

---

# Readings

## of particular interest

---

### Rent Control and the Decline of Cities

"Controlling Rents, Razing Cities" by Roger Starr, in *The American Spectator*, October 1978, pp. 21-24.

"If no one likes to pay rent, why shouldn't it be regulated by law so that politicians can take credit for the largesse," asks Roger Starr. His answer: "One reason only. It doesn't work." In spite of this, rent control is spreading—from New York, where it has continued since World War II, to Washington, Boston, Newark, even Miami Beach. Legislators who support rent control apparently accept two premises: first, that rent control corrects a monopoly pricing system whose victims are the tenants; and second, that without rent control many apartments of acceptable quality would be priced too high for moderate and low-income families.

Starr, a member of the editorial board of the *New York Times* and formerly head of New York City's housing authority, examines both premises. Speaking to the first, he shows that in New York, for example, the largest single owner of apartment housing is the New York City Housing Authority, which owns less than 10 percent of the city's total, and no private party owns as much as 5 percent. In every American city there are thousands of owners of every description, so that no such monopoly exists.

As for the second premise, the effect of controls (and indeed their objective) "becomes the perpetuation of low rents and unchallengeable tenure for those tenants who happen to be protected"—usually those who move the least often, or never, and who are rarely the families with the most modest incomes. This bias toward immobile tenants results from the fact that rent control systems permit rent increases only with a change of tenancy. Two undesirable effects follow. Because the highest turnover is among those who are poor and must move to

find work, or must move because they can no longer pay the rent or because the building has become a financial burden to the owner who is abandoning it, the poor tend to live in apartments where the rent is raised most often. It was discovered in New York that the *top floor* in six-story walk-up tenements had the highest "legal rent ceiling" of all the apartments in the building. Because these apartments were the worst, they had turned over most often, with the rent being raised with each turnover.

The other undesirable effect of the bias toward the tenant-in-residence is a "gross misallocation of housing space," according to Starr. Rent control inhibits moving when important changes in family size occur (either expansion or contraction) because there is such a large economic benefit from staying put. But for the city as a whole, rent control amounts to a vast waste of "*public space*." In effect, these controls create a "tenant monopoly that distorts land value downward or, at best, prevents a municipality from taking advantage of its major economic asset, the value of locations that are in high demand." In Starr's opinion, this misuse of valuable land is an indication of the way rent control serves the people who do not need it, at the poor's expense—"it tends to be a middle-class subsidy."

Focusing again on New York City's experience, Starr notes that a vast sum of money is diverted from the owners of rental property to the tenants, whether or not the latter need the subsidies. In his opinion "a very significant part of the deterioration in the better buildings of New York has been due to rent control," that is, to this loss of rental income. The deterioration in middle-class housing creates a demand for government to produce new housing "for the very people who should have been living in the formerly middle-class apartments." Furthermore, no public official dares publicly criticize rent control or point out the connection between it and housing deterioration. In the larg-

er context, the attitudes that rent control fosters—"attitudes which support the myth that social benefits cost nothing"—are the attitudes that led to New York's financial disasters. Starr suggests that cities contemplating rent control might get a better idea of its true costs by observing New York City's vast debts.

### The Real Issue

"Executive Reorganization and Presidential Power" by Barry Karl, in *1977 Supreme Court Review*, ed. Philip Kurland and Gerhard Caspar (Chicago: University of Chicago Press, 1978). pp. 1-37.

Recent discussions of the constitutionality of various reorganization devices (for example, the legislative veto) have tended to obscure the real issue, argues Barry Karl, University of Chicago historian. In his view, that issue is "presidential power versus congressional power in the management of the nation's basic resources," and what is most lacking is a broad historical perspective.

Karl traces the problem of administrative reorganization as a theme in national politics. In the early 1900s, many reformers readily ac-

knowledged that their desire to remove petty politics from national administration implied far-reaching constitutional change, with some urging evolution toward party discipline and cabinet government on the British model, and others looking to the powerful civil service of the German Empire. But, according to Karl, those proposals illuminated without quite solving the central problem: with the federal government playing an ever larger role in managing (or regulating) the use of the nation's economic resources, the power of federal agencies was unavoidably growing to fearful proportions. And, if it was no longer realistic to entrust this potentially immense regulatory power to the necessarily fragmented and partisan Congress, was it, however, safe to entrust so much power to a centralized and self-directed presidency increasingly being freed from legislative restraints in the name of efficiency?

Fears that it was not safe surfaced most dramatically in response to Franklin Roosevelt's reorganization proposals of 1937, which (like his "court-packing" plan of the same period) were denounced as steps on the road to presidential dictatorship. Almost every subsequent administration, in Karl's view, has simply refined the techniques developed by the



Reprinted from Scripps-Howard Newspapers.

