POLICY REPORT

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The Return of Gasoline Price Wars

by David Glasner

Remember the good old days when gasoline price wars every month or two used to send gasoline prices falling by several cents a gallon practically overnight? (The major oil companies used to get blamed for causing price reductions. Price wars were viewed as a predatory tactic by the majors to eliminate their competition.) Well, thanks to Mr. Reagan's decontrol of crude oil and gasoline prices, the gasoline price wars have begun to make a comeback.

I am aware how outrageous this may sound to those who are convinced that Mr. Reagan's decontrol order of 28 January was responsible for increases in gasoline prices of 8 to 15 cents a gallon. Even those, like the *Wall Street Journal*, who have consistently dissented from the conventional wisdom that controls were reducing prices at the pump were stunned by the alacrity with which refiners and retailers seemed to pass through higher prices immediately after Mr. Reagan's decontrol order.

But a look at what has actually happened as opposed to what people imagine to have happened will more than repay the effort. It will show that, contrary to the conventional wisdom, the price of domestic crude oil had no discernible impact on the price of gasoline.

Consider changes in the retail price of regular gasoline as shown in the boxed insert on p. 3. These are changes that have occurred not just since the decontrol order of 28 January 1981 but since gradual decontrol began in January 1980, at a time when the world price of crude oil was still rising rapidly in response to the permanent reduction in Iranian oil output following the overthrow of the shah.

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But from March to October 1980, while the average cost of imported oil to refiners was nearly stable, the average cost of domestic crude to refiners rose 19% because of phased decontrol. Nevertheless, the retail price of gasoline actually fell by 1% during this period. Moreover, part of the reduction occurred during the peak driving season when the demand for gasoline is greatest and when the price of gasoline usually rises.

"For the better part of 1980 gasoline prices were stable or falling in the face of a substantial increase in the cost of domestic crude oil caused by phased decontrol."

The conventional wisdom holds that controlling the price of domestic crude oil and, as a result, reducing refiner costs, reduces the price of refined products because refiners pass through their cost savings to consumers. It is amazing that many people who believe this also believe that the oil companies are engaged in an ongoing conspiracy to cheat consumers by raising prices. If so, why should they have passed on these lower costs to consumers instead of pocketing them as higher profits? Even more damaging to the conventional wisdom is the brute fact that for the better part of 1980 gasoline prices were stable or falling in the face of a substantial increase in the cost of domestic crude oil caused by phased decontrol.

A better theory is that price controls on domestic crude were merely a disguised income transfer from producers of crude to refiners of crude with little or none of the transfer reaching consumers. According to this theory, prices began rising in October 1980, not because of the effects of decontrol but because of the Iran-Iraq war that broke out in late September and quickly deprived the world of about 4 million barrels of crude per day.

In late September primary stocks of petroleum in the United States exceeded the stocks held a year earlier by the equivalent of eight days' consumption. Because expectations at first were for a short war, the loss of production was initially replaced—with only minimal impact on prices—by drawing down inventories. Prices did not begin to rise rapidly until December, when inventories had been drawn down nearly to the levels of a year earlier and rumors of a Saudi production cutback began to circulate. Moreover, the outlook for a quick end to the war had worsened, and the willingness to make up the difference between consumption and output by drawing down inventories was completely eroded. To restore a balance between consumption and reduced production, it was necessary for crude and product prices to rise. Viewed in this light, the 10-cent-a-gallon increase in the price of gasoline between 7 October and 28 January and the 7-cent increase following decontrol are small in comparison to previous adjustments to less severe curtailments in the world output of crude. The conventional wisdom that attributes the 7-cent increase in gasoline prices shortly after 28 January to decontrol must explain how the loss of most of the combined

(Cont. on p. 3)

EDITORIAL

What Kind of Deregulation?

President Reagan's newly appointed Federal Communications Commission chairman, Mark Fowler, has outlined his views on broadcasting deregulation. At first glance, they sound good.

Speaking to the Oregon Association of Broadcasters, Fowler said, "The same basic premises that led to the recent decision to begin deregulation of radio also apply to television."

The new chairman went on to say, "In the last few years, we have seen deregulation of airlines, oil and gas, and trucking industries. The FCC itself has substantially deregulated some common carrier services and cable TV and even CB radio. There must come a time that the FCC catches up to the realities of your industry and eliminates regulations that no longer have valid purposes."

Fowler spelled out some of the rules he thinks are outmoded or unnecessary. For example, he said he sees no valid purpose for rules that "limit your ability to diversify by expanding into ownership of new technologies" or to produce programs for cable TV and other media. Currently, the FCC prohibits the major networks from owning a cable system and bars broadcasters from owning a cable system in the same city where they have a radio or television station. The commission has also suggested it would apply the same rules to broadcaster ownership of low-power TV stations.

In another major issue for broadcasters, Fowler said he thought that the commission should end its policy of looking at the character qualifications of broadcasters, saying he questioned "whether the commission ought to be involved in a microscopic examination of every nook and cranny of a licensee's character," especially if the character questions have arisen with regard to an unrelated business.

Commendably, Fowler also indicated that he opposes government restrictions on programming, telling the broadcasters, "More than anything else, I question whether there remains any longer a positive public purpose to be served by rules and policies that restrict your First Amendment rights to provide programming and viewpoints as you see fit." He said he would like to leave "matters of taste," including decisions over "a particular word" or "a sensitive subject" to "the discretion of the broadcaster."

All this is quite appealing to those of us who favor a free market in broadcasting as well as every other industry. But there's another important aspect to deregulation. Deregulation should mean not just lessening restrictions on existing businesses but greater freedom of entry for new competitors. And on this subject Fowler was ominously silent. Our apprehension is heightened by the news that the FCC is moving to scuttle a proposal by its previous chairman to increase the number of AM radio stations (see *Policy Report*, June 1981).

