

# POLICY REPORT

Volume IV Number 1

A PUBLICATION OF THE CATO INSTITUTE

January 1982

## What's Wrong With Regulation and Antitrust: The AT&T Case

by Jack High

• November 20, 1974. The Department of Justice files civil antitrust suit charging American Telephone and Telegraph with monopolizing telecommunications service and equipment in the United States. The suit seeks substantial divestiture by AT&T.

• November, 1974 to January, 1981. Wheels of justice turn slowly.

• January 16, 1981. Trial begins. Government states charges. AT&T responds it is being sued for policies it developed in good faith to state and federal regulations. Before any testimony is heard, trial is recessed until February 2, to allow sides to reach an out-of-court settlement. Wheels of justice obviously running a slippery course.

• January 23 to January 28. Ad Hoc Committee for Competitive Telecommunications urges the Justice Department not to allow Bell to compete in long-distance market. So does MCI, another Bell competitor.

• January 30. Justice Department requests further delay, this time for 30 days, to enable Reagan administration officials a chance to study proposal. However, Reagan has not appointed anyone who can study case. Attorney General William French Smith disqualifies himself, because he formerly served on the board of Pacific Telephone, an operating company of AT&T.

• February 24. AT&T breaks off talks with Justice Department.

• March 4. Trial resumes. Judge thinks it will be over within a year. Both sides say it will take longer.

• April 8. Wall Street Journal reports that Secretary of Defense Caspar Weinberger has been urging the attorney general to drop suit against AT&T. Weinberger's

actions, says the Journal, were revealed in previously secret testimony before the Senate.

• April 10. William Baxter, newly sworn assistant attorney general, promises to "litigate it [the case] to the eyeballs." English professors across the land blink and scratch their heads.

---

**"AT&T is a monopoly in the only meaningful sense of the word: The law prohibits local competitors."**

---

• July 30. Baxter himself blinks. He requests one-year suspension of trial, so that legislation deregulating telecommunications industry can be passed. Trial Judge Greene calls motion peculiar and refuses to grant suspension.

• July 30 to present. Wheels of justice keep turning.

Nobody who has followed the AT&T case expects justice to be served, no matter what the outcome. Nevertheless, the case does illustrate what is wrong with American regulation and antitrust policy.

### Ineffectual Regulation

The very existence of this case implies that the regulation of business does not accomplish its purpose. AT&T is a monopoly in the only meaningful sense of the word: The law prohibits competitors from encroach-

ing on AT&T's local telephone business. To keep this governmentally established monopoly from abusing its customers, the federal government is supposed to regulate the monopoly. If the regulatory agency were doing its job, no antitrust suit would be necessary.

As things stand, the taxpayer is paying twice. He is paying the regulatory agency to do a job that the Justice Department claims the agency is not doing, and he is paying the Justice Department to bring the AT&T suit. At last count, the Department had spent \$25 million and AT&T, an estimated \$300 million. One possible remedy would be to require that when the Justice Department brings suit against a regulated company, it also bring a negligence suit against the responsible agency. If those in the agency were held personally liable for the injury to consumers caused by the agency's neglect (and no regulatory agency is a limited liability corporation), perhaps agencies would do what they say they do—prevent monopolistic abuse. Even more likely would be the agency's closing shop. No one would serve as a regulator were he personally liable for damages.

### Ignorance of Competition

Another shortcoming revealed by the AT&T case is the bountiful ignorance of competition and its effects on the part of policymakers.

The complaint brought by the Justice Department against AT&T states that "actual and potential com-

---

Jack High is affiliated with the Center for the Study of Market Processes at George Mason University.

(Cont. on p. 3)



# Closing the Door on Immigrants

President Reagan has recently asked for emergency powers for up to a year to seize U.S.-bound vessels carrying prospective illegal aliens, to seal harbors, ports, airports and roads, to restrict travel of Americans to certain countries, and to limit sharply the access to federal courts of those accused of being illegal aliens. In addition, sanctions against employers who hire illegal aliens would be instituted.