New Dealers for outflanking or overcoming congressional anxieties without directly confronting or redefining the underlying constitutional conflict. These techniques include compromise and cooperation in formulating new policies that could be the basis for more independent executive initiatives later on. The very concept "executive reorganization," Karl maintains, was introduced quite deliberately to avoid confrontation with the presidency itself. "Indeed one could argue that the entire history of the American use of the term 'public administration' is an effort to find a vocabulary capable of removing partisan politics from debates about policy." The same charade has given us terms like "administrative management" and "policy science." However, power "to create and abolish offices, to shift and consolidate functions, to increase or decrease personnel in the management of these functions, is a great power": the power "to limit congressional control over national resources and their distribution, the economic base of political power itself."

Though the Watergate experience has again brought the dangers of an overly powerful presidency to public attention, presidents will undoubtedly continue to struggle for better control over the federal bureaucracy. For if the opponents of FDR's reorganization effort had a very real and powerful claim, so too did its advocates, according to Karl. Given modern conditions, piecemeal congressional oversight of the vast regulatory structure is ineffectual, and lack of central direction and control within the executive branch is intolerable. The tangled connections between agencies and congressional sponsors make it difficult for presidents to translate what they see as their new management or policy mandates into effective action. "Executive management or administrative reorganization, by whatever name, is a response," Karl concludes, "to changes in the basic historical condition of American government."

---

## Profile of the Ethical Drug Industry

*The Pharmaceutical Industry*, Cotton M. Lindsay, ed. (New York: John Wiley & Sons, 1978), 154 pp.

The 1962 amendments to the 1938 Food, Drug, and Cosmetic Act brought increased regulation to the ethical drug industry, with consequences

that are a continuing subject of controversy. This new regulation has accomplished three things: (1) some ineffective drugs have been removed from the market, (2) every new drug undergoes thorough testing before marketing, and (3) claims made for drugs must be supported by sufficient evidence and are now carefully monitored. This collection of studies, which describes the ethical drug industry in this regulatory environment, was edited by economist Cotton M. Lindsay of the University of California at Los Angeles and organized by John H. Wood of Hoffmann-La Roche, Inc.

The history of drug regulation is discussed by Jerome E. Schnee of the Graduate School of Business Administration at Rutgers University, who argues that the 1962 legislation has had unexpected consequences. First, the number of new chemical entities introduced in the United States has sharply dropped and, second, concentration in the drug industry has apparently increased, along with further entrenchment of larger firms. According to Schnee, this is the result of increased drug development costs and of the fact that fewer new drugs appear to "challenge the market position of older drugs." He also discusses the comparative efficacy of premarketing and postmarketing testing of drugs, pointing out that many side effects only show up after widespread use in humans and that the action of certain drugs is "demonstrable only in man." This and other evidence suggests that "premarketing observations can never be an adequate substitute for effective postmarketing surveillance."

The ethical drug industry in the United States has expanded seventeenfold since World War II, is characterized by dynamic competition and a rapid firm turnover, and spends \$1 billion annually for research and development. In a chapter describing the industry, Schnee and Erol Caglarcan of Hoffmann-La Roche point out that it also enjoys a higher rate of return on investment than most other industries—allegedly because it charges high prices. Two other explanations are suggested here: (1) the practice of treating research and development as current expense rather than as investment inflates rates of return, and (2) a premium for risk and for growth in pharmaceutical demand produces a higher rate of return.

The book contains chapters on the contributions of the drug industry to improved health

by David A. Siskind of Hoffmann-La Roche, on marketing by Gilbert A. Harrell of the Graduate School of Business at Michigan State, and on the changing research and development environment by Schnee and Caglarcan. In his chapter, Harrell points out that (according to a 1973 AMA study) although over three-quarters of physicians claim they are influenced by *Physicians' Desk Reference* or by other physicians in prescribing drugs, over half believe industry salesmen have an effect on these decisions.

Schnee and Caglarcan discuss the decline in the rate of new drug introductions. In their view, it has been caused not by industry inefficiency (as industry critics charge) or by the impact of new federal drug regulations (as industry countercharges), but by a more complicated phenomenon: "a widening biological knowledge gap regarding drug knowledge and disease processes in man," which has made advances in drug research more difficult than they were in the past.

