
Readings

of particular interest

More Economies of Scale in Regulatory Compliance

Firm Size and Regulatory Compliance Costs: The Case of LIFO Regulations by John C. Hilke (Federal Trade Commission Bureau of Economics, December 1984), 64 pp.

Most businesses use one of two accounting systems to put a value on their inventories. Under the older of the two systems, FIFO (first-in-first-out), items sold from inventory are typically valued at prices prevailing some time earlier. Consequently, when prices of inventory items are rising, firms that use FIFO report higher profits than similarly situated firms that use LIFO (last-in-first-out), a system that values inventories at approximate replacement value. Businesses often regard the extra profits reported under FIFO as an artifact of inflation rather than a sign of real prosperity; in addition, FIFO users pay higher taxes than LIFO users in periods of general inflation like the past two decades. Thus there has been a broad shift toward LIFO since it was introduced shortly after World War II.

Many firms, however, particularly small ones, have still not switched to LIFO. According to this staff report by John Hilke, an economist in the Federal Trade Commission's Bureau of Economics, federal tax regulations that govern the adoption of LIFO have helped slow down the switch. Moreover, by creating economies of scale in regulatory compliance costs, the rules have differentially handicapped small firms. To the extent that FIFO overstates profits, the result may be to distort the tax system and introduce a bias against small firms and against inventory-intensive methods of doing business, resulting in the misallocation of resources.

The main body of the report is an analysis of the response to a 1983 survey of wholesaler-distributors about LIFO regulations and costs.

The survey data confirm indications from the Internal Revenue Service that many firms, particularly small firms, continue to use FIFO. According to Hilke, the survey data indicate that small firms' low rate of LIFO usage is not a result of their clustering in low-inflation and low-inventory industries where LIFO might not make much difference in tax liability.

More than half of the small firms that did not use LIFO in 1983 said that the cost of switching was a very important factor in their decision to stay with the old system. More than 40 percent of the medium to large firms also considered switching costs to be a major reason for avoiding LIFO. Among firms that already use LIFO, perceptions were different: few of them indicated that conversion costs had been much of a deterrent in their decision to switch.

That might suggest that the fears of switching are to some extent groundless and arise from a lack of information. But the data contradict that thesis. Non-LIFO users that are well informed about conversion costs are just as concerned about them as their less informed colleagues.

The FTC study finds that the pattern of conversion costs incurred by LIFO users surveyed provides a reasonable explanation for small firms' concerns about the costs of switching. Respondents reported that the costs of switching totaled more than \$35,000 for the average firm and \$23,000 for firms under \$5 million in annual sales, a figure that is proportionately much more burdensome for these firms; it represents 30 percent of an average year's profits. In effect, the report says, the costs of complying with LIFO regulations or sticking with FIFO seem to act as a regulatory economy of scale that inflicts particular comparative disadvantage on small firms during inflationary periods. The effect seems to hold within the industry subgroups that were studied as well as for firms overall, Hilke says.

Various regulatory changes have been suggested to lessen the burdens of switching. The most promising, in Hilke's view, is a proposal to change IRS regulations to allow firms to use government price indexes to reevaluate inventory instead of calculating inflation rates based on the specific mix of items held by each firm. Such a change could provide substantial cost savings to both large and small firms: the firms surveyed estimated that it would cut their compliance costs by slightly more than half.

State Severance Taxes: Are the Dangers Exaggerated?

"Energy, Taxes and Growth" by Bernard L. Weinstein, in *Transaction: Social Science and Modern Society*, vol. 22, no. 1 (November/December 1984), pp. 41-47.

For decades many energy-producing states have levied taxes on the coal, oil, and natural gas produced within their boundaries. Texas, for instance, has taxed oil for more than seventy-five years. These "severance" taxes, as they are sometimes called, started to attract wide attention in 1979 when the federal government instituted a phased decontrol of oil and natural gas prices. As oil and gas prices began to rise, severance tax collections rose in tandem. Revenue from Texas's oil tax jumped by 200 percent from \$435 million in 1978 to \$1.3 billion in 1982. In 1974, state severance taxes nationwide had amounted to \$1.2 billion; by 1982 they were bringing in \$7.8 billion, with just four states (Texas, Alaska, Louisiana, and Oklahoma) capturing 72 percent of the total.

