The Cost of Bad Government: One Trillion Dollars

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THE COST OF BAD GOVERNMENT

Policy	Cost to the U.S. Economy in 1986 (billions)
Monetary Policy	$625
Progressive Tax System	125
Penalties on Saving	105
Labor Law	50
Income Transfer Programs	20-25
Environmental Regulation	12 +
Agricultural Policies	10
Trade Policies	9
FDA Pharmaceutical Regulation	9
Postal Service	5
Land Management	2
ICC Regulation	1 +
Alaskan Oil Export Prohibition	1
Antitrust Policies	*
Tort Law	*
Failure to Privatize	*
Other Policies	5 +

*Not estimated

PREFACE

John C. Goodman

This is one of the most remarkable studies the NCPA has ever produced. In terms of its breadth and scope, it constitutes an academic equivalent to the Grace Commission report.

The Grace Commission took a businessman's approach to the federal budget. Using some of the most talented and experienced professionals in the business community, the Grace Commission identified about $400 billion worth of waste in the federal budget--money that could be saved over a three-year period by employing sound business techniques that are routinely employed in the private sector of the economy.

Economists have long known, however, that bad government policies can cause a different kind of waste--waste which is never reflected in the federal budget. This occurs when government policies cause individuals and companies to engage in wasteful behavior--behavior which would not have occurred in the absence of these policies. This second kind of waste is very difficult to quantify and measure. Even making intelligent guesses about its magnitude requires highly sophisticated statistical techniques, which are the tools of trade of contemporary professional economists.

Professor Yale Brozen has surveyed more than 100 scholarly studies produced at colleges and universities throughout the country. These studies reflect the state-of-the-art knowledge of academic economists about the effects of government policies on virtually every aspect of private sector activity.

The results are staggering. According to the best estimates available,

- Bad government policies over the last 30 years have caused our current Gross National Product to be about 20 percent lower than it otherwise would have been.
- The total cost to the economy is approximately $1 trillion dollars.
- That loss is equal to more than $4,000 for every man, woman and child in the country.

The word "cost" is used in more than one sense in this study. In some cases, the cost to the economy of bad government policy is cumulative, over time. Take monetary policy, for example. According to the best estimates, unstable monetary policy over the last 30 years causes average income in America to be about $2,600 lower than it could, and should, be.

Unfortunately, we cannot go back in time and correct the sins of the past. All we can do now is try to avoid making similar mistakes in the future. Adopting good monetary policy today will not make every American $2,600 richer. The cost of 30 years of bad monetary policy is a sunk cost--one which we cannot recoup.

On the other hand, there are certain policies that impose a recurring cost on the economy. These costs can be avoided, and the average American would enjoy an increase in real income in the near future if these policies were changed today. For example,

- By adopting sensible agricultural policies, instead of the ones currently in place, we could add about $11 billion to our annual GNP in a short period of time.

- Changes in certain environmental regulations would add about $13 billion to our annual GNP.

- Changes in some of our trade policies would add about $9 billion to our annual GNP.

- Changes in regulations governing the production and sale of pharmaceuticals would add another $9 billion to our annual GNP.

If bad government policies impose such heavy costs on the economy, why do politicians enact them? In virtually every policy area examined by Professor Brozen, "bad" policies are not simply mistakes that politicians make because they lack the knowledge to enact good policies. To the contrary. In almost every instance, the politicians who enacted bad policies ignored sound economic advice from the experts. According to Professor Brozen, politicians enact bad policies not because they are mistakenly trying to do good, but because they yield to political pressures.

Bad policies, like good ones, always have their defenders. And one of the most common justifications for bad government policies is that, despite the harm they do to the economy, they create greater equality of income and wealth among the American people. Yet one of the most astonishing findings of Professor Brozen's study is that policies which are commonly thought to create more equality actually have the reverse effect--they create greater inequality. Take the progressive income tax system, for example. Many people believe that a highly progressive income tax system leads to greater equality in after-tax income. In fact, the opposite is true.

- Every time the income tax rates have become more progressive, actual tax payments have become less progressive.

- Every time the tax rates have become less progressive, actual tax payments have become more progressive.

Contrary to popular notions, then, highly progressive income tax rates lead to less, not more, equality in income and wealth. A similar finding applies to other key policy areas.

Professor Brozen's study is a classic, first-of-its-kind analysis of the ways in which government policies affect the standard of living of the American people. It should be read and re-read by all those interested in seeing America achieve a higher standard of living and a higher rate of economic growth.

THE COST OF BAD GOVERNMENT: ONE TRILLION DOLLARS[1]

> The tool of politics (which frequently becomes its objective) is to extract resources from the general taxpayer with minimum offense and to distribute the proceeds among innumerable claimants in such a way as to maximize support at the polls.[2]

> ...The government consists of a gang of men exactly like you and me. They have, taking one with another, no special talent for the business of government; they have only a talent for getting and holding office. Their principal device to that end is to search out groups who pant and pine for something they can't get, and to promise to give it to them .... by looting A to satisfy B. In other words, government is a broker in pillage, and every election is a sort of advance auction sale of stolen goods.[3]

INTRODUCTION

In a democracy, even the most well-intentioned political leaders rarely have the opportunity to enact policies which they believe to be the very best economic policies. This is because politicians cannot merely weigh economic costs against economic benefits when they make decisions. They also must weigh political costs (How many votes lost?) against political benefits (How many votes gained?). It is precisely for this reason that the economic policies chosen by

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[1] An earlier version of this study was presented at the symposium, Economic Policy in the Market Process: Success or Failure, January 29, 1986, Slot Zeist, The Netherlands.

[2] James R. Schlesinger, "Systems Analysis and the Political Process," Journal of Law & Economics, Vol. II (Oct. 1968), p. 285.

[3] H. L. Mencken, A Carnival of Buncombe.

politicians very often are policies which, although politically practical, cause harm to the economy as a whole.[4]

In what follows I have identified some of the most harmful of these policies and provided estimates of their net economic costs (excess of costs over benefits) to the economy as a whole. These estimates are based on a survey of contemporary economic research. In most instances, there is a widespread consensus among economists that the policies are harmful, although there may be some debate over the magnitude of the harm. In all cases, the reader must be alerted that economics is not an exact science, and estimates of the costs of these policies are at best intelligent guesses, based on modern tools of statistical inference.

Setting aside legitimate differences of opinion, of one thing we can be fairly certain. The cost of bad government is huge. Based on a wide array of scholarly studies produced at colleges, universities and research institutes throughout the country, it appears that the cost to the economy of bad governmental policies is at least $1 trillion.

THE COST OF BAD MONETARY POLICY: $625 BILLION

Ever since the seminal work of Milton Friedman, economists have been alerted to the fact that increases and decreases in the nation's money supply have major and powerful effects on the economy.[5] Today, no one doubts the fact that monetary policy (controlled by the Federal Reserve System) is the most important single weapon the federal government has for influencing economic activity. Generally speaking,

- Every rise in the inflation rate in the U.S. has been preceded by a rise in the growth of the money supply.

- Every recession in the U.S. has been preceded by a slowing in the growth of the money supply.

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[4] The seminal works on how democratic voting distorts the choices of politicians are Anthony Downs, An Economic Theory of Democracy, New York: Harper & Row, Publishers, 1957; James M. Buchanan and Gordon Tullock, The Calculus of Consent, Ann Arbor: University of Michigan Press, 1962; William H. Riker and Peter C. Ordeshook, An Introduction to Positive Political Theory, (Englewood Cliffs, N.J.: Prentice-Hall, 1973.) For an analysis of how the influence of special interest groups results in bad government policy, see George Stigler, "The Theory of Economic Regulation," Bell Journal of Economics, Spring, 1971; Richard Posner, "Theories of Economic Regulation," Bell Journal of Economics, Autumn, 1974; Sam Peltzman, "Toward a More General Theory of Regulation," Journal of Law and Economics, August, 1976; John C. Goodman and Philip Porter, "A Theory of Competitive Regulatory Equilibrium," (forthcoming). See also L. Mueller, "Public Choice: A Survey," Journal of Economic Literature, 14, 1976.

[5] See Milton Friedman and Anna J. Schwartz, A Monetary History of the United States: 1867-1960 (Princeton, New Jersey: Princeton University Press, 1963).

These swings in economic activity (generally referred to as the "business cycle") produce real economic costs. Unstable inflation rates, unstable unemployment rates and unstable interest rates have harmful consequences for the economy as a whole. Such instability creates economic uncertainty, leads to errors in judgment and planning on the part of business enterprises, and causes valuable resources to be wasted. In general, the instability produced by the business cycle causes our economy to be far less efficient and productive than it would be if the economic climate were more stable.

Why, then, do we adopt monetary policies which cause our economy to be unstable? One reason is a legacy of Keynesian economics. A central tenant of Keynesian theory was that the government could use monetary policy to produce more stability, not less stability, in the economy. In practice, however, the opposite has occurred.