In another chapter—on profitability and the ethical drug industry—Walter Campbell of Walter Campbell Associates and Rodney F. Smith of Clark University emphasize the need to study other segments of the health care industry in order to compare their profitability with that of the drug industry. The authors expect to find above-average rates of return on investment "to the extent these other segments produce high-value, relatively low-cost products or services." In the concluding chapter, Campbell describes the emerging health care environment, predicting that the conflict between public and policy objectives, on the one hand, and costs to the taxpayer, on the other, will become greater as new and more expensive procedures are developed in an atmosphere of increased public scrutiny.

---

## Strategies for Regulated Industries

*The Regulation Game* by Bruce M. Owen and Ronald M. Braeutigam (Cambridge, Mass.: Ballinger Publishing Co., 1978), 271 pp.

This analysis of the "strategic use of the administrative process" supplies the following advice: "No industry offered the opportunity to be regulated should decline it." Among the benefits catalogued here are protection from

competition, protection from antitrust attack, some protection from congressional investigation, a greatly reduced risk of bankruptcy, and the virtual guarantee of a "steady stream of adequate profits." Bruce Owen, director of the Center for the Study of Regulation of Private Enterprise at Duke University, and economist Ronald Braeutigam of Northwestern University find the strategic use of the administrative process to be just as important to many businesses as their traditional concerns with prices, entry, and innovation.

Written as a "how-to manual," this book describes the strategic use of litigation (to buy time), of innovation (to forestall an agency decision, for example), and of offering products or services below cost to those favored by government's redistributive policies (in order to protect an entire industry from competition). Given their fundamentally New Deal outlook, many agencies "will not allow competition to affect profits" if they are convinced those profits are necessary to subsidize redistribution. Another important strategy is to get the agency to allow industry self-regulation so that the industry operates as a cartel "under an umbrella of antitrust immunity." Owen and Braeutigam give further advice on how to lobby (by establishing social relationships so that agency decisions come to have human—not merely institutional—impact) and how to co-opt experts and the leading Washington law firms (in order to reduce the threat that the talent will be arrayed against you).

Using six case studies, the authors examine two "tentative hypotheses" about the regulatory process. One hypothesis is that regulated firms and industries operate inside the regulatory environment as they would in the market: they engage in strategic behavior to reach economic objectives. The second is that regulation significantly slows the rate at which "market and technological forces impose changes on individual economic agents." Owen and Braeutigam observe that voters appear to prefer to minimize the risk of the market at some cost in efficiency, viewing a process that gives persons and firms some "legal rights to the status quo" as "fairer" than a laissez faire market system.

The case study material ranges from AT&T's success with the Federal Communications Commission in using strategic innovation, to the success of real estate title insurers in

using regulation to protect themselves from competition and antitrust attack. Though it supports the two hypotheses, the authors point out that a great deal of empirical research must still be done before the essential validity of these hypotheses can be demonstrated. If research shows that the two hypotheses are true, the next question must be whether the costs are acceptable, or whether there are better means to "achieve economic security and justice." The authors quote Gibbon's comment on the fall of Athenian democracy: "In the end they valued security more than they valued freedom, and they lost both."

---

## Breaking a Cartel

"Price Deregulation in the Brokerage Industry: An Empirical Analysis" by Aharon R. Ofer and Arie Melnick, in *The Bell Journal of Economics*, vol. 9 (Autumn 1978), pp. 633-641.

The New York Stock Exchange was "one of the oldest cartels of modern times." Then on January 23, 1975, the Securities and Exchange Commission adopted Rule 19b-3, prohibiting securities exchanges from fixing brokers' commission rates and bringing competitive pricing to the industry for the first time since 1792. Aharon Ofer of Tel Aviv University and Northwestern University and Arie Melnick of the Israel Institute of Technology and Haifa University view the change as a "rare opportunity" to study the effect of price deregulation in an industry historically protected from price competition. They find that this new negotiated commission system has "led to lower prices and to a pricing structure that more properly reflects the costs of executing different types of transactions."

The exclusive right of national securities exchanges to set commission rates noncompetitively was first modified in 1968 when, as the result of pressure from the SEC and institutional customers, volume discounts were introduced. Other modifications followed, including the introduction of negotiated commissions for transactions over \$300,000 and culminating in the 1975 rule.

The authors hypothesize that the following factors ought to explain brokerage commission rates in a competitive market: the size of the transaction, the broker's total assets (a proxy

for reliability and service), the quality of the broker's execution, average trading volume in the stock (a measure of how quickly a broker's mistake could be rectified), the price of the stock (a measure of the broker's risk if he makes a mistake), and how soon after deregulation a trade was made (there appeared to be a period of transition when competitive pricing was first initiated). Ofer and Melnick analyze the period from May 1, 1975, to May 1, 1976, to establish the relationship between these factors and commission price per share and to measure the impact of deregulation.