An unpublished but widely circulated 1979 study for the U.S. Treasury estimated that the increased state and local revenue over the 1980s resulting from oil decontrol would amount to \$128 billion. The accuracy of these estimates later came into question, since oil prices could go down as well as up. But the amounts were enormous enough to evoke the spectre of substantial fiscal disparities between energy "have" and "have-not" states. Severance taxes, it was feared, would enable a few states to grow rich at the expense of consumers in other states.

A number of Northern politicians and groups began calling for reform, and bills were

introduced in Congress to limit the states' power to impose severance taxes. Some went even farther and called for replacing the state taxes with a uniform federal severance tax, on the grounds that the benefit from energy deposits belongs in some sense to the nation as a whole rather than the producing states.

Any such bill would certainly come under constitutional challenge, because states have traditionally guarded their right to tax with great jealousy, writes Bernard Weinstein of the Cox School of Business at Southern Methodist University. In fact, carried to its logical extreme, the Northerners' line of reasoning would justify the federalization of far more than just energy revenues, Weinstein says. If Minnesota can lay claim to some of Texas's oil, why should not Texas lay claim to some of Minnesota's water and fish? In fact, why should states with ample rainfall not be forced to send some of it to the arid West through long-distance irrigation pipelines?

In spite of all the consternation about the severance tax, Weinstein says, little attention has been paid to its impact on the economies of energy production and consumption (as opposed to the fiscal condition of state treasuries). While federal taxes are for the most part based on the net income or profits of the producing company, state severance taxes are typically based on the value of the commodity itself. Even more than profits taxes, severance taxes directly reduce the amount that will be produced and offered for sale at a given price, discourage new investment in extractive activities and depress the long-term level of production.

In the short run, the severance tax and other state energy levies can have serious effects on industry profitability. A recent study by the General Accounting Office found that changes in state taxes significantly affected the value of operating mines to their owners and the investment potential of undeveloped deposits. Over time, however, capital and skilled labor will withdraw from states with differentially high severance tax burdens. Investors will leave the industry and employment will shrink. After these adjustments, the burden of the tax will fall in the form of property losses to owners of the least mobile resource, land. Because most of the factors of production enjoy long-run mobility, in other words, officials in energy-

producing states will eventually find themselves harming not out-of-state corporations, but their own land-owning taxpayers. In addition, the decline in production will itself depress severance tax revenues. These factors may give states an incentive to keep their severance tax rates from getting too far out of line with those of other states.

Two other considerations also make it less likely that severance taxes will lead to a polarization of rich and poor states. First, all states have ways to tax consumers in other states, notably through the "unitary" tax by which states can reach the out-of-state profits of companies that operate in the state, including oil retailers. Second, especially in the case of coal and synthetic fuels, severance taxes may be barely enough to cover the cost to the state of extending new public services to the areas of new production.

In any case, the author says, Washington could employ market mechanisms, rather than federal preemption, to reduce the dangers of runaway severance taxes. Such an approach might include rapid and complete decontrol of all energy prices, revision of federal laws and regulations pertaining to fuel use, the revival of the nuclear power program (including the fast-breeder reactor), a modest relaxation of air quality standards so as to encourage greater use of coal and lignite as boiler fuels, and the building of coal slurry pipelines to reduce transportation costs of both eastern and western coal. These steps and others would hasten the day when all fuels were priced on an energy-equivalency basis, a policy, says Weinstein, that would make it harder for any single state to levy excessive production taxes.

Stoking Toxic Fears

Chemical Risks: Fears, Facts, and the Media, with a foreword by Patrick D. Maines, published by the Media Institute (March 1985), 71 pp.