When President Reagan promised to "get the government off our backs," we assume he was not addressing only those of us who own businesses. Although the regulations on businesses should be drastically reduced, creating a free economy means more than simply removing the regulatory burdens. It also means removing the regulations and protection that keep new entrants from so many fields. Free enterprise means the freedom to set up an enterprise—whether a barbershop, a taxicab, or a radio station. Yet currently no American can enter any one of those fields—or 800 others—without getting the permission of a regulatory agency. And such permission is not easy to get from agencies usually dominated by the industries they regulate. Unsurprisingly, Mark Fowler was a broadcast lobbyist-attorney before his appointment to the FCC.

It seems clear that Fowler's policy will be to get the heavy hand of government off existing broadcasters but to continue the protection against new competitors that currently helps to make broadcasting such an incredibly profitable business.

This is the kind of "free enterprise" that gives the free market a bad name. People who don't already own a business are told that free enterprise isn't for them. Those who don't like what they see on television can only turn to government regulation since they can't go into the business themselves. Minorities, women, and the poor, who are just beginning to move into the economic mainstream in significant numbers, find hundreds of businesses closed to them. What do they think of "free enterprise"?

If we are going to have a free, open economy, we must start opening the fields that are currently closed off by regulatory protection. There is no right to make a profit. There is only a right to seek one in a free market. Government should neither burden businesses with regulation nor protect them from competition. And if we want the free enterprise system to retain the support of the American people, it's going to be necessary to demonstrate that free enterprise is for everybody.

President Reagan should instruct his FCC chairman and his newly appointed Interstate Commerce Commission chairman (where the story is similar) to dismantle the system of protection their agencies maintain and open up their industries to all comers. Then he'll really be getting government off our backs.

A final word: In response to Fowler's speech, a spokesman for the National Association of Broadcasters said, "I'm not sure it's everything (we want), but it sure is a lot." Not for the rest of us. ■

Price Wars (Cont. from p. 1)

output of Iran and Iraq would not raise gasoline prices by more than 10 cents a gallon when a smaller reduction in Iranian output 18 months earlier increased the price of gasoline two or three times as much.

Furthermore, decontrol is putting the refining segment of the oil industry into a cost-price squeeze that is reflected in all-time low rates of capacity utilization, widespread refinery closures, and falling stock prices for almost all major oil companies. The pressure on downstream operations can be expected to continue, if not intensify. In the struggle for survival, further price-cutting—even price wars in many parts of the country—has been forced on refiners and marketers.

RETAIL PRICE OF REGULAR GASOLINE

2 January 1980	$1.0287 per gallon	30 December 1980	1.2342
18 March 1980	1.2001	28 January 1981	1.1860
3 June 1980	1.2106	25 February 1981	1.3571
7 October 1980	1.1876		

SOURCE: *Oil and Gas Journal*

AVERAGE COST PER BARREL OF CRUDE OIL TO REFINERS

	Domestic	*Imported*
January 1980	$19.78	$30.75
March	22.07	33.42
June	24.48	34.48
October	26.21	34.63

SOURCE: *Monthly Energy Review*

SPOT FUEL PRICES PER GALLON

	Fuel Oil	*Regular Gasoline*
28 January 1981	$1.005	$ .9900
10 February	1.0375	1.0300
31 March	.9450	.9500

Further evidence concerning the effects of decontrol can be gleaned from changes in the spot prices of gasoline and fuel oil since 28 January, as shown in the boxed insert.

After small increases immediately following decontrol, the spot prices of both fuel oil and gasoline fell sharply. These reductions, which have already begun to show up at the pump, reflect the return to the world market of significant quantities of crude from Iran and Iraq, especially since the reopening of pipelines from Iraq to the Mediterranean through Turkey and Syria and the Saudi decision to maintain its current rate of output. If the conventional wisdom ignores the tendency of a reduction in output from Iran and Iraq to increase gasoline prices, it cannot very well use the restoration of part of this output to explain falling prices. But then what explanation is the conventional wisdom left with?

The pressure downstream is now beginning to be felt upstream. Crude prices worldwide have started to fall substantially and may fall even further in the future because refiners are not able to recover high crude costs in a work products market. The reduction in the world price of oil, for which decontrol is at least partially responsible, will in the end result in lower product prices to consumers.

Ironically, with most of the extra revenue generated by decontrol at the wellhead collected by the government and downstream operations caught in a cost-price squeeze, decontrol has turned out to have been anything but a bargain for the oil industry as a whole. For consumers, however, it has been an unqualified, though unappreciated, benefit. ■

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Economic Recovery and the Inflation Tax

by Thomas T. Nagle

The Reagan administration's economic plan promises to reduce inflation, increase real growth, and balance the federal budget by 1984. Yet despite Mr. Reagan's efforts to reduce spending, his proposed tax cuts will leave a deficit nearly as large as Mr. Carter's. A Reagan deficit, no less than a Carter deficit, will have to be financed. If the Federal Reserve pays for it with new money, the effect will be inflationary. If the Treasury finances the deficit in the capital market, it may crowd out private investment. How then is the Reagan budget supposed to promote prosperity?

The key to success for the President's economic program is a substantial increase in saving. If the administration's tax cuts inspire Americans to increase their saving, either by consuming less or by working more, then capital markets will have enough money to finance both the deficit and the capital required for increased economic growth. The Fed will be free to rein in the growth of the money supply, which will slow inflation. And the budget will come into balance as prosperity increases revenues and reduces the demand for social services.

Few economists believe that the administration's tax and spending cuts will generate this increase in saving, however. Nevertheless, we could save substantially more than we do. Americans currently save only 5.9% of their incomes. By comparison, Germans save 14.2%, the French save 16.7%, and the Japanese save over 20% of their incomes. As a result, America's capital formation as a percentage of GNP is among the lowest of the developed nations.

The Reagan administration has correctly identified the problem: Taxes make saving in America an unattractive activity. Unfortunately, the administration's attempt to solve the problem simply by reducing marginal tax rates reflects a misunderstanding of its cause and its magnitude. The problem is the interaction of taxes and inflation that can convert any tax *rate* into a confiscatory tax on invested wealth.

"The problem is the interaction of taxes and inflation that can convert any tax rate into a confiscatory tax on invested wealth."