Reagan, of course, is not the only person who has been interested in further restricting immigration. The freedom to move has been systematically attacked, as have many other freedoms, by liberals as well as conservatives. Sen. Edward Kennedy (D-Mass.) has stated that there is no need for Mexican immigrants while Americans are out of work. Sen. Alan Simpson (R-Wyo.) has called for counterfeit-proof I.D. cards to qualify for a job. Cesar Chavez, president of the United Farm Workers of America, has demanded that the Immigration and Naturalization Service stop the "flood of desperately poor workers."

Such proposals reflect a long history of xenophobia in the development of civilization, with resentment toward immigrants justified on many diverse grounds. However, none of these arguments is new and none has stood the test of time. In 1903 J.R. Commons argued that American institutions are based on particular ethnic groups—namely Anglo-Saxon. He warned that the horde of immigrants from other cultures would transform America into the type of society these immigrants were escaping. Similar concerns about democracy in the United States have been voiced recently. Another charge is that immigrants take jobs away and lower the wages of the American worker. Such an indictment is currently being leveled against Mexican immigrants just as it was leveled against Chinese immigrants in the last half of the 19th century.

It is common knowledge that immigrants have had a tremendous impact on the development of the United States. The people who chose to immigrate tended to be young, ambitious, future-oriented and productive people. Unwilling to acquiesce to the political repression and economic misery in their home countries, they looked for places where they could work to start a new life. These are not the type of people who readily accept a position in the welfare line. Furthermore, it's not true that immigrants always have lower earnings. Thomas Sowell points out that black immigrants from the British West Indies have higher earnings than native-born American blacks.

Barry Chiswick reports that despite language and cultural differences, most immigrants surpass the earnings of the native-born in 10 to 12 years. Paul Schultz of Yale University found that immigrant children are in better health and receive more schooling than do comparable native-born children.

Are these the type of people who will destroy the social fabric of America and accept as much public dole as is handed out? The argument that an open immigration policy might add a welfare strain to the nation is an indictment of the welfare system, not of immigrants. One of the fundamental problems associated with our disastrous welfare system is that it discourages people from working. The solution to this problem is to either overhaul or eliminate the welfare system.

Almost every technological advance from the sewing machine to high-speed computers has been accused of taking jobs away from workers. And in every case these advances have ended up generating more jobs in the economy by increasing the productivity of the worker and stimulating jobs in complementary industries. Similarly, immigration not only increases jobs but also enhances the overall health of the economy. The increase in the number of workers increases the productivity of capital goods and thus induces investment. Immigrants take jobs many workers shun because of their reliance on the welfare system.

By far the most serious problem of the present closed-door immigration policy is the savage treatment of immigrants by the INS and other groups. The actions of these groups are thoroughly un-American. Sasha Lewis's *Slave Trade Today* documents cases of rape, murder, assault, theft and intimidation by INS agents on just the Mexican-American border alone. That Americans tolerate such moral outrages compounds the problem.

One has to wonder what happened to the country formed and molded by immigrants, a country whose national symbol, the Statue of Liberty, boldly declares:

Give me your tired, your poor,  
Your huddled masses yearning to breathe free,  
The wretched refuse of your teeming shore.  
Send these, the homeless, tempest-tossed to me,  
I lift my lamp beside the golden door!

How can such a country brutally close its doors to brave people fleeing from poverty and persecution and seeking only to be free? ■

## The AT&T Case (Cont. from p. 1)

petition in telecommunications service... and telecommunications equipment... has been restrained and eliminated."<sup>1</sup> This complaint was filed under section 4 of the Sherman Act, which makes restraint of trade unlawful.

The trouble with the Justice Department complaint, and with the Sherman Act in general, is that *competition, if it is successful, always restrains or eliminates trade.* The whole purpose of competition is to take business away from one's competitors. If it does not restrain or eliminate trade, it is not competition.

Moreover, we depend upon this effect of competition to give consumers "the benefits of a free and competitive market," as the Justice Department complaint says. If a business firm is charging too high a price in a free market or is inefficient in production, it opens up the field for others to capture business by charging a lower price and supplying the good more efficiently.

