction with the writings of public choice economists and such books as Cato's *Balanced Budgets, Fiscal Responsibility, and the Constitution*, this book is an important case study in the workings of the budget process and government spending in a democracy.

*Porkbarrel* is available from the Cato Institute for $7.95 (paper, 200 pages).

Richard Stroup, a Cato adjunct scholar and outgoing chief of the Office of Policy Analysis in the Department of the Interior, was the featured guest at a Cato policy luncheon before he left Washington to return to Montana State University. Stroup discussed how the incentives facing politicians and bureaucrats do not encourage a commitment to principle. Here Stroup (second from left) talks with Gordon Brady of the Council on Environmental Quality, Philip Shabecoff of the *New York Times*, and George Siehl of the Congressional Research Service.

# Bolick, Webbink at Policy Forum

Clint Bolick, author of Cato's study "Cable Television: An Unnatural Monopoly," spoke on the problem of cable regulation at a recent Cato Policy Forum.

Bolick argued that cable is not a natural monopoly and that even the concept of natural monopoly is under increasing attack. Various studies have suggested that unregulated competition could keep prices at least as low as regulated monopolies.

In Phoenix, as well as a few smaller cities, cable companies do compete, and the Phoenix companies have set speed records for wiring the city. This message was well-received by his Washington audience, still waiting for cable 30 years after it became a feasible technology.

Douglas Webbink, a former Federal Communications Commission economist now with the Federal Trade Commission, commented on Bolick's talk. Webbink agreed with many of his criticisms and pointed out that if cable really is a natural monopoly, there is no need to restrict entry. Webbink urged Bolick to offer more suggestions about specific policies to deregulate cable.

The forum was well attended by representatives of such organizations as the Freedom of Expression Foundation, the National Cable Television Association, the Senate Commerce Committee, the FCC, and the Justice Department, as well as by journalists covering cable issues.

## Seminar (Cont. from p. 6)

Indeed, history has demonstrated beyond doubt the intellectual and economic bankruptcy of the rush to statism. Governments have killed in excess of 100 million people this century; free men never have come up with a comparable murder machine. Governments have confiscated and squandered trillions of dollars of private wealth; the so-called crimes of corporations are invisible in comparison. Racism has been exalted as the official ideology in nations like the United States and South Africa. Free speech has been suppressed and all manner of human dignity violated in the name of the state.

Perhaps more of these sorts of conferences—the Cato Institute hosts at least one a year, and it is not alone—will cause people to meditate on the basic principles that motivated our forefathers to revolt in 1776. We need to stage a modern revolution. And soon. For the president, Congress and the Supreme Court seem unlikely to wait for us to act. ■

# Pentagon, GAO Confirm Ravenal Analysis

Two confidential government studies have recently confirmed that spending for the defense of Western Europe is the single largest component of the U.S. military budget. The reports, by the Department of Defense and the General Accounting Office, both put the cost of the U.S. commitment to NATO at more than half the total defense budget.

According to a report in the *New York Times*, the Pentagon report says that "the total cost of European-deployed United States forces and all of the United States-based forces that we have pledged to contribute as NATO reinforcements over the course of a conflict" amounts to about $177 billion, or 58 percent of the Reagan Administration's initial budget request of $306 billion for fiscal year 1985. The GAO report maintains that the U.S. spent $122 billion in actual outlays for NATO in fiscal year 1982, or 56 percent.

The *Times* reported that "estimates of the high cost of the American contribution to the defense of NATO have been produced privately by strategic specialists before. But authoritative assessments based on official data have been rare, either from the Pentagon or the General Accounting Office." The Pentagon has been reluctant to make such figures public because it believes they could be used by critics of NATO to question the alliance.

The most prominent analyst to have estimated the cost of our alliance system in the overall U.S. military budget has been Cato board member Earl C. Ravenal. An earlier article in the *New York Times* discussed Ravenal's Cato monograph *Defining Defense: The 1985 Military Budget* as one of three prominent proposals for reducing the defense budget, emphasizing that Ravenal saw cutting back our military commitments overseas as the only real-

(Cont. on p. 13)

## New Senior Policy Analyst

**Catherine England, an economist with the Heritage Foundation for three years, joins the staff of the Cato Institute this month as a Senior Policy Analyst. She will conduct research in various domestic policy issues as well as assist in editing the *Cato Journal*.**

**Formerly a faculty member at American University, Ms. England received her master's degree in economics from Texas A&M University, where she is also a doctoral candidate. She is the author of numerous articles on economics, including "Bank Regulation and Economic Change," *Policy Report*, March 1983; "How to Avoid Another Banking Crisis," *Consumers' Research*, August 1984; and "Regulatory Reform" from *Agenda '83* (Washington, D.C.: Heritage Foundation, 1983).**

# Law Conference in October

The final list of speakers for Cato's October 26 conference on "Economic Liberties and the Judiciary" has been confirmed, and it includes 18 distinguished legal scholars, economists, and policymakers.