All too often, policy-makers gun the monetary engine only after they recognize that we are in a recession. Unfortunately, by the time the effects of monetary expansion are felt, we are long past the time when those effects are needed. Conversely, policy-makers all too often apply the monetary brakes about the time they see inflation getting out of control. Yet by the time the full effects of the deceleration are felt, the problem of inflation has greatly subsided. For example,

- On average, monetary expansion begins about three to five months after the beginning of a recession--about the length of time necessary to recognize that a recession has begun.

- Yet the full effects of monetary expansion generally are not felt until about two years later--at a time when the recession already has subsided.

These stop-and-go monetary policies make peaks and valleys of business cycles higher and lower than they otherwise would be.

Could a highly variable monetary policy work to our benefit if it were more intelligently applied? The answer is not clear. For one thing, there is the problem of a lack of knowledge about how our economy actually works. Our economic system, it turns out, is extremely complicated. Our experience during one period may not be repeatable during a later period. As a result, we can't know what to do in the future simply by looking at the past. As Table I shows:

- In the years following World War II, the length of time between the peak in monetary growth and the peak in the business cycle has varied from as few as five months to as many as 30 months.

- Over the same period, the length of time between the trough in monetary growth and the trough of the business cycle has varied between two and 13 months.

Given such extreme variability in the length of time between policy actions and policy effects, there is no way that policy-makers can predict with accuracy the future effects of policies enacted today.

A second problem is a political one. At various points in the business cycle, politicians come under extreme pressure to "do something." Unfortunately, the political gains they accrue from highly visible policy changes come at the expense of invisible and not-well-understood economic costs brought about by bad policy decisions.

No one is quite sure to what extent political considerations have dominated monetary policy decisions. At least one economist has argued persuasively that the overriding aim of monetary policy has been to please Congressional banking committees which have oversight over the Federal Reserve System.[6]

Of one thing we can be certain. Had we adopted a policy of stable monetary growth over the post-war period (a policy prescription long advocated by Milton Friedman and other monetarists) we would be much better off. According to the most recent estimates,[7]

- An unstable monetary policy has cost the United States 15 percent of its real growth since the 1950s.
- Had monetary growth been moderate and stable since 1950, the current real Gross National Product would be $625 billion higher than it is today.
- That loss is equal to $2,600 for every man, woman and child in the country.

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[6] Kevin B. Grier, "Congressional Preference and Federal Reserve Policy," Working Paper No. 95, (St. Louis, Missouri: Center for the Study of American Business, Washington University, November 1985).

[7] Roger C. Kormendi and George G. Maguire, "Determinants of Economic Growth," Journal of Monetary Economics, Vol. 15 (September 1985). In addition to the cost of stop-and-go monetary policy, there also has been a large cost caused by the resulting inflation. See Martin S. Feldstein, "The Welfare Cost of Permanent Inflation and Optimal Short-Run Economic Policy," Journal of Political Economy, Vol. 87, No. 4 (August, 1979), p. 765; Dennis Carlton, "The Disruptive Effect of Inflation on the Organization of Markets," (presented before the Applied Economics Workshop, University of Chicago, February 24, 1981); and Craig S. Hakkio and Bryon Higgins, "Cost and Benefits of Reducing Inflation," Federal Reserve Bank of Kansas City Economic Review, Vol. 70, No. 1 (January, 1985).

TABLE I

Number of Months From the Peak In Monetary Growth to the Peak in the Business Cycle		Number of Months From the Trough In Monetary Growth to the Trough of the Business Cycle	
Time Periods	Months	Time Periods	Months
Aug. '47 - Nov. '48	15	Feb. '49 - Oct. '49	8
Dec. '51 - Jul. '53	19	Nov. '53 - May '54	6
Feb. '55 - Aug. '57	30	Jan. '58 - Apr. '58	3
Jan. '59 - Apr. '60	15	Feb. '60 - Feb. '61	12
Jan. '66 - Dec. '66	11	Oct. '66 - May '67	7
Jan. '69 - Dec. '69	11	Dec. '69 - Nov. '70	11
Jan. '73 - Nov. '73	10	Sep. '74 - Mar. '75	6
Aug. '79 - Jan. '80	5	May '80 - Jul. '80	2
Nov. '80 - Jul. '81	8	Oct. '81 - Nov. '82	13

Sources: Federal Reserve Bank of St. Louis, Monetary Trends, various monthly issues. Survey of Current Business, October 1982 and various monthly issues.

THE COST OF PROGRESSIVE INCOME TAXES: $125 BILLION

One of the achievements of the Reagan Administration has been to draw national attention to the fact that high marginal income tax rates cause serious economic harm to the nation as a whole. An individual in the 50 percent income tax bracket loses 50 cents through taxes on every additional dollar of taxable income he earns. Such an individual has an incentive to spend up to 50 cents to avoid incurring this additional taxable income.

How do individuals avoid incurring additional taxable income? One way is simply to quit working. In that case the cost to the economy as a whole is lost production. Another way is to take advantage of tax shelters and engage in other activities that allow individuals to realize financial gain without paying taxes on that gain. When individuals engage in such behavior, however, they are making decisions based on the tax advantage, rather than the economic advantage. This means oil wells are drilled that otherwise might not be. Buildings are built that otherwise might not be. These kind of investments are made at the expense of other, more productive investments simply because of the incentives created by the tax system.[8]

How great is the economic waste created by progressive income taxes?

- The President's Council of Economic Advisors estimates that at the 46 percent tax bracket, each additional dollar of taxes collected leads to 53 cents of economic waste.[9]

- The total economic waste produced by all federal, state and local income taxes combined is probably at least $125 billion.

Progressive Taxes and Government Revenues

One of the interesting discoveries of recent economic research is that when government increases the tax rate on income, government revenues do not necessarily go up. In fact they may go down. If we continue to raise tax rates, eventually we reach a point where people engage in so much tax-avoiding behavior that total tax payments actually fall.

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[8] For an analysis of how rising marginal tax rates through "bracket creep" affected U.S. productivity during the 1970s, see Robert J. Genetski, "The Impact of Marginal Tax Rates on U.S. Productivity Performance," Testimony submitted to the Congressional Subcommittee on Oversight of the Internal Revenue Service, Washington, D.C., April 13, 1984.

[9] Economic Report of the President (Washington D.C.: U.S. Government Printing Office, 1985), pp. 71-73. See also Y. Brozen, "Foreward" to John Agria, The Federal College Housing Program (Washington D.C.: American Enterprise Institute, 1971).

It appears that we have reached that point with respect to the very highest tax brackets in the federal income tax code. The upshot is that the very highest tax brackets are self-defeating, from the point of view of increasing government revenues. We could collect more taxes from individuals in these tax brackets by lowering their tax rates. In general,

- In order for government to collect the greatest amount of taxes from high-income individuals, the highest tax rate should not exceed 43 percent.[10]

- Yet combined federal, state and local income tax rates in the U.S. today range from a low of 50 percent in Texas, Florida, Wyoming, Nevada and South Dakota (states which have no state income tax) to a high of 68.3 percent in New York City.[11]

Progressive Taxes and the Distribution of the Tax Burden

A common myth about the U.S. income tax system is the belief that steeply progressive income tax rates cause the rich to bear a larger share of the tax burden, whereas less progressive tax rates cause the rich to bear a smaller share of the tax burden. In fact, experience shows that just the opposite has been true throughout the 20th century.

Take the period of the 1920s, for example. Between 1921 and 1926 the tax system became increasingly less progressive, with the highest tax rate falling from 73 percent to 25 percent.[12]

- Although people earning more than $100,000 (1929 dollars) saw their tax rates fall by almost two-thirds, their share of total federal income taxes rose from 28 percent to 51 percent of government revenues.

- Over the same period, the share of total taxes paid by people earning less than $10,000 fell from 23 percent to five percent.

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[10] Lawrence Lindsey, "Estimating the Revenue-Maximizing Top Personal Tax Rate," (Cambridge, Massachusetts: National Bureau of Economic Research Working Paper No. 1761).

[11] Bruce Bartlett, "Reagan's Tax Revolution: Ending the Free Ride for State and Local Taxes," Issue Bulletin No. 114, (Washington, D.C.: The Heritage Foundation, June 14, 1985).

[12] James Gwartney and Richard Stroup, "Tax Reductions, Incentive Effects, and the Distribution of the Tax Burden" (unpublished manuscript, 1982).

In the 1930s, the same phenomenon occurred in the opposite direction:[13]

- In 1931, the top marginal tax rate was raised from 25 percent to 63 percent.
- Yet the share of total taxes paid by people earning more than $100,000 (1931 dollars) fell from 47 percent to 36 percent.
- At the same time, people earning less than $10,000 saw their share of total taxes rise from eight percent to 22 percent.

The phased-in tax reductions that took place between 1963 and 1965 further illustrate that less progressivity in tax rates leads to more progressivity in tax payments.[14]

- In 1963, when the top tax rate was 91 percent, the top five percent of taxpayers paid 35.6 percent of all income taxes.
- By 1965, when the top rate had been lowered to 70 percent, the top five percent of taxpayers paid 38.5 percent of all income taxes.