Inflation drives up the pretax rate of return on an investment. A bond, for example, that yields 2% a year in times of no inflation must yield 12% a year to provide the same *real* before-tax return when inflation is 10%. The real pretax yield on the bond remains 2% because the additional 10% return simply compensates the investor for the decline in the purchasing power of his investment. On a $1,000 bond the investor earns $100 more interest because of the inflation premium, but at the end of the year it costs $100 more to buy the goods that he could have bought, instead of investing, when the year began.

Our income tax laws do not distinguish between an investor's real return and the inflation premium. In the example above, the entire 12% yield would be taxed, although only 2% represents a real increase in purchasing power. As a result, inflation can quickly drive up taxes on investment. In times of no inflation, an investor would earn a real return of $20 (2%) on a $1,000 bond. If his marginal tax rate were 50%, he would pay $10 in tax and retain the remaining $10 as his reward for investing. But when inflation is accurately anticipated to be 10%, he earns a return of $120 (12%). Of that amount, $100 is the inflation premium he earns to maintain the value of his investment. His real return remains $20. His taxes, however, skyrocket from $10 to $60, since both the inflation premium and the real return are taxed. Although the investor's legislated tax rate is 50%, inflation makes his actual tax rate 300% and leaves him with less purchasing power at the end of the year than he invested at the beginning!

It is hardly surprising, then, that as inflation grew progressively worse over the last decade, saving declined. People consumed what they earned or rushed to buy real goods: land, gold, or anything that at least partially shielded their wealth from confiscatory taxation. The attempt to "beat inflation" by buying real goods was in actuality an attempt to beat the tax man. If the inflation premium on investments had not been taxed, stocks and bonds would have been as good as gold as a hedge against expected inflation.

Unfortunately, the inflation premium on investments has been taxed. Those who had to save for retirement or other anticipated needs saw the purchasing power of their savings destroyed more each year. Housing prices were driven beyond the reach of many who really wanted and needed a home because "speculators" bought them, or retained them after their children were grown simply to preserve their savings from inflated taxation. Many people bought other tax shelters of dubious worth to themselves or society. And the largest number of people just saved less and consumed more before the purchasing power of their dollars was taxed away. As a result, many worthwhile capital investments were left without funding, thus restricting the growth of jobs and productivity.

If Americans believed strongly enough that Mr. Reagan's economic program would quickly reduce inflation, then the program would be more successful. The expectation of lower inflation would reduce the inflation premium on investments and therefore reduce the expected real tax on saving. If people consequently resumed saving at preinflation levels, capital markets could easily finance both the Reagan budget deficit and a rapid rate of economic growth.

At present, however, Americans' attitude toward the Reagan economic program is more hopeful than confident. The latest numbers do not indicate a rush to save, and interest rates are not dropping substantially, as they would with reduced inflationary expectations. This skepticism is justified. The Reagan administration's attempt to stimulate growth by cutting tax rates focuses on the disincentive effect of inflation's shifting everyone into higher marginal tax brackets. Although such "bracket creep" is no doubt a problem, its effect is much smaller than the effect of taxes and inflation on investment income. The administration's small proposed cuts in marginal tax rates will hardly offset the disincentive effect that even 1% inflation imposes on investors. Consequently, anyone who bets on reduced inflation either by saving more and investing it in financial assets, or by shifting his savings from unproductive tax shelters to productive but taxable investments, stands to lose substantially if high inflation rates continue.

Regrettably, prosperity from the administration's current economic program is probably a quixotic hope since savers and investors appear unlikely to risk money on the chance that it will work. Fortunately, there is an alternative course of action that does not require a leap of faith by savers and investors in order to succeed. Congress could simply tax investments the way they would be taxed were there no inflation. That is, Congress could simply exempt the inflation premium from taxation. Such an exemption would need to apply not only to interest but also to dividends, capital gains, and the profits of business enterprises. All are distorted and therefore overtaxed because of inflation. In the case of corporations, exemption of the inflation premium in profits could replace unrealistic accelerated depreciation rules, which distort investment decisions and reduce the comparability of corporate financial reports.

(Cont. on p. 6)

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Briefs

☐ It has been estimated that the federal government's total liabilities exceed $6.5 trillion—only $1 trillion (roughly) of this being the national debt. The single largest source of these liabilities is Washington's $2.4 trillion deficit in retirement, disability, and compensation programs. Insurance programs, multiyear contracting, and federal loans are also major categories comprising the $6.5 trillion figure. The total liability is up 23% from last year and up 300% from 10 years ago.

☐ Most econometric forecasters predicted a moderate downturn for the first quarter of 1981 and were acutely embarrassed when the Commerce Department reported that real GNP grew at an annual rate of 6.5% in the first quarter. The difference between the actual result and the consensus of more than 40 respected forecasters was 7.6 percentage points. Since the beginning of 1980 this surveyed group has had an average error of 6.6 points, and in three of the last five quarters it has had the direction of the change wrong.

☐ Records recently accumulated by the GAO show that many of the loans granted by the Small Business Administration have been given to some of the nation's largest companies and that these companies have defaulted or liquidated their loans to the tune of $92 million. For instance, Shell Oil Co. franchisees have received 107 loans worth $2.9 million. Thirty-two percent of these borrowers have defaulted, leaving the federal treasury with a net loss of $346,000. Franchisees of Mobil Oil Corp. have defaulted on 16% of their loans, costing the federal government $163,000, while defaults from American Motors Corp. franchisees have cost $393,160.

☐ Many of the budget cuts in President Reagan's "austerity" plan will have their impact significantly blunted by cost overruns in weapons systems. For instance, the $607 million increase for the F-18 fighter plane is almost as large as Reagan's proposed cut in welfare spending. The $757 million increase for the M-1 tank is approximately equal to Reagan's planned cuts in energy conservation funding.

☐ Though *Policy Report* has made clear its belief that the economy needs much larger tax and spending cuts than President Reagan has proposed, we can only applaud the House's passage of the Reagan package instead of the Democratic substitute cuts. But we are concerned at the price the President paid for his victory. To get $5 billion more in budget cuts, Reagan made deals with various conservative Democrats that included administration support for $350 million more for Medicaid, $400 million more in energy assistance for the poor, $260 million in mass-transit subsidies, additional federal support for Conrail, more guaranteed student loans for upper-middle-income families, $230 million for the Clinch River breeder reactor, a solar energy project in Rep. Charles Stenholm's Texas district, and sugar price supports. We are reminded of Pyrrhus's comment after his defeat of the Romans: "Another such victory and we are undone."