Confirmed speakers include, in the order of appearance, Antonin Scalia (U.S. Court of Appeals), Peter M. Aranson (Emory University), Wesley Liebeler (UCLA School of Law), Louis De Alessi (Law and Economics Center, University of Miami), Roger Pilon (U.S. Office of Personnel Management), Randy Barnett (ITT-Kent School of Law), Bernard Siegan (University of San Diego, School of Law), James C. Miller III (Chairman, Federal Trade Commission), Robert Tollison (Center for Study of Public Choice), Kenneth G. Elzinga (University of Virginia), Dom Armentano (University of Hartford), Henry Manne (Director, Law and Economics Center, Emory University), Homer Kripke (University of San Diego, School of Law), Simon Rottenberg (University of Massachusetts), Charles Goetz (University of Virginia, School of Law), Mario Rizzo (New York University), and Glen O. Robinson (University of Virginia, School of Law).

Panel topics will include recent developments in law and economics, property rights and judicial decision making, antitrust policy, and the scope of judicial action. Bernard Siegan will deliver the luncheon talk on economic liberties and the constitution.

As in the past, the conference will be held at the Capital Hilton in Washington, D.C. Special rates are available to those needing accommodations.

The cost of the one-day conference is $150 for corporate and individual participants, and $50 for non-profit attendees. This includes all speeches, a luncheon, and an evening reception. Additional information is available from the Cato Institute by contacting Sam Staley, assistant director of public affairs. ■



## Ravenal (Cont. from p. 12)

istic path to significant and permanent budget savings. And in its March 6, 1983 issue, the *New York Times Magazine* featured Ravenal's "The Case for a Withdrawal of Our Forces." In that article and in his Cato study, Ravenal estimated the cost of NATO at $115 billion for fiscal year 1984, and $129 billion for 1985, respectively.

At the time, Ravenal's budget numbers for the cost of NATO were challenged by some critics as excessive. In the light of the studies by the Pentagon and GAO, however, it appears that—if anything—Ravenal might have erred in underestimating the total costs of U.S. support of the Atlantic Alliance.

Ravenal's *Defining Defense* has continued to draw attention and acclaim. In July, as the Democratic convention opened, the Sunday *San Francisco Examiner-Chronicle* discussed Ravenal's proposals along with those of other prominent analysts. The article pointed out that Ravenal "advocates de-coupling [from NATO] because of his fiscal conservatism," and also because he believes that the existing alliance pushes the U.S. toward an unstable nuclear posture. As the article points out, "There is a contradiction, writes Ravenal, between trying to limit a nuclear conflict ('firebreaks') and guaranteeing Europe by nuclear weapons ('coupling')." Ravenal would resolve this contradiction by American disengagement from NATO.

Columnist Warren Brookes, a prominent supply-sider, was also impressed with Ravenal's proposals. In a lengthy syndicated column, Brookes referred to *Defining Defense* as "brilliant . . . thoughtful and readable," and presented the figures from Ravenal's critique showing that "our overseas 'containment' and defense-alliances costs account for nearly 80 percent of outlays." This led Brookes to question the wisdom and viability of the direction of America's foreign policy.

With two government studies now confirming that NATO takes the lion's share of the U.S. military budget, it is likely that even more attention will be paid in the future to arguments favoring American disengagement and Western European self-defense. ■

**Mattias Bengtsson, a Swedish libertarian leader and speechwriter for the parliamentary leader of Sweden's Moderate Party, discussed Swedish politics and economics at a Cato Institute luncheon for journalists and policy analysts. Here Bengtsson (left) talks with Michael Lindstrom, First Secretary of the Swedish Embassy. Bengtsson told the audience that the non-socialist parties had failed to take advantage of their recent term in power, but that the growing influence of free-market economics would provide a better basis for action when they next win a parliamentary election.**

# Closure Laws Restrict Jobs

A revised and expanded edition of *Plant Closings: Public or Private Choices?*, edited by Richard B. McKenzie, has just been published by Cato. First released in 1982, *Plant Closings* has been expanded to include several essays about industrial policy by Charles Schultze, senior fellow with the Brookings Institution, William Branson, professor of economics at Princeton University, and James C. Miller III, chairman of the Federal Trade Commission, as well as new material on plant closure legislation. An index and appendix are also included.