In 1982, a similar experience occurred with a reduction from 70 to 50 percent in the top rate:

- The income tax collected from the top 1.4 percent of taxpayers rose from 20.4 percent of all revenues in 1981 to 21.8 percent in 1982.[15]
- The burden on the bottom 50 percent of taxpayers dropped from 7.6 percent of all revenues to 7.0 percent.[16]

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[13] Ibid.

[14] Ibid.

[15] Most of the increase in share of taxes paid came from the top 80,000 taxpayers. Their share rose from 8.5 percent to 9.7 percent. See Lawrence Lindsey, "Taxpayer Behavior and the Distribution of the 1982 Tax Cut," (Cambridge, Massachusetts: National Bureau of Economic Research Working Paper No. 1760, 1985).

[16] James Gwartney and Richard Stroup, "The Redistributionist Tax Reduction," Wall Street Journal, June 26, 1984. The share of income taxes paid by the bottom 50 percent rose from 6.5 percent in 1978 to 7.6 percent in 1981. The share paid by the bottom 75 percent rose from 26.4 to 28.4 percent. These changes occurred as income tax rates on the top 25 percent increased as a result of bracket creep caused by inflation. Meanwhile, the share paid by the top 25 percent dropped from 73.6 percent in 1978 to 71.6 in 1981. "Highest Earning Half of Population Pays 90 Percent of All Federal Income Taxes," Tax Foundation's Tax Features, Vol. 29, No. 5 (May, 1985), p. 1.

Although tax rates were less progressive in 1983 than in 1981, tax payments were more progressive.[17]

TABLE II

Tax Rates and Tax Payments
1921 and 1926

Income Grouping (1929 Dollars)	Range of Marginal Tax Rate on Joint Return		Share of Tax Revenues Contributed	
	1921	1926	1921	1926
Less than $10,000	9-11%	3-5%	22.5%	4.6%
$10,000 to $25,000	12-19%	6-12%	17.6%	9.9%
$25,000 to $50,000	19-31%	12-18%	15.7%	15.4%
$50,000 to $100,000	32-56%	18-24%	16.1%	19.2%
Over $100,000	60-73%	25%	28.1%	50.9%

Source: James Gwartney and Richard Stroup, "Tax Reductions, Incentive Effects, and the Distribution of the Tax Burden," (unpublished manuscript, 1982)

[17] Richard Vedder and Lowell Gallaway, "Soaking the Rich Through Tax Cuts," Wall Street Journal, March 21, 1985.

TABLE III

Tax Rates and Tax Payments
1931 and 1932

Income Grouping (constant 1931 dollars	Range of Marginal Tax Rate on Joint Return		Share of Tax Revenues Contributed	
	1931	1932	1931	1932
Less Than $10,000	1.5-5%	4-9%	8.0%	21.7%
$10,000 to $25,000	6-12%	10-18%	13.0%	14.8%
$25,000 to $50,000	12-18%	18-30%	16.3%	13.0%
$50,000 to $100,000	18-24%	31-55%	18.2%	14.1%
Over $100,000	25%	56-63%	44.6%	36.4%

TABLE IV

Effect of 1965 Tax Rate Reduction

Income Group	Adjusted Gross Income Interval (1963 dollars)		Share of Income Taxes Collected from Group	
	1963	1965	1963	1965
Bottom 50 percent	$0 - $ 4,704	$0 - $ 5,148	10.4%	9.5%
50 to 75 percentile	$4,704 - $ 7,620	$5,148 - $ 8,426	20.8%	20.0%
75 to 95 percentile	$7,620 - $13,667	$8,426 - $15,000	33.2%	32.1%
Top 5 percent	above $13,667	above $15,000	35.6%	38.5%

Source: James Gwartney and Richard Stroup, "Tax Reductions, Incentive Effects, and the Distribution of the Tax Burden," (unpublished manuscript, 1982)

TABLE V

Effect of 1982 Tax Rate Reduction

	Income Tax Collected (billions)		Share of Income Taxes Collected from Group	
	1981	1982	1981	1982
Bottom 50 percent	$21.7	$19.5	7.6%	7.0%
50 to 75 percentile	$59.0	$55.6	20.8%	20.1%
75 to 98.6 percentile	$145.4	$141.3	51.2%	51.0%
Top 1.4 percent	$58.0	$60.5	20.4%	21.8%

Source: James Gwartney and Richard Stroup, "The Redistributionist Tax Reduction," Wall Street Journal, June 26, 1984.

THE COST OF PENALIZING SAVING: $105 BILLION

A fundamental principle of economic theory is that in order to have a higher rate of economic growth, there must be more investment. In order to have more investment, there must be more saving. Government policies that discourage saving, therefore, are policies that result in lower rates of economic growth. That means that Americans enjoy a lower average income today than they otherwise would have.

The income tax system, as it currently is structured, biases the choice between consumption and saving. When a dollar is saved, the interest or investment income from that saving is subjected to taxes. Yet our federal income tax system imposes no similar penalites on the enjoyment we receive when a dollar is consumed. In this way, the tax system encourages consumption and discourages saving.

How severe is the problem? According to one estimate:[18]

- The annual cost to the economy as a result of a tax system that distorts the choice between consumption and saving is 2.5 percent of GNP.
- That equals about $105 billion in 1986 dollars.

Investment, Saving and the Distribution of Income

As in the case of the progressive income tax, one of the justifications given for taxing saving is that it leads to a more equal distribution of income. This popular conception turns out to be wrong. In general, more saving and more investment leads to a more equal distribution of income. Conversely, less saving and less investment tends to make the distribution of income more unequal.

The share of national income received in the form of wages (as opposed to income from investments) in the United States increased in the 40 years from 1929 to 1969, continuing a rise that began long before 1929. During this period, division of income between labor (wage income) and capital (investment income)

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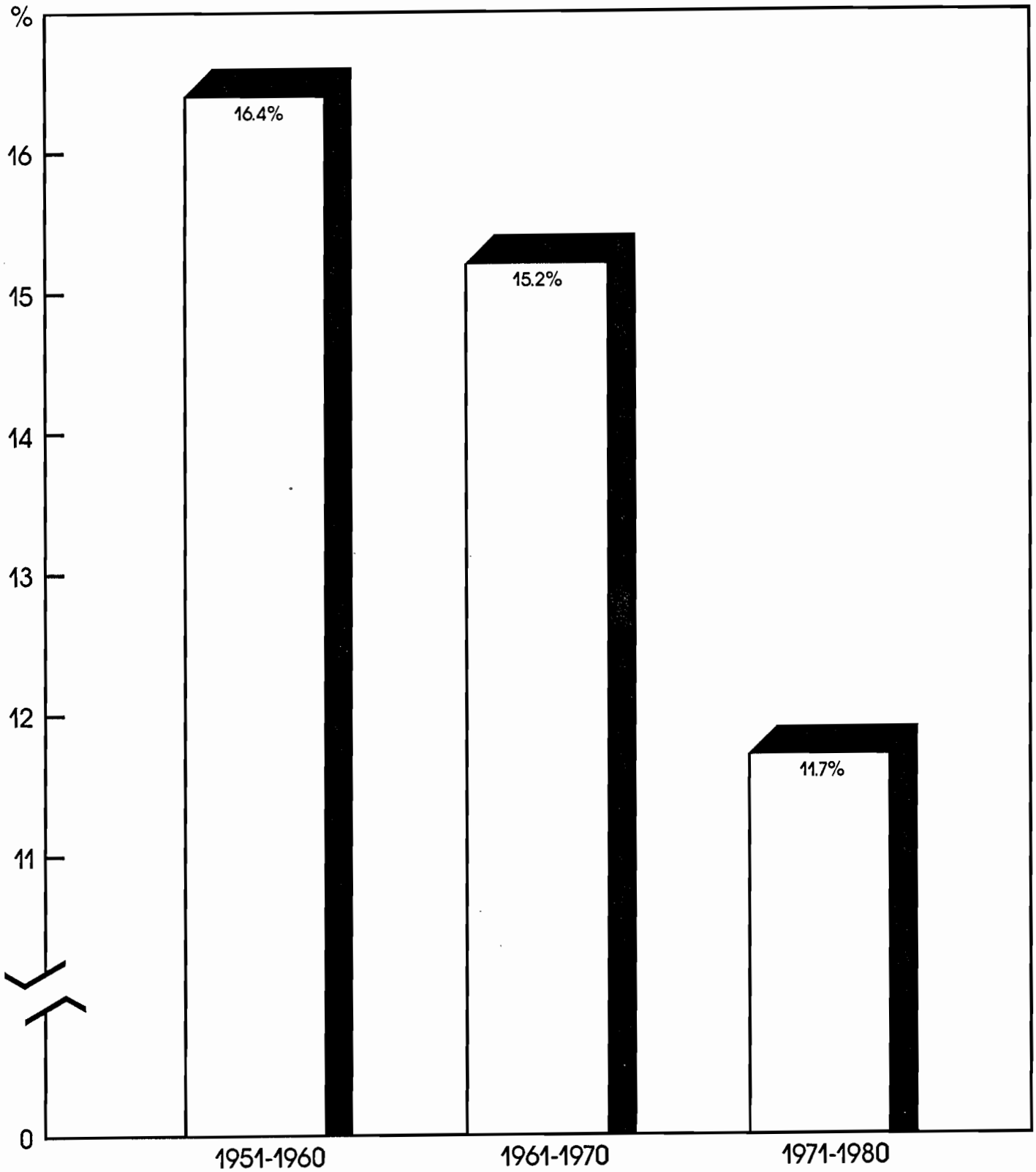
[18] Michael Boskin, "Taxation, Saving, and the Rate of Interest," Journal of Political Economy, Vol. 86, No. 2, Part 2 (April 1978), p. 19.