☐ A new report issued by the General Accounting Office has indicated that even after the federal government spent $30 billion in the last decade to clean up the water supply, no one knows if the nation's water is any cleaner. In coming to this conclusion, the report criticized the EPA for its sloppy, irregular, and inadequately advanced water-cleanliness sampling techniques. It was also pointed out that not only do most federally built waste-water treatment plants not operate properly, but that a third of them actually seriously violate pollution laws. Another recent report, this one undertaken by the President's Council on Environmental Quality, seemed to confirm the results of the GAO study. The Council's report noted that ". . . the quality of surface water nationally has not changed much in the last five years. . . ." ■

Economic Recovery (Cont. from p. 5)

The result would be a general increase in the attractiveness of new investment.

Such a change in our tax laws may reduce revenues by even more than the tax cuts Mr. Reagan proposed. On the other hand, if we believe the Laffer curve, eliminating the inflation premium from taxation may actually increase tax revenue. In either case, however, the size of the deficit is not really important as long as any tax cut generates sufficient saving to fund both the deficit and economic growth.

Finally, taxing only the real return on investment income would be more politically palatable than explicitly cutting tax rates. It should be obvious to anyone who favors justice in our tax laws that something is wrong when an income tax takes not only all of one's investment income, but part of the investment as well. Exempting from taxation the income an investor earns simply to maintain the real value of his investment would only return real tax rates to the levels Congress originally intended. The fact that savers would no doubt pay significantly less tax is but a measure of the disincentive, not to mention the injustice, that inflation and outdated tax laws have imposed upon them. ■

Some Neglected Aspects of Equal Employment Opportunity Policy

by Howard R. Bloch and Robert L. Pennington

A major cause of the expanding role of the federal government has been the drive to eliminate discrimination and promote equality in employment and earnings. Calls for higher levels of government involvement continue despite evidence that the government has done little to aid, and perhaps has even hindered, the economic development of women as well as racial and ethnic minorities.[1] Improvement in the economic position of these groups actually predates the period of active government intervention. Table 1 shows that blacks, both male and female, made substantial economic progress in the decade of the 1960s, a period before statistical goals and quotas for employment and affirmative action became important.

The most careful statistical analyses currently available indicate that it is unlikely that much of the nonwhite progress of the late sixties is a direct result of the administration of either Title VII of the 1964 Civil Rights Act or of the activities of the Office of Federal Contract Compliance programs.[2]

The absence of any strong correlation between government intervention and the economic progress of protected groups may well result from the fact that market forces will, over time, eliminate discrimination on their own. This view of discrimination as a disequilibrating factor was analyzed by Gary Becker in his book *The Economics of Discrimination*.[3] Becker sees discrimination as a cost; the stronger an employer's "taste for discrimination," the higher the cost he would bear.[4] On the basis of his analysis, Becker predicted that one would not find high levels of discrimination in a competitive labor market, a prediction that has been extensively investigated and found to be accurate. Once adjustments are made for factors like age, amount of education and training, and labor force experience, so that one is truly comparing like with like, 70%–85% of observed differences in income and employment between various groups disappear. Numerous studies, dating back to the mid-1960s, have shown that once such adjustments are made, one finds little trace of discrimination in the U.S. labor market.[5] This finding calls into question the usual arguments for extensive and expensive government programs to counter discrimination.

Questions are often raised about the apparently slow rate of economic development of present-day minorities, especially blacks. Other groups worked their way into the economic mainstream in two to four generations; blacks, however, have been in the United States for centuries and they still cannot be said to have risen (as a group) to middle-class status. Reduced job opportunities for low-skilled labor, especially virulent discrimination against people of different skin color, vanishing entrepreneurial opportunities, family disorganization, and a great sense of alienation among blacks have all been advanced as reasons for the economic problems of blacks. On closer examination, however, the *special* economic problems of blacks may be more apparent than real. One must bear in mind that blacks have been free for only a little more than a century, and most blacks come from families that have been in urban centers for two generations or less. The experience of other ethnic minorities makes it clear that the length of time a group has spent in urban commercial centers is a major factor in explaining its circumstances and its rate of economic development. When one realizes that the young black people one sees in America's cities are usually third-generation urban dwellers, it becomes clear that blacks are developing at the same rate as did immigrants who sprang from poor peasant backgrounds. The evidence suggests that black economic progress is much less affected by specific political programs than by general economic conditions and by the development among blacks of the attitudes necessary for advancement in an industrial commercial society.

TABLE 1

BLACK AND WHITE WORKERS IN SELECTED OCCUPATIONS AS A PERCENT OF ALL WORKERS OF THAT RACE, 1960–1970

	Blacks			Whites		
Occupation	*1960*	*1970*	*% Change*	*1960*	*1970*	*% Change*
Professionals (male)	3.1	5.9	90%	10.3	14.3	39%
Craftsmen (male)	9.8	15.3	56%	19.6	21.2	8%
Private Household Workers (female)	35.7	17.9	− 50%	NA		
Clerical (female)	7.6	20.7	172%	NA		

SOURCE: Nathan Glazer, "Issues on Availability" in *Perspectives on Availability* (Washington, D.C.: Equal Employment Advisory Council, 1977), pp. 229–230.