Anyone who watched television news or read a typical newspaper over the last five to ten years could easily have come to believe that our world is made far riskier and more dangerous by the presence of synthetic chemicals all around us (and in us, thanks to the foods we eat). Many

scientists and other observers have complained that the press and especially the broadcast media report the direst-sounding scientific warnings while omitting the uncertainties and qualifications with which the warnings are hedged—resulting in a sensationalized and distorted public discussion.

This study by the Washington-based Media Institute examines print and broadcast coverage of three chemical-related events that occurred between 1982 and 1984: the contamination of soil in Times Beach, Missouri, by the toxic chemical dioxin; the discovery of residues of ethylene dibromide (EDB) in some citrus fruits and grain products; and the derailment in Livingston, Louisiana, of a freight train carrying vinyl chloride and other chemicals. The centerpiece of the research project was a content analysis of 250 stories that had appeared in the *New York Times*, *Washington Post*, and *Los Angeles Times*, and on the ABC, CBS, and NBC nightly news shows.

The study suggests that these news outlets were not shy about sounding the warning alarm. Assertions that chemicals posed significant risks appeared in stories from three to seven times more often than counter-assertions that risks were low or nonexistent.

Significantly, government sources were cited more often than all other identified sources combined. In newspaper coverage of Times Beach, for example, government sources accounted for 53 percent of all sources quoted, while the next-most-quoted group consisted of "man-in-the-street" figures (17.2 percent). Industry sources accounted for less than 1 percent (0.6 percent) of Times Beach coverage, while independent experts outside industry were quoted sparingly, when not virtually ignored. These two groups combined amounted to only 2 percent of all sources quoted in the Times Beach case, 3 percent in the train wreck case, and 15 percent in the EDB case.

Not only was government quoted far more often than other sources, but nearly four-fifths (79 percent) of the statements by government sources on health risks alleged that a serious risk did exist. By contrast, the independent (nonindustry) experts who were interviewed were only half as likely as government officials to say that risks were significant.

In all three controversies scientists were actively debating whether the residents or con-

sumers in question were or were not exposed to significant risks. By focusing on government warnings and simplifying ambiguous scientific data, the report says, the media tended to foreclose each debate in favor of the conclusion that the health risks were real. President Patrick D. Maines of the Media Institute writes in his foreword that if the media had relied more on outside experts and less on government sources, the thrust of these stories and their emphasis on risk would have been markedly different. By emphasizing the warnings of government sources, the coverage effectively sided with those who took a grim view of the incidents.

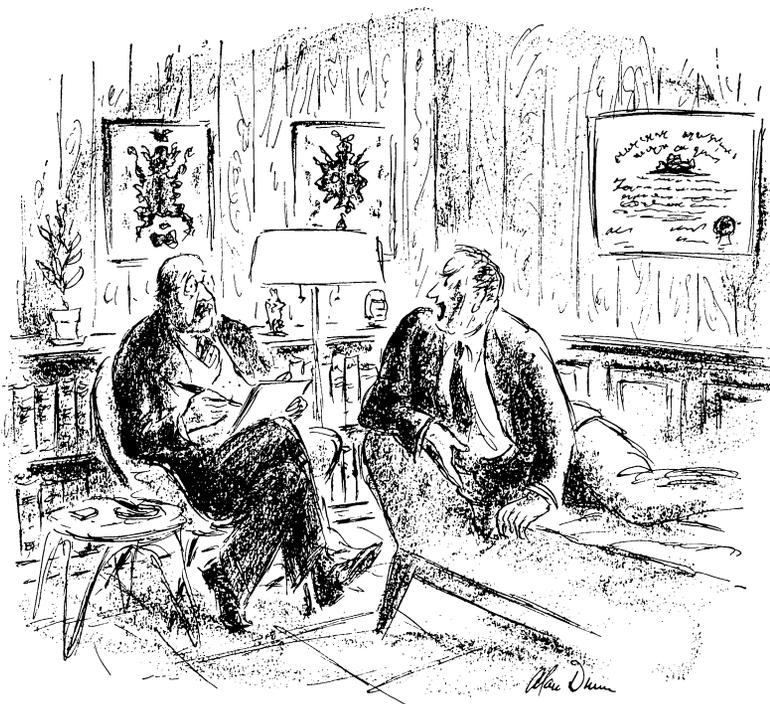
Television reporting, in particular, relied heavily on "man-in-the-street" interviews with average citizens, even when cases turned on complex technological issues where expertise would seem to be called for. In all three cases, citizens were second only to government spokespersons among identifiable sources in TV coverage. Typical was this NBC quote from a citizen in the aftermath of the Louisiana train wreck: "Some of us went into our houses and there are dead bugs in the houses. If bugs can't live—we can't either." The report observes that such emotional public interviews enhance the tone of dramatic urgency that characterizes television coverage, and that scientists rarely are given a chance to analyze the resulting anecdotes or assertions either on camera or for publication. Rarely even do the journalists themselves subject the public fears to serious scrutiny.