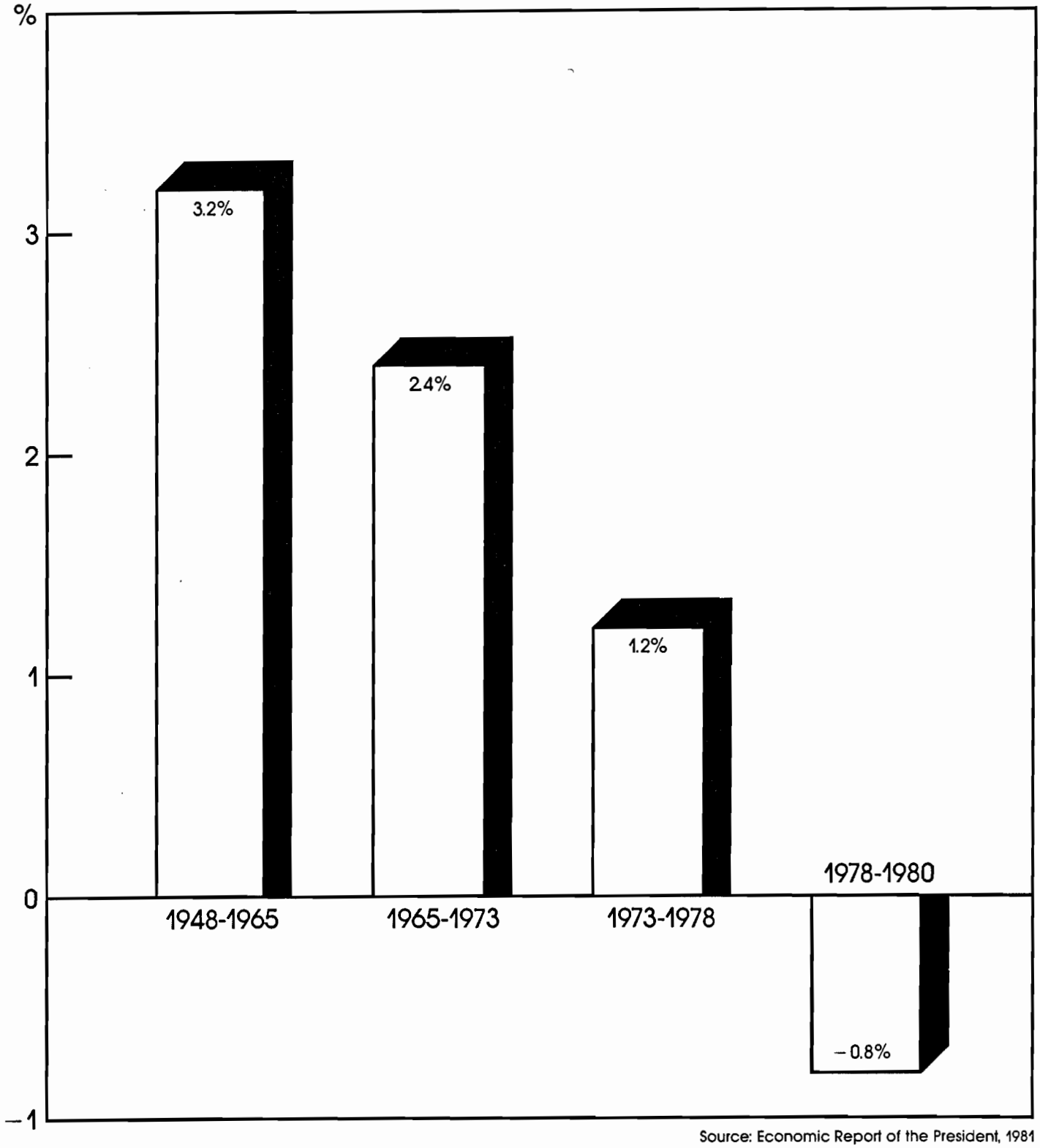
DECLINING U.S. SAVINGS RATE

Net National Savings as a Percent of Net National Product



Source: Economic Report of the President, 1982

DECLINING GROWTH IN LABOR PRODUCTIVITY



Source: Economic Report of the President, 1981

became more equal. A high savings rate leading to a high rate of investment plus technological change produced this trend.[19]

- In 1929, when employee compensation amounted to 60 percent of national income, the top five percent of all families ranked by income received 30 percent of national income.

- During the next 40 years, the share of the top five percent declined and the employee share rose.

- By 1969, the employee share of national income reached 72.5 percent, and the top five percent's share dropped to 16.5 percent, half of what it was in 1929.

Since 1969, the employee share and the top five percent share have been relatively stable. From 1929 to 1969, the employee share of national income (including income of the self-employed) rose at a rate of 3.2 percentage points per decade. From 1969 to 1979, the rate of rise slowed to 0.3 of a percentage point. This is also the decade in which the savings rate declined. Net national saving dropped from 16 percent of net national product to 12 percent, the growth in capital per employee dropped from three percent annually in the early part of the decade to zero, and the growth in average output per worker hour dropped from a three percent annual rise to less than one percent. It is evident that the 1970s saw a marked change in the trends shaping incomes in the U.S. economy.

Why is it that more investment and more capital lead to a more equal distribution of income? The reason is that capital equipment and labor are complementary. That is, the more capital per worker, the greater the productivity of a worker (and the lower the productivity of capital). Other things equal, a more rapid growth in the quantity of capital than in the amount of labor

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[19] Labor's share (including the income of self-employed people) of national income rose from 69.9 percent in 1899 to 72.3 percent in 1929. By 1957, it rose to 81.3 percent. The price of capital relative to the price of labor dropped from 1.43 in 1899 to 1 in 1929 to 0.43 in 1957. See John W. Kendrick, Productivity Trends in the United States, (Princeton, New Jersey: Princeton University Press, 1961), p. 121. Labor's share of income originating in the private domestic business economy (including income earned by the self-employed) rose from 67.3 percent in 1929 to 72.5 percent in 1966. See Kendrick, Postwar Productivity Trends in the United States, 1948-1969 (New York: National Bureau of Economic Research, 1973), p. 72.

causes a rise in the productivity of labor and in the wage rate. It also causes a fall in the productivity of capital and in the rate of return on capital.[20]

For example,

- If the stock of capital in the United States were doubled with no increase in the quantity of labor and no change in the technology available, national income would rise 26 percent.

- About four percentage points of the increase in national income would go to the providers of capital and 22 percentage points would go to the providers of labor services.

A doubled stock of capital would increase the total income of property owners by about 20 percent. It would, however, reduce the rate of return on capital by about 40 percent. At the same time, the real wage of labor would rise by 27.5 percent.[21]

Removing penalties on saving, therefore, would lead to more equality, not less equality in the distribution of income. In fact, one economist has estimated that if we completely abolished taxation of income from capital, the share of national income received by the owners of capital would fall by about 15 percent.[22]

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[20] Both Joseph Schumpeter and John Maynard Keynes believed that the inherent forces in a capitalist system eventually cause all income to go to providers of labor services. Schumpeter characterized this tendency as the result of the "suicidal stimulus of profits." He believed that the tendency of capitalists to invest in any profitable field caused supplies to increase and prices to drop. As a consequence, he said, profits tend toward zero in the absence of innovation. (Joseph Schumpeter, Business Cycles, New York: McGraw-Hill, 1939, p. 105.) Keynes believed that returns to capital would drop to zero in "one or two generations." (John M. Keynes, The General Theory of Employment, Interest, and Money, New York: Harcourt, Brace and Company, March, 1936) p. 376.

[21] This principle also helps to explain why American investment in developing countries, far from resulting in worker exploitation, actually benefits native workers more than it benefits the investors. See Yale Brozen, "The Use of Capital in Developing Areas," Revista Brasileira de Economia, Ano 9, Numero 3 (Septembro de 1955); "The Path to Industrialization," Contribucoes a Analise de Desenvolvimento Economica, (Rio de Janeiro: Livaria AGIR Editora, 1957), pp. 69-96.

[22] Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," Journal of Political Economy, Vol. 86, No. 2, Part 2 (April 1978), pp. S21-S22.

THE COST OF LABOR POLICY: $50 BILLION

Government policies governing trade unions and labor relations also cause harm to our national economy. In the short run, labor unions and minimum wage laws can and do win wage increases for a small part of the labor force. However, wage increases won in this way cause unemployment among other parts of the labor force and cause labor's share of national income to be lower in the long run.