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The Cost of Affirmative Action Programs

Measuring the true cost of government-imposed affirmative action programs is extremely difficult, so difficult that a recent survey by the Library of Congress was unable to discover any substantive academic study of their overall economic impact. The major reason is that a large part of the cost is not reflected in direct or outlay costs, but rather takes the form of indirect costs such as the cost of lost production, investment disincentives, construction delays, added inflation, and loss of international competitiveness. A recent report by Arthur Andersen & Co., counting only direct costs that could be well documented and ignoring all the indirect costs noted above, arrives at a figure of $4.35 billion for the cost of such programs in the private sector. Using these figures plus data supplied by various federal agencies, Sen. Orrin Hatch (R-Utah) estimates the direct cost of government affirmative action programs to be between $5 billion and $7.5 billion, which he reminds us is only "the tip of the iceberg."[6]

The Government's Objective

Early government efforts to eliminate discrimination in the labor market were primarily designed to equalize employment opportunities. Opponents of racial

(Cont. on p. 8)

Regulatory Watch

The Food and Drug Administration has recently undertaken a probe into the chemical composition of frozen orange juice concentrate in order to determine whether manufacturers are defrauding consumers by diluting the concentrate. Charges leveled by the FDA indicate that many of the manufacturers under question may have watered down their mix by adding water, sugar, and pulp wash solids. The focus of the investigation is on private-label frozen orange juice concentrate and ready-to-drink juice made from concentrate. Many of the major name brands have already been cleared of these charges by the USDA.

Lionel H. Olmer, the new Commerce Department undersecretary, has declared that the Reagan administration does not intend to dismantle or modify the steel trigger-price mechanism. Olmer's statement is seen as removing any doubt as to the Reagan administration's intentions regarding the TPM (trigger-price mechanism), which was temporarily suspended last year pending a resolution of several complaints issued by U.S. Steel that foreign manufacturers were selling below TPM levels.

The Supreme Court has ruled that federal safety and health regulations do not have to be subject to a cost-benefit analysis before they are issued. This ruling is seen as a blow to the Reagan administration, which had asked the court to allow the administration to determine whether worker safety and health standards were worth the cost.

The Justice Department is currently negotiating with International Business Machines Corp. to settle the government's 12-year-old antitrust suit by reducing the number of issues. Although each side has recently rested its case, settlement negotiations are continuing. It is not likely that a decision will be arrived at for months, but each side is to give a periodic report to U.S. District Court Judge David N. Edelstein of New York. The initial suit (1969) charged IBM with monopolizing the computer industry and sought to split up IBM into several independent companies.

The Reagan administration has issued a report claiming that the pace of federal rule-making has been cut nearly in half and that the administration has either delayed, altered, or stopped more than 180 rules, saving up to $18 billion in compliance costs. James C. Miller III, head of Reagan's regulatory task force, admits that the $18 billion estimate was "fairly crude" and based on the assumption that the rules would be abolished, when, in actuality, many of the regulations will eventually return in a scaled-down form. Over half of the 180 rules changed or killed by the Reagan administration involve either the Department of Housing and Urban Development, the Environmental Protection Agency, and the Transportation Department. Despite these changes, 636 of the 847 regulations issued since January have been okayed by Reagan's regulatory review process and another 36 have passed without being subjected to scrutiny. Only one "major" rule and 55 "minor" rules have actually been sent back to the issuing agencies for revision.

Miller has recently been named head of the Federal Trade Commission by President Reagan. Miller, who was head of the administration's FTC transition team, takes a softer position on the agency than many of his OMB compatriots, who wish to eliminate the FTC's antitrust activities altogether. Miller's position is that the FTC should concentrate on horizontal mergers and ignore antitrust cases that are based upon "social theories."

The Federal Reserve Board has taken the first steps toward changing regulations on margin buying of stocks, revisions that will be formally announced on 15 September 1981. An analysis by the Federal Reserve Bank of New York called the regulations "highly complex, poorly organized, difficult to interpret, and unnecessarily burdensome" and recommended 11 major changes in the rules.

✓ Washington Update

✓ Federal Reserve Board Chairman Paul Volcker has recently met with members of the House Banking Committee in an effort to revise several details of proposed legislation for bailing out failing thrift institutions (savings and loan and mutual savings banks). In its current form, the legislation would grant the Federal Deposit Insurance Corp. the power to arrange interstate mergers for ailing banks and thrift institutions. The bill would also make it easier for the FDIC and FSLIC to inject funds into troubled banks. Volcker's meeting with the House Banking Committee was prompted by a recent announcement that savings and loans and mutual savings banks suffered a net outflow of deposits of $6.6 billion during the month of April and are expected to lose between $6 billion and $8 billion over the entire year.

✓ The Senate has voted to approve President Reagan's proposal that the federal government should spend an additional $50 million on laser weapons designed to destroy incoming enemy missiles. The laser amendment passed by a 91-to-3 margin with Mark Hatfield (R-Oreg.), William Proxmire (D-Wis.) and Paul Tsongas (D-Mass.) voting against the measure.

✓ A House subcommittee has voted down the Reagan administration's proposal that the federal government stop providing certain social services, child welfare, foster-aid, and adoption measures but attempt to maintain these programs (albeit with a 25% cut) by giving state governments sufficient block grants to cover their costs. One main reason for the failure of the proposal to make it through the subcommittee was that the state governors would be given almost complete discretion on how to spend the block grants.

✓ The Reagan administration has announced that it will effectively discontinue the Carter administration's "dollar rescue" plan of 1 November 1978 and formulate a new course of action. Henceforth the U.S. government will intervene in foreign exchange markets only in the event that so doing is necessary to protect the dollar and "counter conditions of disorder." Carter's plan, which was more activist, involved the building up of foreign currency reserves to be used for buying up dollars whenever the price of the dollar fell in foreign exchange markets.

✓ The House Ways and Means Committee has voted to nearly eliminate the trade adjustment assistance program for workers who have lost their jobs as a result of exports. The total sum of the benefits awarded would be cut from $1.7 billion to about $364 million by reducing the size and duration of the payments and by tightening the eligibility requirements.

✓ The Ways and Means Committee also cut unemployment compensation by $1.3 billion. The cuts come primarily from an elimination of the trigger mechanism that provides an extra 13 weeks of benefits after the initial 26 weeks have expired and from a reduction of benefits for people leaving the armed services.

✓ Interior Secretary James Watt has announced that although he favors opening up more federally owned lands for energy exploration, he is interested in changing the royalty system that the federal government uses in order to increase the government's revenue. The current federal policy requires the payment of royalties at a 16.7% rate for all offshore drilling. Watt is considering adopting a plan similar to that of the Texas state government, which has royalty rates of 20 to 25%.