The functions of this market competition are 1) to teach consumers who will best serve them, and 2) to reveal which methods of production, and which market structures, will serve consumers well. No one can know this information independently of the test of market competition. AT&T claims, for example, that several suppliers of long distance services will be inefficient, and will raise long distance telephone rates. Its competitors claim that competition will lower rates. The only way to know is to open the market to competition and observe the results.

The very fact that the Justice Department seeks to determine market structure through its lawsuit shows that it does not understand the most fundamental and important functions of market competition.

Independent of this process, neither a business firm, a legislature, nor a court can know what industry structure should be. As the *Wall Street Jour-*

*nal* noted in an editorial, "It's becoming increasingly clear that this [the structure of markets] is an area where the judiciary has no special expertise, especially in high technology industries where competitive forces rapidly change markets in unanticipated ways."<sup>2</sup> The very fact that the Justice Department seeks to determine market structure through its lawsuit demonstrates that its members do not understand the functions of market competition.

Another area where policymakers misunderstand competition is "cross-subsidizing." Cross-subsidizing is the use of monopoly profits to compete in unregulated markets. The Justice Department opposes it and filed a brief (in a separate court case this year) which said AT&T shouldn't be allowed to enter unregulated markets "until effective structural safeguards have been fashioned to insure that AT&T cannot engage in cross-subsidization or other abuses of monopoly power."<sup>3</sup>

The only way to earn profits in an open market is to serve consumers better than others in the market. The only way for AT&T to compete effectively in providing centralized answering or data-retrieval services, for example, is to do it better, or for less, than others. This is true regardless of where AT&T obtains the money to compete. If it uses the monopoly profits of its franchises to compete in unregulated fields, this eliminates the need to raise the money through capital markets and provides a competitive edge over other companies who must capitalize their ventures. But this competitive edge works to the advantage of the consumer, who now gets a lower-priced product because AT&T is competing. Far better that Bell use its ill-gotten gains to compete in unregulated markets than to buy more legislative influence that hinders competition.

The perception of the ill effects of cross-subsidizing stems largely from AT&T's monopolization of the communications equipment business.

(Cont. on p. 4)

## In This Issue

What's Wrong With Regulation and Antitrust: The AT&T Case	1
Closing the Door on Immigrants (Editorial)	2
Foreign Aid: An Obstacle to Economic Growth	7
Briefs	5
Regulatory Watch/FCC	6
Washington Update	8
Government Receipts Monitor	10
PR Reviews	11
"To be governed . . ."	12

## POLICY REPORT

ISSN: 0190-325X

Published by the Cato Institute, *Policy Report* is a monthly review that provides in-depth evaluations of public policies and discusses appropriate solutions to current economic problems.

David Boaz . . . . . Executive Editor  
Richard H. Fink . . . . . Managing Editor  
Tyler Cowen, Daniel Klein . . . . . Research

### EDITORIAL BOARD

Yale Brozen . . . . . University of Chicago  
Karl Brunner . . . . . University of Rochester  
Friedrich A. Hayek . . . . . University of Freiburg  
M. Bruce Johnson . . . . . University of California at Santa Barbara  
Israel M. Kirzner . . . . . New York University  
Gerald P. O'Driscoll, Jr. . . . . New York University  
Edwin G. West . . . . . Carleton University  
Leland B. Yeager . . . . . University of Virginia

Subscriptions and correspondence should be addressed to: *Policy Report*, P.O. Box 693, Englewood, CO 80151. The annual subscription rate is \$15.00 (12 issues). Single issues are \$2.00 per copy. *Policy Report* is published monthly by the Cato Institute, 224 Second Street SE, Washington, D.C. 20003. POSTMASTER: Send address corrections to P.O. Box 693, Englewood, CO 80151.

Copyright © 1982 by the Cato Institute



## The AT&T Case (Cont. from p. 3)

AT&T buys most of its equipment from Western Electric, a wholly-owned subsidiary, despite offers from other companies to sell AT&T better equipment or the same equipment at a lower price. This is seen as evidence that AT&T is abusing its monopoly power by extending it from telecommunications delivery to telecommunications manufacture.