Part of the cause of current unemployment, particularly in the auto and steel industries in the United States, is union victories in the past three decades.[23]

- In the auto and steel industries, workers were paid 15 to 20 percent more than the average manufacturing worker in the 1940s.

- Over time, that wage premium kept rising. In more recent times, auto and steel workers have been paid from 78 to 81 percent more than other manufacturing workers.

- Unionized employees in the transit industry, who formerly were paid the same wage as manufacturing workers, now receive wages that are 33 percent higher than those of the average manufacturing worker.

These wages increase the income of workers lucky enough to keep their jobs, but they cause unemployment or displacement of other workers and depress wage rates in other industries. They also cause an inefficient allocation of both capital and labor, a slowing of the growth of the capital stock, and a slowing in the long-run rate of rise in employee real earnings.

The historical record shows that in every period when wage levels were kept artificially high, there was a rise in the unemployment rate. By contrast, when wage levels move closer to their natural level there always is a reduction in the unemployment rate. This can be seen by looking at those time periods when changes in wage rates did not match changes that were occuring in the economy as a whole. For example,

- Between 1929 and 1933, wage rates fell only half as rapidly as GNP. As a result, the unemployment rate rose from 3.2 to 24.9 percent.

- From 1933 to 1948, wage rates rose 202 percent while GNP rose 365 percent. As a result, employment rose 51 percent and the unemployment rate fell to 3.8 percent.

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[23] Marvin H. Kosters, "Disinflation in the Labor Market," in William Fellner, Essays in Contemporary Economic Problems: Disinflation, (Washington D.C.: American Enterprise Institute, 1984), p. 259.

In 1949, wage rates rose four percent while GNP fell by 0.5 percent. The unemployment rate increased to 5.9 percent. The overly rapid rise in wage rates between 1979 and 1982 increased the unemployment rate from 5.8 percent to 9.7 percent. And so the story goes.

We could allow the market to operate free of government interference by repealing the minimum wage law, the Fair Labor Standards Act, the Davis-Bacon Act, the Walsh-Healy Act, the Wagner Act, Section 13c of the Urban Mass Transit Act, and subsidies to the shipping and mass transit industries. If we did these things, there would be far less unemployment and higher real incomes in the U.S. today. The annual cost of these policies is approximately $50 billion.

Labor Policy and the Distribution of Income

As in the case of other policies we have examined, one of the arguments used to justify U.S. labor policies is that they create a more equal distribution of income in society as a whole. In fact, the reverse is generally true. Policies which help some workers obtain higher than market-clearing wages cause other workers to be unemployed and depress wages in other markets. This leads to more income inequality than there otherwise would be.

In general,[24]

- Each period in which the employee share of national income rose above the trend dictated by the rising capital stock was also a period in which the division of income among U.S. families became more unequal.

- Each period in which the employee share of national income moved back toward the trend dictated by the rising capital stock was also a period in which the division of income among U.S. families became more equal.

Over the long run, rising employee income shares have diminished differences in income, but pushing it up too rapidly in the short run increases inequality. Impatience in achieving higher wage rates defeats itself. It may increase nominal wage rates, but it decreases real wage rates and equality.

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[24] The index measuring inequality in the division of income rose from 415 in 1948 to 421 in 1949, as employee share of national income rose from 64.2 percent to 66.0 percent. From 1952 to 1954, the index rose from 408 to 415 as employee share rose from 67.3 to 68.4 percent. From 1969 to 1971, the index rose from 403 to 409 as the employee share increased from 72.5 to 73.4 percent. Unemployment and its Effect on Family Income in 1980, (Washington: U.S. Bureau of Labor Statistics, 1982, Bulletin 2148.) The employee or labor share of national income is not the key variable influencing employment levels. We give it notice in this discussion because it is central to the goals of union leaders and Marxian socialists. See, for example, Andrew Healey, "Labour's Share and Profitability Crisis in the United States: Recent Experience and Post-War Trends" (Coventry, Great Britain: Warwick Economic Research Papers No. 269, Nov. 1985).

THE COST OF INCOME TRANSFER POLICIES: $20-25 BILLION

Economists have long known that if you tax an activity there will be less of it, and if you subsidize an activity there will be more of it. In the U.S. today, we tax employment and subsidize unemployment. With few exceptions throughout the post-war period both the taxes and subsidies have steadily risen. As a consequence, we have had progressively less work and more non-work.

Today, there are a large number of people who have left jobs and taken a one-third cut in income, on the average, in order to collect disability pensions, Aid to Families with Dependent Children, general welfare allowances, early retirement pensions under Social Security, and unemployment compensation.[25] As a result of this withdrawal from the labor force, families in the bottom one-fifth of the income distribution have less real income and a smaller share of national income than they otherwise would have.[26]

THE COST OF REGULATORY POLICIES: $43 BILLION +

Government intervention in specific markets in the United States is widespread. It ranges from setting price floors for commodities such as corn and wheat, to regulating the design of automobiles, to setting prices for electricity, gas and local telephone and water service. Some of the interventions are aimed at providing economic security for producers, some at preventing pollution of the environment, and some at maintaining low prices for consumers.

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[25] Donald O. Parsons, "The Decline in Male Labor Force Participation," Journal of Political Economy, Vol. 88, No. 1 (Feb. 1980); C.T. Brehm and T.R. Saving, "The Demand for General Assistance Payments," American Economic Review, Vol. 54, No. 6 (Dec. 1964); Arlene Holen and Stanley Horowitz, "The Effect of Unemployment Insurance and Eligibility Enforcement on Unemployment," Journal of Law & Economics, Vol. 17, No. 2 (Oct. 1974); James Gwartney and Thomas S. McCaleb, "Have Antipoverty Programs Increased Poverty," Cato Journal, Vol. 5, No. 1 (Spring/Summer 1985).

[26] Edgar R. Browning, Redistribution and the Welfare System (Washington D.C.: American Enterprise Institute, 1975). Also, see Y. Brozen, "Welfare Without the Welfare State," Il Politica, Vol. 32, No. 1 (1967), pp. 135-136. For a compendium of the reasons why attempts to redistribute income may have a perverse effect, see J.E. Stiglitz, "Equality, Taxation and Inheritance," in W. Kreble and A. Shorrocks (eds.), Personal Income Distribution (Amsterdam: North-Holland, 1978). Also, see Martin Feldstein, "Social Insurance," in Colin D. Campbell (ed.), Income Redistribution (Washington, D.C.: American Enterprise Institute, 1977). For a summary discussion of the behavior of income shares, see Richard B. McKenzie, "Taxation and Income Redistribution," Cato Journal, Vol. 1, No. 2 (Fall, 1981).

Agricultural Policies. In their attempts to create greater security for farmers, workers, and the unfortunate victims of unforeseen changes or accidents, politicians have designed policies that often create greater insecurity. Perhaps the foremost example is the 1981 Agriculture Act. Under the act, prices for agricultural commodities were set at artificially high levels. This caused increased agricultural production in the U.S. and at the same time made American farm products less attractive to foreign buyers. In addition, agricultural production outside of the United States also was stimulated by the high prices set by the U.S. government. As a result, foreign markets for U.S. produce now have been permanently pre-empted by foreign producers[27] and American agriculture now has more excess capacity than ever before.

- Overall, U.S. agricultural policies result in annual payments of about $22 billion to farmers by the federal government.
- Of this $22 billion, about $12 billion adds to the real income of farmers.
- The remaining $10 billion is pure economic waste.

In addition to the incentives created by the high price supports set for the 1981-1985 period, farmers also were encouraged to borrow money and buy additional land. Changes in federal law prompted some Farm Land Banks to grant liberal loans on land whose price was inflated because of these easy loans. As foreign markets disappeared, the price of land fell. In many cases the land was no longer valuable enough to serve as full collateral for some of the loans that were made. As a result, government policy created a financial disaster for many farmers and the private banks that made agricultural loans.[28]

Trade Policies. To provide job security for American workers in import-competing industries, the federal government negotiated "voluntary restraints" on the import of Japanese automobiles into the U.S., and on the import of textiles and steel into the U.S. It also imposed tariffs on imported tuna. This

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[27] John Antle, World Agricultural Development and the Future of U.S. Agriculture (Washington D.C.: American Enterprise Institute, forthcoming).

[28] This is not the first of government agricultural policies that created unintended results and were counterproductive. It seems obvious that subsidizing the use of fertilizer and machinery would help farmers by reducing their costs of production. What seemed so obviously true turned out to be untrue. The increased output with subsidies drove prices down with the result that farmers were not better off. Those who were tenants, obtaining their return from their labor, were worse off because labor value was decreased by the substitution of fertilizer and equipment. Landowners were worse off because the return from their land decreased. (Fertilizer and equipment are substitutes for land as well as labor.) D. Gale Johnson, "Output and Income Effects of Reducing the Farm Labor Force," Journal of Farm Economics, Vol. 42 (November 1960); "Labor Mobility and Agricultural Adjustment," in E.O. Heady, H.G. Diesslin, H.R. Jensen, and G.L. Johnson, eds., Agricultural Adjustment Problems in a Growing Economy (Ames, Iowa: Iowa State College Press, 1958), p. 170.

reduction of imports into the U.S. resulted in foreigners having fewer dollars with which to buy U.S. exports. As a result, export industries (including agriculture) found it difficult to maintain their foreign sales, causing job insecurity for their workers.