Federal legislation regulating or restricting plant closures is still a top priority of organized labor, and has been endorsed in concept by presidential candidate Walter Mondale. Bills are now pending in Congress that would, among other things, require a year's notice to close a plant from any firm which employs more than 100 persons and mandate continuation of health and welfare benefits to laid-off workers.

McKenzie and the other authors in this volume offer conclusive evidence that these kinds of restrictions ultimately harm all workers. The editor points out that only a small fraction of plant closings are due to business relocations. The rest are due to business contractions, and the proposed restrictions would merely delay the transition to a more productive and efficient use of resources.

Dr. McKenzie is professor of economics at Clemson University and is the author of several books, including *Bound To Be Free* (Hoover Institution, 1982), *Constitutional Economics: Containing the Economic Powers of Government* (editor; Lexington Books, 1984), and *Fugitive Industry: The Economics and Politics of Deindustrialization* (Pacific Institute, 1984).

*Plant Closings: Public or Private Choices?* is available from the Cato Institute for $9.50. ■

# Cooperation and Spontaneous Order

**The Evolution of Cooperation,** *by Robert Axelrod (New York: Basic Books, 1984), 241 pp., $17.95.*

There are situations in which mutual cooperation would be to everyone's benefit yet a calculation of the prospects of individual benefits leads all participants not to cooperate. This problem (called by game theorists the "prisoner's dilemma") has long been cited as evidence that mutually beneficial cooperation cannot spontaneously emerge from voluntary market processes; conscious, state-directed coercion is therefore necessary to bring about such exchanges. Appeal to such logic is most pronounced in writing about the provision of public goods.

Many criticisms have been leveled against this view, among them that prisoner's dilemmas may abound within governmental coercion as well as within voluntary markets. A new and devastating argument is now at hand. Robert Axelrod, professor of political science at the University of Michigan, has written a revolutionary book that should go far to weaken this already rickety prop of statism. By using the device of computer tournaments (based on the most formal and mathematized model of the prisoner's dilemma), in which different strategies of "cooperation" or "defection" are pitted against each other, Axelrod has shown that "under suitable conditions, cooperation can indeed emerge in a world of egoists under no central authority." Competing strategies were submitted by academicians and lay people in economics, psychology, computer science, and other disciplines. The strategy most successful (called "TIT-FOR-TAT") in Axelrod's "iterated" prisoner's dilemma tournaments was quite cooperative; after introducing a weighting system that multiplied successful strategies and "killed off" unsuccessful ones, successive rounds of the tournament yielded a world of all cooperative strategies, harmoniously reaping the fruits of cooperation.

Axelrod identified four properties which make a decision-rule successful: "avoidance of unnecessary conflict by cooperating as long as the other player does, provocability in the face of an uncalled for defection by the other, forgiveness after responding to a provocation, and clarity of behavior so that the other player can adapt to your pattern of action." He shows how the introduction of a temporal element into the interaction of potentially cooperative entities changes the likely outcome of the game; his introduction of evolution into cooperative interaction is complementary to the emphasis on process and dynamic analysis of the Austrian school of economists.

## Policy Report Reviews

Axelrod is weakest in his recommendations for the future. He recommends cooperation of the TIT-FOR-TAT variety as a strategy for such possible prisoner's dilemmas as negotiations over the arms race. To examine an evolutionary process for general rules can, no doubt, generate insights into what is or is not likely to be successful. But at any *given* opportunity for interaction, the insight derived may lead to disaster. A fish may read Axelrod and decide—cautiously and wisely—to cooperate with another, only to be gobbled up. Every decision, every choice, takes place at one decisive moment; evolutionary theory may tell us how or why, over time, certain choices yielded success or failure, but it may be of only limited value at any given moment.

But this is a minor caution regarding a very important—indeed, pathbreaking and revolutionary—new book. Robert Axelrod's scientific investigations have lent considerable support to the theory of spontaneous order, including the theory of market exchange.

**Rebuilding America: The Case for Economic Regulation,** *by Frederick C. Thayer (New York: Praeger Publishers, 1984), 168 pp., $27.95.*

In virtually every public debate concerning regulation of industry in America in recent years, one finds the name of Prof. Frederick C. Thayer. Widely published and quoted in the *Washington Post*, the *New York Times*, and other publications, Thayer began his crusade for re-regulation of the air transport industry, later expanding his polemical efforts to encompass surface transportation and other industries. Most of the arguments advanced by Thayer in these forums were pure assertions backed up by his authority as an "expert" in organization theory. We are fortunate, then, to now have the fruit of Prof. Thayer's deeper meditations on regulation, from airlines to baseball. *Rebuilding America: The Case for Economic Regulation* presents Thayer's full-fledged attempt "to illustrate the need for regulation everywhere."