In conjunction with the study, the institute also conducted a "Q-Sort" analysis (which is akin to a focus group analysis) involving George Washington University students. Participants agreed that TV news was more sensational in its coverage than newspaper reporting. Asked to rate the lead sentences of newspaper and TV stories for sensationalism, participants found all the outlets (except the *New York Times*) to show some degree of sensationalism, with CBS at the top of the heap. The coverage in both media of the EDB case was slightly less sensational than that

of the Times Beach and Louisiana train-wreck cases.

The report concludes that the media "missed the opportunity to present the legitimate debate that was taking place among government, scientific, and industry experts" on the three incidents. Repeated warnings of impending chemical catastrophe may make good copy, the report warns, but they can inadvertently seduce viewers (and policy makers) into unconscious chemophobic choices. "It does not require an overly developed capacity for cynicism to understand that government sources (particularly at places like EPA) have their own vested interests, every bit as real and compelling as those imputed to businessmen and industrialists," Maines writes. "That so many eminent journalists spend so much time acting as little more than the conduits of government handouts is one of the greater, and lesser, ironies of their profession."

The study also includes a brief preliminary look at the first three days' coverage of the gas leak in Bhopal, India. Media outlets examined were the *New York Times*, *Washington Post*, *Wall Street Journal*, and the three networks.



"All right, I am afraid! I'm afraid to eat, to drink, to smoke, to drive, to fly, to breathe! And why shouldn't I be?"

Drawing by Alan Dunn;
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Like the three earlier chemical incidents, Bhopal tended to receive sensational coverage, but this time for a good reason: an actual disaster had taken place, killing two thousand people. Television footage was more vivid by far in portraying the drama of the event, while the strength of the print outlets was in conveying a broader range of information, devoting more space to background material and related stories, and better analyzing the long-term implications of the accident. An opinion survey of thirty-five print editors and chemical industry communications executives, reported in this section of the report, finds both groups giving the media high marks for their coverage of Bhopal, although executives found the coverage more sensational than did editors.

On Judges as Risk Managers

“Safety and the Second Best: The Hazards of Public Risk Management in the Courts” by Peter Huber, in *Columbia Law Review*, vol. 85, no. 2 (March 1985), pp. 277-337.

Much of the legal community shares a three-part consensus about the hazards of technology. First, the price we pay for new technologies and mass-produced goods is public exposure to a large and growing amount of external and nonconsensual risk. Second, public risks represent both market failures and moral wrongs. Third, the courts not only may but must provide stricter regulation. They can do this both prospectively, through injunctions and strict review of agency action, and retrospectively, by awarding damages to victimized parties in class actions for actual injury, exposure to risk, or even the apprehension of risk.