According to studies done by the Federal Trade Commission,

- The annual cost to consumers of the restraint on imports of Japanese automobiles was approximately $241,000 per U.S. job saved.
- Tuna tariffs cost the U.S. consumer $240,000 annually per job saved.
- The cost to consumers per job saved by steel quotas was $114,000, and for textiles it was $43,000.

In effect, consumers were taxed to save jobs in these industries. But jobs in other industries from which consumers would have bought goods (were it not for the taxes they paid) were destroyed.

On the average:

- For every two jobs saved in the protected industries, three jobs were lost in other industries.
- The total annual cost to the U.S. economy of all tariffs and quotas is $8.52 billion (1983 dollars).[29]

Regulation of Emissions. Government intervention to protect the environment seems to be justified in cases such as the emission of pollutants. Yet we have achieved our goals in a very costly way. The United States has chosen to compel manufacturers to design automobiles with low emissions. During the early years, there was some positive net benefit to the economy as a whole:

- Reducing auto emissions by 90 percent in the 1970s produced annual benefits worth about $10 billion.
- The annual cost of these regulations was $8 billion, producing a net gain of $2 billion.

This policy, however, created about $4 billion worth of waste. Most of the harmful effects of emissions occur in a few major metropolitan areas, such as Los Angeles and Chicago. Yet we impose the same federal regulations on all automobiles, regardless of where they are located. By loosening control standards

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[29] David G. Farr and Morris E. Morkre, Aggregate Costs to the United States of Tariffs and Quotas on Imports (Washington, D.C.: Federal Trade Commission Bureau of Economics, December 1984), p. 2.

in areas where no pollution problems exist, the cost of emission control could be cut in half with no loss in benefits.[30]

New regulations in the 1980s have become even more irrational.

- The tightening of emission standards in 1979 and 1980 added another $5 billion to costs, but produced less than an additional $1 billion in benefits.

- As a result, the United States is spending about $13 billion annually (about $9 billion more than is necessary) to produce $8 to $9 billion worth of benefits.[31]

The 1977 amendments to the Clean Air Act require costly scrubbers to be used by new, coal-burning, electric power plants, regardless of the sulphur content of the coal used. (The higher the sulphur content, the "dirtier" the coal.) These 1977 regulations will produce more sulphur oxide emissions than the less costly alternative of allowing the use of low-sulphur coal as a means of controlling pollution. We deliberately replaced the pre-1977 regulations, which were less costly and which resulted in less pollution, with new regulations which are more costly and which will increase pollution.

The apparent motive behind the 1977 regulations was political. In general, eastern coal mines in the U.S. tend to contain coal with a much higher sulphur content than coal mines in western states. Owners of the eastern mines and their employees were fearful that they would lose out in the competition with western coal if power plants were left free to reduce sulphur emissions in the least costly way. By forcing all new power plants to purchase scrubbers, the law removed any incentive for power plants to choose low-sulphur western coal, rather than high-sulphur eastern coal. The 1977 regulations did produce an economic benefit for the owners of eastern coal mines and the miners who are employed there. But this gain is minuscule compared to the cost to users of

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[30] One reason why environmental regulations tend to be applied nationwide is political. Firms in more polluted areas persuaded politicians to impose costly burdens on firms in less polluted areas in order to keep their rivals from having a competitive advantage. See B. Peter Pashigian, The Political Economy of the Clean Air Act: Regional Self-Interest in Environmental Legislation (St. Louis: Center for the Study of American Business, Washington University, 1982).

[31] For an analysis of the politics involved in this decision, see Howard Margolis, "The Politics of Auto Emission," The Public Interest, No. 49 (Fall 1977).

electricity, which will amount to at least $3.4 billion a year by the year 2000, in addition to the harmful affects on the health of those who suffer by breathing.[32]

Regulating automobile and electric generating plant designs is the most costly method for accomplishing a specified amount of emissions reduction. By simply placing a tax on sulphur emissions and leaving power plants free to reduce emissions in the most economical way, the same reduction in emissions could be achieved at a much lower social cost. A tax imposed locally in the case of automobiles, (since auto emissions are a local problem) and nationally on electric-generating plants would minimize the costs of achieving a desired level of atmospheric purity. Alternatively, and preferably, transferable emission "tickets" could be issued permitting only the amount of emissions consistent with the desired objectives, but again leaving producers free to achieve the objective in any way they like.[33]

Regulation of Pharmaceutical Innovation. In 1962, the Food and Drug Act was amended to require proof of efficacy before a new drug is allowed on the market. The result was: (1) a reduction by more than 50 percent in the number of new chemical entities reaching the pharmaceutical market, (2) no reduction in the incidence of ineffective drugs, (3) a doubling of the cost of research, (4) less replacement of dangerous drugs with safer drugs, (5) higher prices for pharmaceuticals, and (6) more sickness and death. The net losses resulting from the new regulation amount to $800 million (1986 dollars) in additional sickness and death resulting from delays in the marketing of new and effective drugs, and $8.1 billion in unnecessary research and development costs.[34]

ICC Per Diem Rate Regulation. The Interstate Commerce Commission (ICC) requires railroads to accept each others' loaded cars and to pay each other rent (per diem) for those cars. But rather than let these rental rates be determined in a market, the ICC prescribes the rates. Per diems, as a consequence, are a politically determined price.

As a result of Congressional pressures, the ICC has adopted a formula that sets rates above the market-clearing level. The formula contains a perverse feature that produces higher per diem rates when there is a surplus of cars, while a shortage of cars leads to lower rates--a response that is precisely opposite of a normal market. Freightcar production has responded to these incentives. As a consequence, there is now a surplus of more than 80,000 boxcars and an additional surplus of specialized cars. Unneeded investment in rail cars exceeds $3.2 billion.

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[32] Paul R. Portney, "How Not to Create a Job," (Washington D.C.: American Enterprise Institute, Regulation magazine, Vol. 6, November/December, 1982), p. 35.

[33] Charles Upton, The Economics of Pollution (Chicago: Graduate School of Business, University of Chicago, 1970).

[34] Sam Peltzman, Regulation of Pharmaceutical Innovation: The 1962 Amendments (Washington: American Enterprise Institute, 1974).

In addition to this waste of capital, railroads now go to great effort to get "foreign" cars off their lines to avoid these high per diem payments. Empty mileage has skyrocketed in the last several years and hundreds of millions of dollars of unnecessary expense in moving empty cars has been caused. The total net loss from above-market per diem rates is estimated to be in excess of $1.2 billion.[35]

Alaskan Oil. Congress forbids the exportation of Alaskan oil to foreign countries. Consequently, oil produced in Alaska must be shipped through the Panama Canal to Gulf and East Coast ports in the U.S. In the absence of this restriction, the international oil market would behave quite differently. It would be less costly for Japan to purchase Alaskan oil and for East Coast and Gulf Coast refineries to buy oil from other sources in the international marketplace. In general,[36]

- The restriction on the sale of Alaskan oil to Japan unnecessarily increases transportation costs by about 150 percent.
- The total cost of this restriction to the U.S. economy is about $1 billion a year.

Other Regulatory Policies. To mitigate the suffering from misfortune, we have reshaped tort law to force "involuntary good samaritans" to assume the burden of supporting those who carelessly use a product or operate a machine and injure themselves. In the United States, product liability law has run amok.[37] Government also enacts ex post facto laws that change existing contracts between

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[35] Yale Brozen, "Time to Pull the Plug on the ICC" (unpublished manuscript, 1985); "The Per Diem Rate," The School of Business Newsletter (University of Chicago), Vol. 5, No. 3 (Spring, 1958), reprinted in E.E. Nemmers and J.H. Myers, Business Research: Text and Cases (New York: McGraw-Hill Book Co., 1966); Warren Brookes, "The Great Boxcar Robbery," The Washington Times, April 30, 1986.

[36] U.S. General Accounting Office, Pros and Cons of Exporting Alaskan North Slope Oil (GAO/NSIAD-83-69, Sept. 26, 1983).

[37] Richard S. Higgins, "Product Liability Insurance, Moral Hazard, and Contributory Negligence, Journal of Legal Studies, Jan. 1981: Richard A. Epstein, "Manville: The Bankruptcy of Product Liability," Regulation, Vol. 6, No. 5 (Sept./Oct. 1982).

employers and employees. In addition, it regulates the promotion of workers and the choice of employees, overriding the market that has "failed" to avoid discrimination.[38]

THE COST OF ANTITRUST LAW

Antitrust laws in the United States also are costly.[39] Although they presumably are aimed at preserving the benefits of competition for consumers, the fact is that most of the ways antitrust laws are applied are anticompetitive.[40] Where the applications are procompetitive, the results frequently cause inefficiency.[41]

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[38] Discrimination in the marketplace is in part due to the government's regulation of entry and prices, which reduce or eliminate the cost of discrimination to the discriminator. Free markets make it costly to discriminate. Harold Demsetz, "Minorities in the Market Place," North Carolina Law Review, Feb. 1965; Thomas Sowell, Markets and Minorities (New York: Basic Books, 1981); Walter E. Block and Michael A. Walker, eds., Discrimination, Affirmative Action, and Equal Opportunity (Vancouver, Canada: Fraser Institute, 1981).