✓ The Federal Reserve Board has given final approval to the establishment of international banking facilities in the United States. In order for these banks to be profitable, the Fed had to suspend interest rate ceilings and reserve requirements, thereby establishing free-trade zones for the banks. Furthermore, the facilities (which are expected to spring up in New York City) will be exempt from New York State and City income taxes. These new international banks are expected to be important depositories for both Euromarket funds and OPEC dollars. ■

Equal Opportunity (Cont. from p. 7)

discrimination urged that "affirmative action" be taken to break up or bypass hiring patterns and practices that tended to leave racial and ethnic minorities largely outside the usual hiring channels. Guidelines were mandated that emphasized public avowals of equal opportunity recruitment of minority group members and restitution for those harmed by previous discriminatory practices.

The first official use of the term "affirmative action" occurred in an Executive Order issued by President Kennedy that required that government contractors act affirmatively to recruit workers on a *nondiscriminatory* basis. A similar order was issued by President Johnson, mandating affirmative action to ensure that workers be hired *without regard* to their race, creed, color, or national origin. In a similar vein, the Civil Rights Act of 1964 stipulated that personnel decisions be made *without regard* to race or ethnic background. The original objective of affirmative action programs was thus to include minorities in the pools of applicants, with the actual selection process to be made *without regard* to race, religion, etc.

The attitude of civil rights agencies and organizations has changed since 1964, however. The focus, which used to be on relief for individuals, is now on relief for whole groups. Rather than eliminating observed discrimination, the objective now is to obtain preferential treatment, and the measure of an employer's commitment to equal employment opportunity is often a numerical comparison between the proportion of minorities and women in the company's workforce and the availability of those groups in the appropriate labor force. As a result, equal employment—rather than the equal employment opportunity—has become the keystone of the enforcement policy of federal officials. Their basic objective is not merely to provide equal opportunity, but to eliminate, now, the effects of past discrimination by society as well as by particular employers.[7]

Admitting that there is little evidence of a systematic refusal on the part of employers to hire minority group members, some observers nevertheless cite a need for government intervention to ameliorate the effects of perceived discrimination and the lingering effects of past discrimination. These people impute to American business the responsibility for past discrimination and maintain that individual employers should be required to indemnify disadvantaged individuals, presumably by lowering selection standards for them or at least by making extraordinary efforts to reassure and attract them. This policy has led to the problems of "availability."

Availability

We have arrived at a point where government evaluation of affirmative action plans and allegations of group or class discrimination are based primarily on the definition and determination of availability. It is this standard against which an employer's utilization of protected groups and the fairness of employment practices are measured. Availability also serves as the basis for developing remedial quotas or goals and timetables. The importance of availability has not led, however, to a common understanding of the concept within the federal government or among interested parties in the private sector, even though whole books have been written on the subject. While not every government agency at every point in time has had the same definition of availability, a representative definition is the following one, taken from p. 9 of the 1977 *General Services Administration Manual:*

> Availability is the percentage of minorities or females among those in the applicable labor market area who possess the skills required by a specific job group, or who are capable of acquiring these skills within a reasonable period of time.

The government tends to believe that the available labor force consists of all those workers, or potential workers, in an area who meet the requirements for minimum-skill or entry-level jobs (from which a worker is normally promoted to the job or jobs in question). Sometimes government agencies are willing to adopt a more lenient position and accept as the available labor force only those already qualified for the specific positions in question. Employers, however, usually prefer to define the available labor pool as only those who have actually applied. The employers' position has received support from recent judicial opinions. However, no matter which standard of availability is accepted in a particular case, another critical question, glossed over in the definition of availability, must be addressed. To make a reasonable decision on availability, we must determine the boundaries of the relevant labor market. Here economic analysis can be of considerable help.

"It is unlikely that much of the nonwhite progress of the late sixties is a direct result of affirmative action programs."

The Labor Supply Concept

To some, the term "labor market" refers to a given geographic location, e.g., the Richmond, Virginia, labor market. In economics, however, the concept of a labor market is often more rigorously defined as the area in which buyers and sellers of labor are in sufficiently close communication so that wages tend to be equalized. Equating a labor market with a given geographic area is sometimes a convenient simplification, but is not accurate. Any given area is composed of a large number of submarkets (partially overlapping but essentially noncompeting) that shade gradually into one another. The more highly trained and paid the workers in a market or submarket are, the wider the geographic boundaries of the market will tend to be. Other factors such as transportation facilities and alternative employment opportunities in the area will also influence the size of a local labor submarket. It has been known for years that such submarkets do not compete with one another and must be analyzed separately.

Once the boundaries of the local labor market have been established, it is then possible to estimate the supply of labor to the firm.[8] The economic analysis of labor supply treats the pool of potential employees not as a given constant number (as availability does) but rather as a variable, dependent on wages, transportation facilities, alternative employment opportunities, etc. This makes labor supply a more realistic and useful concept. For example, the focus on resources required to attract personnel suggests that, other things being equal, higher-wage firms can more easily increase utilization of minority employees than can low-wage firms.[9] Labor supply analysis is grounded in the basic welfare maximization model of contemporary economic theory, which explicitly takes individual tastes and preferences into account. Availability analyses of affirmative action plans fail to do this. In the real world, the preferences of persons for different kinds of jobs vary greatly, and employment patterns must be interpreted in light of these differences. For example, failure to take account of individual tastes might lead one to believe that different patterns of employment by sex are due to *employer* discrimination, whereas in fact the observed patterns may result from *employee* preferences.[10] Furthermore, the existence of an affirmative action plan may distort the labor supply to a firm in such a way as to create the false appearance of discrimination.

Since the early 1960s, economists have been interested in the process by which workers search for employment within a labor market. George Stigler views a searcher's decision problem (whether to drop out of the labor market altogether, accept the most recent offer, or continue to search) as just another variation of the economic calculus, suggesting that the worker would continue to search until the

expected marginal benefits from further search were equal to the expected (or known) marginal search costs.[11] The costs of search are composed of several elements, including forgone earnings, information costs, and the actual effort of applying for the job.