From an examination of 3,718 purchase orders by ten bank trust departments, the authors report that, for transactions under \$300,000, competitive commission rates averaged 36 percent lower after price deregulation than before. However, prices did not respond immediately to the new situation, a lag that is attributed to a transition or learning period.

Multiple regression analysis further shows that economies of scale exist in the brokerage industry, that there is "some support to the notion that the commission price will be lower for actively traded stocks," and that large brokers charge higher commissions than small brokers (which may measure a premium for reliability). During the period considered, the trend was one of declining commissions per share traded.

The SEC's abolition of fixed commission rates broke a cartel that began in 1792 when twenty-four brokers agreed "not [to] buy or sell from this date for any person whatever, any kind of public stock at a less rate than one quarter of one percent . . . and [to] give preference to each other. . . ." The result of deregulation is lowered commissions for the public.

---

## Stimulating Price Competition

*The Promotion of Price Competition Where Sellers Are Few* by Frank Kottke (Lexington, Mass.: D. C. Heath and Company, 1978), 227 pp.

"Given the limitations of human nature," competition is the only means of reconciling the majority of the "conflicts of interest in a modern economy" and, at the same time, promoting full use of its resources to meet consumer demands. This book by Frank Kottke, a

former Federal Trade Commission economist who is now at Washington State University, describes and evaluates policies the government can use to promote price competition "where the rivals are relatively few." His primary thesis is that the "federal government has adequate powers to obtain price competition in every important market dominated by a disciplined oligopoly. . . ."

The author first evaluates the effectiveness of antitrust enforcement in promoting price competition, concentrating on two areas—that in which industry-wide trade practices have the effect of stifling price competition and that in which a few large firms monopolize an industry's output.

In the first area, Kottke examines the Federal Trade Commission's limited success in ending the use of "delivered pricing"—that is, pricing in which all suppliers of a particular good charge any buyer the same "delivered price" regardless of geographic location. He concludes that, in some instances, "there is significant place for the regulation of trade practices by statute, or by a statute once removed through its interpretation by a regulatory commission." However, for three reasons, this is an impracticable way of securing price competition in the absence of evidence of a conspiracy to suppress price competition. (1) There is difficulty in proving the offense. (2) Even if a court order requiring price competition is obtained, the order is difficult to enforce when both buyers and sellers are opposed to it. And (3) where the questioned practice does not directly and unambiguously suppress price competition, the business sector may cry "unnecessary interference" in economic affairs—a cry to which Congress often responds.

In the second area (where few large firms monopolize an industry's output), the author analyzes the ten occasions where the federal government has broken up a company that controls a large part of the supply of its main product lines. In his view, the effect of these actions on price competition has not been significant. He attributes the poor results largely to the self-restraint of the courts, which guarantees that no plant will be disturbed, that facilities supplying a particular market will be divided among no more than three successor companies, and that the divested firm will have substantial freedom in choosing new rivals.

Therefore, "efforts to secure divestiture should be an occasional tactic," not the government's main program to promote competition.

Instead, Kottke argues, government's objective should be to encourage more businesses to enter markets where price competition is lacking. That, after all, is the goal of "trust-busting"—to increase the number of suppliers in a given market. He suggests a number of initiatives. For example, imports should be stimulated in order to increase price competition in U. S. markets. Rather than protecting domestic industry against foreign producers by imposing import duties and "voluntary" quotas, the government should provide adjustment assistance to affected firms (for the purpose of getting into new lines of business) and to displaced workers (for the purpose of new job training). Furthermore, the 1933 Buy American Act, which requires government agencies to buy from U.S. producers even when cheaper imports are available, should be repealed.

Along with stimulating imports, Kottke proposes that the government reduce the barriers that deter market entry for domestic producers. For example, our laws often make it difficult for a firm to enter a new market by acquiring the facilities of another firm, introducing significant changes, and offering customers substantially lower prices. He suggests that "antitrust agencies should be alert to exempt [certain cases] in their enforcement of the federal statute. . . ."

In markets where new entrants are unlikely or would not introduce price competition, the government should stimulate price competition in other ways. It might, for example, become a dealer in certain goods, buying and selling from suppliers in an effort to promote price competition rather than price stability. Or it might temporarily take over failing firms so as to ensure some degree of competition or subsidize groups that propose to avert a firm's liquidation. Thus, since worker-controlled firms have a strong incentive to leave no capacity unused, they might be more receptive to cutting price as a means of competing.

To put the matter briefly, "the government should avail itself of the alternatives most appropriate in each situation to achieve price responsiveness to changes in demand, as well as to changes in cost."