[39] The antitrust laws have had macro as well as micro consequences. Shughart and Tollison estimate that each one percent increase in annual enforcement activity over the 1947-1981 period added about 7,000 to the number of unemployed persons. "The Employment Consequences of Antitrust" (unpublished manuscript, 1983).

[40] Thomas Hazlett, "Is Antitrust Anticompetitive," Harvard Journal of Law and Public Policy (forthcoming); William J. Baumol and Janusz A. Ordover, "Use of Antitrust to Subvert Competition," Journal of Law and Economics, Vol. 28 (May 1985); Yale Brozen, "Some Behavioral Consequences of Antitrust," Management Discretion and Antitrust (New York: Conference Board Research Bulletin No. 179, 1985). For an instance in which the application of the antimerger laws cost $20 million and 1,500 jobs, see A.F. Ehrbar, "The Needless Death of Federal Glass," Fortune, July 2, 1979.

[41] George Bittlingmayer, "Decreasing Average Cost and Competition: A New Look at the Addyston Pipe Case," Journal of Law & Economics, Vol. 25 (October, 1982), pp. 201-229; Donal Dewey, "Information, Entry, and Welfare: The Case for Collusion," American Economic Review, Vol. 69 (September, 1979), pp. 587-594.

In general, mergers increase efficiency in the use of assets and the efficiency and productivity of the economy.[42] On average, acquirers offer to buy out shareholders by paying 50 percent more than the market price of their shares.[43] Why do buyers find the assets of the target companies to be worth more to them than to the current shareholders?

Merger opponents argue that the returns to the combined firms are larger than those before the merger occurred because of the monopoly power of the new combination. The result, they maintain, is social inefficiency in the form of reduced output and higher prices.

Only anecdotal evidence is offered for this assertion.[44] Systematic evidence points in the opposite direction. The data show that the gains from mergers and from increases in concentration are a result of improved efficiency and productivity, not of output restriction and higher prices.[45]

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[42] See Yale Brozen, Concentration, Mergers and Public Policy, (New York: Macmillan, 1982), pp. 56-75 and 350-358. Also, see Y. Brozen, Mergers in Perspective (Washington D.C.: American Enterprise Institute, 1982) and Paul Asquith, A Two-Event Study of Merger Bids, Market Uncertainty, and Stockholder Returns (Ph.D. dissertation, Graduate School of Business, University of Chicago, 1980).

[43] From 1955 through 1976, premiums averaged 25 percent on the price prevailing before each merger or tender offer announcement. Premiums have trended upward since 1976, reaching 50 percent by 1979. In 1984, premiums averaged 38 percent.

[44] See, for an example of an individual instance, David M. Barton and Sherman Rosen, "The Price and Profit Effects of Horizontal Merger: A Case Study," Journal of Industrial Economics, Vol. 3, No. 2 (December, 1984), pp. 165-177. Also see Richard Zerbe, "The American Sugar Refining Company, 1887-1914: The Story of a Monopoly," Journal of Law & Economics, Vol. 12 (October, 1969).

[45] John McGee, In Defense of Industrial Concentration (New York: Praeger, 1971); Harold Demsetz, The Market Concentration Doctrine (Washington D.C.: American Enterprise Institute, 1973); J.R. Carter, "Collusion, Efficiency, and Antitrust," Journal of Law & Economics, Vol. 21 (1978). Also, see E. Woodrow Eckard, Jr., "Industrial Concentration, Plant Scale Economies, and Multi-Plant Operations: Further Evidence," Review of Business and Economic Research, Vol. 16, No. 3 (Spring, 1981), pp. 90-97; Mischa Gisser, "Price Leadership and Dynamic Aspects of Oligopoly in U.S. Manufacturing," Journal of Political Economy, Vol. 92, No. 6 (December, 1984), pp. 2035-2048.

The National Industrial Conference Board commissioned a study of the turn-of-the-century mergers and their consequences. The study found that the customers of industries with large consolidations benefited relative to the customers of those industries with minor consolidations or none.

- In 26 industries where important consolidations took place and for which price data were available, prices fell by 13 percent from 1900 to 1913.
- In 20 industries in which no consolidations occurred, prices rose by 10 percent from 1900 to 1913.

During the period from 1913 to 1925, when inflation became rampant, [46]

- Prices rose by 49 percent in the 26 industries with major consolidations.
- But in the 20 industries in which no consolidations occurred, prices rose by 96 percent.

Evidently, combinations occurred largely in sectors of the economy where economies could be realized through the merger process. Buyers benefited from the resulting improvements in efficiency and the more favorable prices made possible by greater efficiency.

The consolidations in the 26 industries with this very favorable price experience produced firms whose market shares ranged from 50 to 90 percent. It seems that preventing mergers between firms with market shares of 10 percent or more is far too stringent a policy. Yet that is the current policy of the U.S. Justice Department's antitrust division and the Federal Trade Commission unless there are extenuating circumstances.[47]

In 1968, a White House Antitrust Task Force actually recommended that the United States prevent mergers in industries where four firms collectively have 70 percent or more of all sales. It also recommended breaking up leading firms in those industries--a leading firm defined as one selling more than 15 percent of the product produced by the industry.[48]

Breaking up large firms in such industries would reduce efficiency and cause higher prices. Professor Sam Peltzman demonstrated this in his study of industry experience between 1947 and 1967. He found that, on average, industries in which concentration increased, productivity increased and prices decreased relative

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[46] National Industrial Conference Board, Mergers in Industry (New York: National Industrial Conference Board, 1929), p. 146.

[47] See U.S. Department of Justice, Merger Guidelines (1982), for a description of the extenuating circumstances.

[48] Some members of the White House Antitrust Task Force refused to sign the recommendation and others have retracted their 1968 recommendation. See Yale Brozen, Concentration, Mergers and Public Policy (1982), pp. 388-389.

to the industries whose concentration remained unchanged. Data from the Census of Manufacturers showed that if industries in which the leading four firms collectively produced more than 50 percent of domestic output had their leading firms broken up to reduce concentration to less than 50 percent, costs would rise by 20 percent, on average, and prices would rise by 10 to 15 percent.[49]

The conclusions of Peltzman's study have been confirmed by two other studies using different bodies of data. Professor Steven Lustgarten came to the same conclusion using 1954 and 1972 data.[50] The second study, by Professor Woodrow Eckard, found that among concentrated industries, those in which the degree of concentration increased by more than 10 percentage points had price increases averaging only 89 percent of the overall price increase in all industries. He also found that in concentrated industries, whether concentration did or did not increase, price increases were only 93 percent of the average price increase for all industries.[51]

This information suggests that where horizontal mergers and rising concentration occur in open markets, competition increases, in the sense of falling costs and prices, and buyers benefit.[52] This should not be taken to mean that we should force firms to merge. They voluntarily merge when there are benefits that can be created by a marriage. Some industries are more productive when more concentrated; some are more productive when less concentrated. They will move

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[49] Sam Peltzman, "The Gains and Losses from Industrial Concentration," Journal of Law & Economics, Vol. 20 (October, 1977). Also, see Woodrow Eckard, Jr., "The Role of Efficiency in Changing Industrial Concentration: An Empirical Analysis," (Working paper, University of Colorado at Denver, November, 1985); Michael Smirlock, Thomas Gilligan, and William Marshall, "Tobin's q and the Structure-Performance Relationship," American Economic Review, Vol. 74, No. 5 (December, 1984), pp. 1051-1060.

[50] Steven Lustgarten, Productivity and Prices: The Consequences of Industrial Concentation (Washington, D.C.: American Enterprise Institute, 1983).

[51] E. Woodrow Eckard, Jr., "Concentration Changes and Inflation: Some Evidence," Journal of Political Economy, Vol. 89 (October, 1980), Table 2, p. 1049. Also see William J. Lynk, "Interpreting Rise Concentration: The Case of Beer," Journal of Business, Vol. 57, No. 1 (1984).

[52] Also see B. Espen Eckbo, "Horizontal Mergers, Collusion, and Stockholder Wealth," Journal of Financial Economics, Vol. 11 (1983); Robert Stillman, "Examining Antitrust Policy Toward Horizontal Mergers," Journal of Financial Economics, Vol. 11 (1983) and B.E. Eckbo and Peggy Wier, "Antimerger Policy Under the Hart-Scott-Rodino Act: A Reexamination of the Market Power Hypothesis," Journal of Law & Economics, Vol. 28 (April 1985).

voluntarily to the most efficient structure under the spur of market forces.[53] Public policy toward mergers should be one of neutrality.

The antimerger laws create a "quiet life" for managers. They prevent the migration of assets out of the hands of inefficient managers into more productive uses. They also cause the creation of redundant capacity and waste of capital.[54] This is costly not only to stockholders but also to workers whose productivity and wages would be increased by a more abundant stock of capital.