Peter Huber, a Washington, D.C., attorney, argues that more often than not, activities that create public risks represent progressive—that is, risk-reducing—social investments. The reason is that the incremental public risk created is usually smaller than the existing privately borne risk—often borne by the same people—that is displaced. The main sources of manmade public risks are new technologies, new chemicals, new consumer products, and new industrial processes. Though often hazardous, these advancements are on average much safer than

the old hazards they displace. Central water supply systems, power plants, and pest-spraying programs are generally much safer than the private wells, wood stoves, and yard-by-yard spraying they replace. The products of mass production also create public risks, but these too are generally safer than substitute private-risk sources of goods and services. Greater overall safety thus generally calls for the greater acceptance of public risk.

This has implications, Huber says, for the economics and moral philosophy of public risk activities. In a world permeated with risk of both nature’s and man’s creation, it is economically inefficient to treat every unit of manmade public risk as an economic externality. Hazardous human activities impose external costs only insofar as they create more risk than they remove. A rule of the “second best” thus applies in risk markets, just as in economic ones. Moreover, a morally just law of risk, like an “efficient” risk economy, wastes no time with risk in the absolute, but focuses instead on the marginal changes in the risk environment that a given activity may produce.

Huber concedes that public risk choices inherently require some form of public control, both to protect individuals from overproduction of public risks and to prevent the underproduction of public risks that can result from individual obstruction of worthwhile measures. But the courts do not perform well in setting the public “risk budget” because they are institutionally incapable of accurately balancing risks created against risks averted, as progressive public-risk management requires. Experience demonstrates, in fact, that the courts generally make regressive risk choices. They systematically prefer old risks to new ones, and natural or “custom-built” items to mass-produced substitutes. Both of these preferences tend to make life more dangerous, not safer. Huber illustrates his argument with an account of the current crisis in vaccine liability, in which, he says, a capricious and undisciplined legal system has been brought to bear against products that plainly remove far more risk than they create.

The spheres of competence for the courts and the agencies in fact mirror the division between private and public risks, the author says. Courts can perform adequately in resolving narrowly tailored, bilateral, private hazard dis-

putes. But risks that involve diffuse, low-probability, multilateral, and temporally remote harms should be managed by administrative agencies which, imperfect though they are, are institutionally positioned to weigh risks wholesale and balance risk reductions against risk increases. Thus the courts, Huber concludes, should give much greater deference to risk choices made by the agencies than they currently do.

Updating the Costs of Trade Protection

Aggregate Costs to the United States of Tariffs and Quotas on Imports: General Tariff Cuts and Removal of Quotas on Automobiles, Steel, Sugar and Textiles by David G. Tarr and Morris E. Morkre (Staff Report, Bureau of Economics, Federal Trade Commission, December 1984), 148 pp.

This study is an attempt to estimate the net effect of trade barriers on the American economy in 1984. David Tarr and Morris Morkre, who are economists at the Federal Trade Commission, conclude that tariffs and quotas have been costing the United States economy at least \$8.5 billion a year.

The authors used two quite different methods to gauge the effects of tariffs and of import quotas. In the case of tariffs, they employed a model of the world economy to estimate what would happen to the U.S. economy if all tariffs, both ours and those of our trading partners, were removed. In all, they found that tariffs were inflicting \$6.3 billion in annual damage on

the United States. It was not so easy to estimate the effects of removing quotas and other non-tariff barriers. So the authors restricted themselves to analyzing four major quotas imposed by the U.S. government, using economic models of each industry. They included the quota on Japanese automobiles (which was lifted early this year), and those on sugar, steel, and nine apparel items from Hong Kong. The most important of these was the quota on autos, which cost the U.S. economy \$1 billion a year (in efficiency losses and transfers to foreigners), followed by the restraints on steel (\$780 million), Hong Kong apparel (\$370 million), and sugar (\$250 million). Since many other products are subject to U.S. quota restrictions, the resulting sum understates the costs the United States is unilaterally imposing on itself; the tariff figure, by contrast, includes not only the unilaterally imposed costs but also the costs of foreign tariffs.