The benefit of search is the expected improvement in job offers over the immediately available alternatives. Of course, it is of great importance to realize that both costs and benefits are taken into account by a rational searcher.

Let us assume that the searcher in question is a member of a target group being affirmatively recruited. Let us further assume that the employer, while waging an affirmative action program, nonetheless intends to avoid discriminating for or against any group and plans to treat all applicants fairly (i.e., the employer plans to hire the most qualified applicant or applicants for each job). The affirmative action program may well cause the searcher to reassess the probabilities of receiving an offer. "If they really want people like me (of my race, sex, etc.), they may be prepared to overlook my deficiency (the lack of a high-school diploma or a medical problem) and make me an offer." The change in the searcher's subjective evaluation of the chance of an offer causes him or her to reassess the cost-benefit ratio and seek employment where formerly an application was seen as not worthwhile. To the extent, then, that an employer makes known his or her desire to recruit and hire members of some group, it will cause such group members to reassess their chances of receiving an offer. Some group members, therefore, who are aware that they are not fully (or not highly) qualified will be encouraged to apply, hoping that the desire to increase employment of target-group members will cause the employer to overlook their deficiencies. As a result, many of the additional applicants attracted by an affirmative action plan can be expected to be less than highly qualified. An uncritical comparison of the percentage of minority or female applicants (or even minimally qualified minority or female applicants) with the percentage of such individuals actually hired, may give the misleading impression that discrimination has occurred.

Despite the lack of convincing evidence that such a policy is helpful, the government is pursuing an active policy of promoting equality in employment and earnings, filing discrimination suits where such action is deemed appropriate, and insisting on hiring goals and quotas. The original emphasis of civil rights advocates was on eliminating discrimination against individual minority-group members and females; this has evolved to an attempt to obtain an improved economic position for whole groups of people, however, with the employer being judged on the percentage of protected group members employed by the firm, compared to their proportion in the local labor force. If current policy is justified on the grounds of past or perceived discrimination, it is imperative

that the measure of availability of various group members in the labor force be as accurate and as sensitive as possible. The concept of availability preferred by government agencies is less realistic and less precise than the concept of labor supply that takes into consideration numerous economic variables that may impact on the ability of an employer to attract qualified female or minority workers. If government agencies are eager to use the best and most reliable statistics when considering cases of possible discrimination, then they should be concerned with the economics of labor-market supply rather than availability in assessing the secondary consequences of their actions. ■

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[1]Thomas Sowell, *Race and Economics* (New York: David McKay, 1975), pp. 179–204.

[2]Robert Flannegan, "Applying Concepts of Nondiscrimination to Equal Employment Policy," in *Perspectives on Availability* (Washington, D.C.: Equal Employment Advisory Council, 1977), p. 27.

[3]Gary S. Becker, *The Economics of Discrimination*, 2d ed. (Chicago: University of Chicago Press, 1971).

[4]If an employer does not raise his costs by discriminating against a factor of production (i.e., refusing to hire someone who is equally or more productive than other applicants), it is difficult to know what the definition of the word "discrimination" is.

[5]For example, see Curtis Gilray, "Investment in Human Capital and Black-White Unemployment," *Monthly Labor Review*, July 1975, pp. 13–21.

[6]Orrin Hatch, "Loading the Economy," *Policy Review*, Spring 1980, pp. 23–37.

[7]Kenneth C. McGuiness, *Preferential Treatment in Employment* (Washington, D.C.: Equal Employment Advisory Council, 1977), p. 2.

[8]Howard R. Bloch and Robert L. Pennington, "Use of Applicant Flow Data in a Discrimination Suit," *Public Personnel Management* 9, no. 1 (January-February 1980): 1–6.

[9]Richard B. Freeman, "Availability, Goals, and Achievements in Affirmative Action: Economic Perspectives," in *Perspectives on Availability*, p. 96.

[10]Ibid., p. 98.

[11]George Stigler, "Information in the Labor Market," *Journal of Political Economy* 70 (October 1962): 94–104.

INFLATION MONITOR

A quarterly feature of *Policy Report*, the "Inflation Monitor" shows the distorting effects on relative prices throughout the economy of government fiscal and monetary actions. All figures are expressed as annual rates of change, unless otherwise indicated.

	1981 First Quarter	1980 Fourth Quarter	1980 Third Quarter	Average for Last Year
MONETARY SECTOR				
Monetary Base	5.6	10.3	9.9	7.7
M1-A	–18.6	8.2	11.5	–3.3
M1-B	6.6	10.2	14.6	7.3
M2	8.4	9.2	16.0	9.8
M3	12.0	11.8	13.0	10.7
Discount Rate (average)	13.0	11.8	10.4	11.9
Prime Rate (average)	19.2	16.7	11.6	15.9
PRICE CHANGES				
Consumer Price Index	11.6	3.2	13.8	8.4
All-Finished-Goods Price Index	11.2	7.6	12.1	9.3
Intermediate-Materials Price Index	12.4	19.6	6.4	10.9
Capital-Equipment Price Index	10.8	13.2	8.5	11.0
INDUSTRIAL PRODUCTION INDICES				
Consumer Goods	147.6	147.5	143.3	146.7
Producers Goods	153.8	150.3	147.2	149.5
Raw Materials	153.9	149.8	139.0	146.9
Ratio of Capital Goods Production to Consumers Goods Production (1967 = 1.00)	1.04	1.02	1.03	1.03

SOURCE: *Federal Reserve Bulletin*.

PR Reviews

Fat City: How Washington Wastes Your Taxes by Donald Lambro. Regnery/Gateway Inc., 1980. $12.95.

Donald Lambro's *Fat City: How Washington Wastes Your Taxes* has made a tremendous splash in Washington. Ronald Reagan has ordered his entire cabinet to read the book, and William Simon has described it as "a comprehensive report on the extravagant, inefficient, and ineffective use of tax dollars by the federal government."

Lambro's basic point is that "Americans have more government than they need, more than they want, and more than they can afford...", a charge that is backed up with facts and figures. Lambro outlines $100 billion worth of pure waste in the federal government. This figure of $100 billion comprises such components as $15 billion in fraud, $0.5 billion in bad debts, and $4.3 billion in unauthorized contracts and grants.