THE COST OF PUBLIC MONOPOLY: $13 BILLION +

Advocates of big government do not oppose monopolies or large enterprises as such. It is only private concentration they oppose.[55] Government monopolies and government-sponsored monopolies are accepted, and they abound.

Most cities in the United States operate water enterprises that monopolize the supply of water. They operate mass transit systems that monopolize the supply of mass transit services. They sponsor taxi cab and saloon cartels. They monopolize the provision of garbage and trash collection services. Most states

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[53] Concentrated industries in any one country are usually concentrated in other countries and the unconcentrated in any one country are also unconcentrated in other countries. F.L. Pryor, "An International Comparison of Concentration Ratios," Review of Economics and Statistics, Vol. 54 (1972). This provides strong evidence that technology and markets determine an efficient level of concentration in each industry and that mergers for the purpose of creating monopoly have little influence on the level of concentration.

[54] Charles F. Keithahn, The Brewing Industry (Washington, Federal Trade Commission, 1978).

[55] The U.S. Department of Interior appealed the Federal Power Commission's grant of a license to a private utility to develop a water power site on the Roanoke River, arguing to the court that it would be preferable not to develop the site at all rather than to allow private development. Interior was arguing that the license should be granted to a government agency.

grant monopoly status to the providers of electricity, gas, and telephone services, whether they are owned by government or owned privately.[56]

The federal government in the United States also sponsors numerous cartels and monopolies and operates many large enterprises. By law the Postal Service has a monopoly of the delivery of first class mail. Until very recently, operators of trucking services were granted monopolies of certain routes or over carrying specific commodities on those routes. The only airlines allowed to operate, until recently, were those with "grandfather" rights. The federal government continues to sponsor cartels of dairy farmers, citrus growers, tobacco growers, avocado growers, almond growers and numerous other cartels, with a resulting waste of agricultural products and of resources used in agriculture.[57] The federal government also operates the largest electricity generating enterprise and the largest water supply system in the United States.

The magnitude of the waste and inefficiency in these programs is generally unknowable. However, evidence sugggests that:

- Consumers of the U.S. Postal Service, a government monopoly, pay $5 billion more than they would if its monopoly status were repealed.[58]

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[56] Privately owned firms, even with monopoly franchises, operate more efficiently and are more efficacious in designing services to suit consumers than government-owned firms. Sam Peltzman, "Pricing in Public and Private Enterprises: Electric Utilities in the United States," Journal of Law & Economics, Vol. 14 (April, 1971). For an analysis of inefficiences in government-owned enterprises, see Kenneth W. Clarkson, "Some Implications of Property Rights in Hospital Management," Journal of Law & Economics, Vol. 15 (October, 1972); Louis DeAlessi, "An Economic Analysis of Government Ownership and Regulation: Theory and Evidence from the Electric Power Industry," Public Choice, Fall, 1974; Robert O'Brian, "Public Policy Toward Electric Utilities: Overtax and Underprice," Public Utilities Fortnightly, July 21, 1972; Robert Poole, Jr., Cutting Back City Hall (Universe Books, 1970); Richard H. Silkman and Dennis R. Young, Subsidizing Inefficiency: A Study of State Aid and Local Government Productivity (New York: Praeger, 1985), p. vii.

[57] For an analysis of the cost of one of these cartels, see "Costs of Milk Regulation" in Paul MacAvoy, ed., Federal Milk Marketing Orders and Price Supports (Washington D.C.: American Enterprise Institute, 1977).

[58] Douglas Adie, An Evaluation of Postal Service Wage Rate (Washington D.C.: American Enterprise Institute, 1980); John Haldi, Postal Monopoly: An Assessment of the Private Express Statutes (Washington D.C.: American Enterprise Institute, 1974; James C. Miller, "End the Postal Monopoly," Cato Journal, Vol. 5, No. 1 (Spring/Summer 1985).

- The fruit, vegetable and "specialty" crop cartels organized under the agricultural marketing order system create waste exceeding $1 billion.[59]

- Inefficient management of government-owned timber lands creates a loss of $2 billion a year.[60]

- The cost to consumers of mass transit services, electricity, and water provided by government-operated enterprises and by private enterprises that are granted monopoly franchises by government has not been measured, but the bits and pieces of evidence available indicate that the total is at least $5 billion.[61]

CONCLUSION

Space does not permit an analysis here of the numerous ways in which government wastes resources by running and managing a wide array of enterprises that could be run more efficiently by the private sector. For example, studies suggest that there is enormous inefficiency in government operated enterprises such as schools, garbage collection, mass transit, parking lots, power generation

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[59] Thomas M. Lenard and Michael P. Mazur, "Harvest of Waste: The Marketing Order Program," Regulation, Vol. 9, No. 3 (May/June, 1985).

[60] Thomas M. Lenard, "Wasting Our National Forests," Regulation, Vol. 5, No. 4 (July/August, 1981), p. 30.

[61] Gregg Jarrell, "The Demand for State Regulation of the Electric Utility Industry," Journal of Law & Economics, Vol. 21 (October, 1978); Robert Cervero, "Deregulating Urban Transportation," Cato Journal, Vol. 5, No. 1 (Spring/Summer, 1985); Peltzman, "Pricing in Public and Private Enterprises," op.cit. There is an indirect cost to consumers in some instances with no direct cost. Amtrak consumes $1 billion more worth of resources than the value of the services it provides. This causes consumers to do without $1 billion worth of other products that could have been produced but for this waste. Congressional Budget Office, Federal Subsidies for Rail Passenger Service: An Assessment of Amtrak (Washington D.C.: Government Printing Office, 1982).

and distribution, hospitals, fire departments, housing projects, water distribution and street sweeping.[62]

Numerous studies have discovered that by privatizing these activities, federal, state and local governments could save taxpayers a considerable amount of money.[63] For example, one study of local governments in California suggests that city governments could cut expenditures by up to 50 percent by taking full advantage of privatization.[64]

Defenders of government-operated enterprises often argue that there are vaguely-defined benefits to the poor from having government, rather than the private sector, provide the services. In fact, as with so many other policies we have examined, very often the poor are disadvantaged by government management.

Take state-operated higher education, for example. Most state-supported schools are financed by regressive sales taxes, which are more burdensome for the poor than the middle and upper-middle class. Yet the students who attend these colleges and universities, and who enjoy the government subsidies, are disproportionately drawn from middle and upper-middle class families. In addition, because of the requirement that the state subsidy is attainable only by attending an institution within the state, students receive a lower quality of education

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[62] For examples, see Kenneth W. Clarkson, "Some Implications of Property Rights in Hospital Management," Journal of Law & Economics, Vol. 15 (Oct. 1972); Louis DeAlessi, "An Economic Analysis of Government Ownership and Regulation: Theory and Evidence from the Electric Power Industry," Public Choice, Fall 1974; Robert O'Brian, "Public Policy Toward Electric Utilities: Overtax and Underprice," Public Utilities Fortnightly, July 21, 1972; Richard H. Silkman and Dennis R. Young, Subsidizing Inefficiency: A Study of State Aid and Local Government Productivity (New York: Praeger, 1985), p.vii.

[63] Among the earliest works pointing out the cost-reducing benefits of privatization are Robert W. Poole, Cutting Back City Hall (New York: Universe Books, 1980); James T. Bennett and Manuel Johnson, Better Government at Half the Price (Ottawa, Illinois: Caroline House Publishers, 1981) and E.S. Savas, Privatizing the Public Sector (Chatham, New Jersey: Chatham Publishing House, 1982); The first book to explore the political theory behind privatization and examine successful techniques for achieving privatization through the political process is Madsen Pirie, Dismantling the State: The Theory and Practice of Privatization (Dallas, Texas: National Center for Policy Analysis, 1985). For an analysis of how these techniques can be applied in the U.S., see John Goodman, ed., Privatization (Dallas, Texas: National Center for Policy Analysis, 1985). A comprehensive application of these techniques to federal government programs is contained in Stuart M. Butler's book Privatizing Federal Spending: A Strategy to Eliminate the Deficit (New York: Universe Books, 1985).

[64] Barbara J. Stevens, "Comparing Public and Private Sector Productive Efficiency: An Analysis of Eight Activities," National Productivity Review, Autumn, 1984, pp. 395-406.

than they would receive if they could use the same subsidy at educational institutions in other states.[65]

More often than not bad government policies not only make the nation worse off in the sense of a lower national wealth, they all too frequently have their greatest adverse impact on low-income families.

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

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[65] Sam Peltzman, "The Effect of Government Subsidies-in-Kind on Private Expenditures: The Case of Higher Education." Journal of Political Economy, Vol. 81 (Jan.-Feb. 1973). Also, see E.G. West, Education and the State: A Study in Political Economy (London: Institute of Economic Affairs, 1965); Gordon Tullock, Welfare for the Well-To-Do; George J. Stigler, "Director's Law of Public Income Redistribution," Journal of Law & Economics, Vol. 13 (April 1970), pp. 1-10.

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