When the authors calculated the present value of a continuing stream of these annual tariff and quota losses, the results were more arresting. The present value of the tariff costs over the next twenty years amounts to \$72 billion. As for quotas, those on sugar and apparel could be expected to cost \$2.9 billion and \$4.2 billion respectively over the same period. To take a twenty-year period as a measure of future tariff and quota costs is not unrealistic: textile quotas have already lasted more than twenty-five years, while steel received some protection in eleven of the last fifteen years. Over a conservative span of four years, the sugar quotas would cost the economy \$900 million, the apparel quotas \$1.3 billion, and the steel quotas \$2.8 billion.

SHOE by Jeff MacNelly

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“Double-Breasting”
(Continued from page 12)

Losses to consumers—as distinct from those to the economy as a whole—are much larger than this, because one of the major effects of quotas and tariffs is to transfer wealth from a country’s consumers to its producers and the government. The sugar quota is the best example of this phenomenon: U.S. consumer losses would amount to \$2.7 billion over four years, nearly three times more than the losses to the general economy listed above.

In addition, all four quota schemes bestow windfall benefits on the foreign producers that are awarded quotas, by assuring them a higher price for the products they are allowed to sell on the U.S. market. This transfer—a loss to the U.S. economy, but a gain to other countries—amounts to \$238 million a year for sugar, \$264 million for Hong Kong apparel, and \$557 million for steel.

As they did in an earlier study published in 1980 (see Readings, *Regulation*, January/February 1981), Tarr and Morkre proceed to compare these losses with the possible gains afforded by trade protection, namely, the unemployment and transition costs that are averted if American industries do not close down plants under pressure from imported goods. In the case of steel, “for every dollar of earnings losses saved by otherwise displaced workers, consumers lose \$34.60 and the United States economy loses \$24.57.” The average cost for each job saved by this restriction is \$114,000 to consumers and \$81,000 in efficiency losses to the economy. In the case of apparel, the authors estimated the employment *benefits* of the quotas on not only Hong Kong but also Taiwanese and South Korean apparel, though the *costs* of protection were calculated for Hong Kong alone. Even under that conservative assumption the cost per job saved amounted to at least \$41,800; and since the cost of adjustment for 8,900 unemployed apparel workers is an estimated \$20 million, the ratio of benefits from removing quotas to adjustment costs is at least eighteen to one. In the case of the sugar program the authors assumed that the federal government’s price support system would absorb the output of sugar producers, at some expense to the Treasury; even so, the price U.S. citizens would pay as taxpayers would be considerably less than they are now paying as consumers under the quota system.

places. After an unsettled period, the line-up of contractors would likely emerge much as it is now, except that the roster of owners would have changed, and the firms in each area would be divided into separate union and non-union castes. If so, H.R. 281 might even accelerate the trend toward non-union construction. A spokesman for the building trades unions says that this risk is one his group is prepared to take.

The Clay bill also would enact a number of other union-sought changes in the labor laws governing construction. For example, it is currently possible for an employer who has been operating under an umbrella agreement between contractors and unions in an area to slip out from under the umbrella and operate independently on a non-union basis. Under the Clay bill, such employers would continue to be covered by the umbrella contract unless their workers specifically voted to reject it.

Several attempts to amend H.R. 281 in subcommittee were rejected in votes along party lines. Rep. Steve Bartlett (Republican, Texas) offered an amendment that would have required the holding of a secret ballot, rather than the submission of authorization cards, to secure union representation. Another losing Bartlett amendment would have required secret-ballot votes on whether to go out on strike, whether to continue a strike (with votes taken every thirty days during its duration), and whether to accept an employer’s contract proposals.

A third amendment, offered by Rep. Richard Armey (Republican, Texas), would have ended the double-breasting controversy by defining each job site as a separate bargaining unit. For the unions, that would have been the worst possible outcome: it would have forced them to organize from the “bottom up” rather than from the “top down.” But—to the extent that “worker democracy” makes any sense as a guiding principle—smaller bargaining units possess at least one advantage, in that they provide a closer fit between worker sentiment and representational results than larger ones. As public choice theory tells us, the larger the bounds of the electoral unit, the more people wind up being represented by a candidate they have voted against.