Proponents of free markets will be heartened to know that the best case the most widely cited academic proponent of regulation could produce is an incredible string of misinterpretations of economic writing, cranky attacks upon economists (who are "absurd," "schizophrenic," "insane," "frauds," "theologians," "preposterous," etc.), misuse of evidence, and a baffling mixture of *non sequiturs* and startlingly consistent deductions from bizarre and counter-intuitive premises.

To merely chronicle Thayer's mistakes would take a book even longer than this one, but a few deserve special mention. First, Thayer consistently misinterprets the writings of economists: an argument from Robert Mundell's economics textbook *for* the omnipresence of scarcity is misunderstood and cited as evidence *against* omnipresent scarcity; Mancur Olson is misinterpreted as showing why intervention is "necessary" (when he merely sought to explain why it occurs); and so on. Thayer's apparent inability merely to understand the reasoning of economists may help to explain his disdain for the science.

Second, and more importantly, Thayer has come up with an ingenious refutation of Say's Law of Markets. Say's Law, often expressed in the misleading slogan, "supply creates its own demand," states that every act of production creates goods that can be exchanged for other goods, given a free price system. To create a good is to create effective demand for other goods for which it may be exchanged; hence, while there may be overproduction of *some* goods at *some* prices, there cannot be a *general* overproduction or glut of goods, given the omnipresence of scarcity and a freely operating price system. Thayer interprets Say incorrectly as asserting that producers can consume all of whatever good they produce and then labels Say's contribution to economic thought "preposterous from the beginning."

In place of Say's Law, Thayer contrives to recast all economic transactions in terms of "a decision-making process that begins with the formation of a temporary organization comprising one buyer (of any good or service) and many sellers (of the same good or service)." The buyer seeks to buy only one widget, but one hundred firms have produced one widget each to sell to him. There is, therefore, an excess capacity (overproduction) of ninety-nine widgets. These widgets must then be sold at prices below their costs of production, leading to cutbacks in wages and employment, which leads to still further overproduction, since the worker/consumers are now out of jobs and cannot purchase the ever-increasing glut of goods. Therefore, "Unrecognized and unacknowledged though it may be, the purpose of a free market is to have it collapse into chaos." Since regulation is, in Thayer's view, fundamentally a restraint on production and since everything should be regulated, less of every good would be produced and we would all be richer. Q.E.D.

To return to Earth for a moment, Thayer's logical chain starts from the premise that all producers act 1) as if they were the sole producers of their good and 2) as if they never learned from the past or adjusted their behavior in accordance with the behavior of others (Thayer's view of a transaction is purely static; each transaction brings into being a "temporary organization" that ceases to exist upon consummation of the transaction). Thayer may be partially excused for this misunderstanding; he derives it from equating a free market with the misleadingly abstract model of "perfect competition" in which no producer's actions affect those of any other producer. He has derived from it, however, a bizarre theory that is the epitome of twisted logic. This theory is then clumsily wielded against such difficult problems as the genesis of war and imperialism, the effects on interest rates of federal deficits, public goods, anti-trust laws, and regulation of entry and exit. This book, apparently the best case for regulation available, fails utterly.



**Trade Policy in the 1980s,** *edited by William R. Cline (Washington: Institute for International Economics, 1983) 796 pp., $35.00.*

This is a compilation of the papers presented at a conference held by the Institute for International Economics in June 1982. Eighteen essays, comments, panel discussions, and editorial material from thirty-one authors make up this volume of nearly 800 pages. The nonpartisan group investigates virtually every issue directly related to contemporary trade policy—GATT, the European Community, reciprocity attitudes, exchange rates, the balance of trade, agriculture, and high-tech, to name the most central. The collection is a valuable source of understanding and offers a wealth of statistical information with its fifty-five tables and figures.

A particularly interesting piece by C. Fred Bergsten, director of the Institute, and John Williamson attempts an exposition of the relationship between exchange rates and trade policy. An "overvalued" currency, they argue, incites a clamor for protection because the domestic products are less competitive. Ironically, though, an "undervalued" currency also leads to protectionism because the additional competitive edge attracts marginal firms into export industries. But once the exchange rate adjusts, a number of firms become submarginal and call on the government for survival. The authors make a small but unsuccessful effort to illuminate what it means for a currency to be misvalued and how such a situation affects the trade balance.