One of the most important features of Lambro's book is that he puts his finger on the specific sources of waste: *Fat City* contains a list of over 100 nonessential federal programs that could be cut with savings of billions of dollars. This list includes such extravagances as the Congressional Florist Service ($40,000), the Japan–United States Friendship Commission ($2.4 million), and a foundation for ethnic heritage studies ($2 million).

Fat City is light reading and can be highly entertaining—*if* one does not get too upset at the outrageous examples of the federal government's fraud and waste. It is an excellent book for browsing, containing such anecdotes as this: "A Civil Service Commission study found that 11.5 percent of all federal white-collar workers were being paid nearly half a billion dollars more per year than was commensurate with their positions."

Fat City is a well-written and fact-filled polemic against governmental waste and bureaucracy. It is recommended for both reading and reference.

LSE Essays on Cost, ed. James Buchanan and G. F. Thirlby. New York University Press, 1981. $7.00.

In his well-known *Cost and Choice*, James Buchanan laments the disappearance of what he referred to as the London School of Economics (LSE) opportunity-cost tradition—a tradition that is highly Austrian or "subjectivist" insofar as it treats cost as the subjective opportunity that an individual actor forgoes at the moment of choice. This is in contrast to the neoclassical conception that treats cost as an objectively definable monetary outlay. The LSE tradition has seen a notable resurgence in the last decade, primarily because of Buchanan's own efforts, of which this book is an important part. Originally published in 1973, *LSE Essays on Cost* soon went out of print and was a difficult book to find until this recent reprint by New York University Press.

LSE Essays on Cost contains articles by such economists as F. A. Hayek, Ronald Coase, Lionel Robbins, James Buchanan, G. F. Thirlby, and Jack Wiseman on such topics as the role of cost in accounting theory, the proper use of managerial "cost-rules," the theory of the firm, the role of cost in equilibrium theory, and the role of cost in the problems of economic calculation under socialism. This last topic is covered quite convincingly by G. F. Thirlby's "The Ruler" and Jack Wiseman's "Uncertainty, Costs, and Collectivist Economic Planning." Both authors show the impossibility of effectively imposing managerial cost-rules on socialistic industries in order to help them produce the proper quantity of goods in an economical manner. Such rules have been proposed by Abba Lerner and Oskar Lange, and many economists consider these rules proof of the possibility of rational economic calculation under socialism. Thirlby and Wiseman show that such rules misconstrue the true nature of cost. Even if socialist managers could succeed in minimizing monetary outlays (what many economists call "costs"), this says nothing about whether they are forgoing more valuable subjective opportunities. This sort of judgment can only be accurately made by market entrepreneurs.

LSE Essays on Cost is a superb collection of essays and is highly recommended to all those interested in either economics or the science of business management.

"To be governed . . ."

Solving national problems

Majority Whip Thomas S. Foley called for "a bipartisan consensus on Social Security . . . a very sensitive subject. We have to defuse this highly charged political issue."

—*New York Times*, May 14, 1981

Democracy in action

"There ain't no reason for standing on principle or any of that s—," [Willie] Brown [speaker of the California Assembly] reasons . . . . "It's a lot easier to get along."

—*San Francisco Chronicle*, June 29, 1981

Who's in charge here, anyway?

Rep. [Bill] Hefner has been feeling some heat from constituents, particularly from bankers in his district. They urge Mr. Hefner . . . to back the President's budget cuts. . . .

"Why don't you do the bankin'," Rep. Hefner concluded the telephone talk, "and let me do the Congressin'?"

—*Wall Street Journal*, June 25, 1981

Wonder what compulsory is like

The nation's top tax man says a spreading "tax protest" movement threatens the withholding tax system and even the basic concept of voluntary tax returns.

—*San Francisco Chronicle*, June 11, 1981

Learning about free enterprise

The Thompson kids might have quietly earned a few dollars selling fishing bait, but [they] were soon entangled in a rat's nest of red tape. . . .

The shop, in the garage of the Thompson home, was shut down last week because it was in violation of the zoning code. . . .

Another bait dealer in the area, who apparently sees the backyard business as a significant competitor, filed several complaints.

—*Louisville* (Ky.) *Courier-Journal*, June 5, 1981

The IRS strikes again

"I couldn't believe it. I didn't think it was funny," said former Reno councilman Clarence Thornton. "I thought it was a very expensive way of running the federal government." Thornton was complaining about a notice he received from the Internal Revenue Service saying he underestimated his tax by two cents. That would be insult enough, but Thornton's notice was accompanied with a bill for a $14.25 penalty. Thornton said that by the time IRS finished processing the claim, running it through the computer, and mailing it to him more was spent than the extra $14.23 taken in.

—*The Washington Star*, June 25, 1981

Communist pig!

Although [Leonid] Brezhnev continues to mouth the myth that the USSR is a classless society, he personally owns two yachts and maintains a fleet of fancy foreign cars, including a Rolls-Royce Silver Cloud, a Citroen-Maserati, a Mercedes 450-SCL and two gifts from Richard Nixon: a Cadillac and a Lincoln Continental.

While most citizens of the Soviet Union wait in line for rationed products, Brezhnev and other Communist Party leaders shop at special stores, paying their bills with funds from "open accounts" at the State Bank. Brezhnev's Moscow apartment and his country house are tended by servants and furnished with the latest Western gadgets as well as his famous collection of antique clocks.

—*Parade*, May 31, 1981

I spy

Two nearly identical films on the subject of espionage [were] produced within a three-month period by the Defense Department. One film cost $100,000, the other $70,000. They bring to 24 the number of films on espionage now available in the Pentagon library.

—*U.S. News & World Report*, May 4, 1981

Neither sleet nor snow nor rain . . .

In the last Congress, the Senate spent $20,000 for two four-wheel-drive vehicles to assure that Democratic Leader Robert Byrd of West Virginia and Republican Leader Baker could get to work even in a snowstorm. The vehicles have never been used for that purpose.

—*U.S. News & World Report*, May 4, 1981

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