Gardner Patterson shows how the European Community is biased toward protectionism and therefore presents a problem in the global picture. Logrolling of protective measures among nations is effective because any member can veto an action considered a matter of national interests. This clause also aggravates proposals for the relaxation of restrictions. In the agricultural domain protectionism flourishes because prices are set on the basis of the cost of the least efficient producer. High prices result and the excess production is exported with subsidies. This has transformed the Community from a net importer to a net exporter of grains, sugar, dairy products, and beef since the early 1970s. Sectoral arrangements present another problem: with the encouragement of the Community an industry concentrates in one country or section of a country, thus creating a strong special interest group.

In the conclusion by Bergsten and Cline, a "policy blueprint" is offered, hoped to be utilized by the late 1980s. They call for a standstill of the protectionist drift, to be followed by a gradual phasedown. A greater integration of trade and monetary policies, they say, is critical. "Misvaluation" of the dollar should be altered by government fine tuning if necessary, and the IMF and GATT should be more united via annual joint reviews. ■

## Indexing Repeal (Cont. from p. 1)

1985 to 1990, a family with $20,000 in taxable income in 1985 would see its real income reduced by $924.86 in five years.

The debate over repealing tax indexing is really a debate over whether to increase taxes substantially, with the highest increases falling on low-income Americans. Baye and Black conclude, "The evidence provided in this study demonstrates that the inflation tax put a tremendous burden on Americans during the 1970s and that the repeal of indexation would insure increases in this burden. Moreover the burden of the inflation tax, should Congress decide to repeal indexation, would be the most severe for families with the least ability to pay."

Baye and Black's study, "Indexation and the Inflation Tax," is available from the Cato Institute for $2.00. ■

# "To be governed..."

**Even our dissidents agree with us, not that we have any**

For the first time in the history of the European nuclear-disarmament movement, official delegations from the Soviet Union and some of its allies have been taking part in a mass convention of protest groups. . . . Few of the Western activists believe that the Russians will repeat the experience. . . .

From the opening session last Tuesday, the Soviet delegation has been the target of critical speeches and gestures, and none of the Western groups has rallied to its defense. . . .

Mr. [Yevgeny] Sylin [deputy director of the Soviets' Council for European Security and Cooperation], in reply to persistent questions on why the Soviet Peace Committee had never criticized Soviet policies . . . said that there were never differences between the Soviet Government and people. "Public opinion and official opinion are the same in our society," he said to laughter. "They are always the same. We have ways of establishing the link."

He did not specify the ways.

—*New York Times*, July 20, 1984

**Rosy scenario for protectionism**

Sniffing out a novel argument for a trade complaint, American rose growers have charged they are being driven out of business by cocaine smuggled into the country from Colombia in cases of flowers.

The high profits from the illegal cocaine sales allow the Colombians to dump the roses on the American markets at prices so low that the American growers cannot compete, Roses Inc., a trade association, charged in petitions filed with the International Trade Commission and the Department of Commerce.

—*Washington Post*, June 27, 1984

**We were afraid of that**

*NOW U.S. SAVINGS BONDS OFFER OPPORTUNITY WITHOUT RISK.* . . . Finding the ideal investment is something everyone dreams about. One with a variable interest rate. One that lets you share in the rates offered in today's securities market.

But it must be *safe*. A plan where rates can't drop below a certain level.

Sound too good to be true? Well, it is available to everyone. . . .

It's the U.S. Savings Bond. . . . There is no limit on how high the rates can go.

—Treasury Secretary Donald T. Regan in an ad for savings bonds

**Ethical behavior**

In the wake of Rep. George Hansen's indictment and felony conviction for filing incomplete financial disclosure reports, about 230 House members have amended their congressional ethics filings for the past two years.

—*Washington Times*, July 17, 1984

**The price of free speech**

Internal Revenue Service officials . . . have assessed fines of at least $500 against 5,528 people who wrote insults and protests in their tax returns. . . .

Donna Todd of Billings, Mont., wrote on her tax form that she was paying the $35 she owed on less than $3,000 in earnings only because she had to. . . . "Signed involuntarily under penalty of statutory punishment," her note said.

The I.R.S. not only fined her $500, but also seized the $140.06 in her bank account and filed a lien against her house.

—*New York Times*, June 5, 1984

**But if you knew where to ask, you'd be disgusted**

About 25 demonstrators picketed two 7-Eleven stores in Prince George's and Montgomery counties yesterday, joining a nationwide protest against the sale of Playboy, Penthouse and Forum magazines in the convenience stores. . . .

The magazines . . . are kept behind the counter with covers hidden from view. Customers must be at least 18 years old to buy adult magazines. . . .

[A protest leader] said she felt yesterday's picketing was successful.

"The bulk of the people had no idea what was being sold."

—*Washington Post*, August 7, 1984

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