The question to be answered is this: Why would any company purchase equipment at a higher price than necessary? Even for a monopolist, this would not generally be a good business practice. There is no sense in making something at home when it can be purchased more cheaply in the market.

No sense, that is, unless you are a *regulated monopoly*. If the prices you may charge as a monopolist are based on the costs of providing the service, then running up your costs means running up your profits. Running up costs, however, is expensive. A more efficient way of capturing profits is to make it look as if you have run up your costs. The way AT&T does this is to make its own equipment relatively cheaply and pay a high price for it. As a result, AT&T makes a profit on the manufacture of equipment (which is permitted since it is an unregulated industry) and erects a high cost base on which the regulators calculate your rate of return.

Worrying about cross-subsidizing misses the real significance of Western Electric. If AT&T could simply take its monopoly franchise profits and be done with it, it might or might not dominate the manufacturing market, and it would not really matter. Dominance would simply indicate that the company could compete successfully in the open market. But when AT&T must gain its monopoly profits through subterfuge, Western Electric is most important. The divestiture of Western Electric would deprive AT&T of a means of capturing monopoly profits *in the delivery industry*, and

would take away an incentive to maintain the monopoly.

### Harmful Regulation

Regulation is not merely ineffective, it is also harmful. It does not prevent the monopolist from capturing monopoly profits, it merely prevents

## **"The suit does not challenge the one thing that would restore full and healthy competition to the telecommunications industry."**

him from taking them openly. Yet it is used to justify the granting of monopoly franchises.

This is nowhere so evident as in the history of AT&T. After AT&T's monopoly patents expired in 1894, the company faced vigorous competition. Despite the massive capital support AT&T enjoyed when J. P. Morgan joined the board in 1902, the competition gained ground on AT&T. Historian Gabriel Kolko writes:

In 1902 there were 9,100 independent telephone systems, and by 1907 there were 22,000. The number of phones in the independent system expanded so rapidly that in 1907, the year of peak relative strength for the independents, AT&T had 3.1 million phones in service, the independents 3.0 million.<sup>4</sup>

During this period, AT&T refused to connect independent systems to its own systems and pursued an aggressive merger policy. Neither method of competition retarded the growth of the independents, the attendant fall in telephone rates, or the explosive growth of the telephone industry.<sup>5</sup>

Because AT&T could not gain control of the industry through market competition, it turned to government. It was the telephone company that

asked for monopoly franchises (to prevent competition) and government regulation (to make monopoly palatable to the public). "If there is to be no competition, there should be no public control," said AT&T President Theodore Vail in 1907.<sup>6</sup>

Between 1907 and 1910 AT&T successfully established a telephone monopoly by persuading state legislators to grant AT&T exclusive franchises for providing telephone services. These franchises are the basis for AT&T's present monopoly. This monopoly would not be tolerated by the public were it not for the cover of regulation.

### Political Competition

AT&T's capture of monopoly franchises is an example of political competition—another faulty aspect of regulatory and antitrust policy. While market competition succeeds by providing consumers with better and cheaper goods, *political competition works by using force to prevent market competition*. With competition punishable by law, AT&T's monopoly franchises drove the competition out of business. The result was profits that were gained by charging customers higher prices than could have been charged in the market. Political competition is a way of plundering the consumer.

We see political competition today in the activities of those who want to exclude AT&T from competing in unregulated fields. The newspaper industry, for example, wants to include a provision in the current telecommunications bill that will prevent AT&T from originating the data they send through their networks. In other words, the newspaper industry wants laws that prevent AT&T from entering the news business.<sup>7</sup> William McGowan, chairman of MCI, a competitor of AT&T in long-distance communication, wants the courts to prevent AT&T from competing in the long-distance market.<sup>8</sup> Potential com-

petitors also want the telecommunications bill to prohibit AT&T from entering the data processing field.<sup>9</sup> And the Justice Department tried through the courts to prevent AT&T from offering answering and other telephone services.<sup>10</sup> All of these efforts use coercion to prevent a potentially more efficient and lower cost delivery of services to consumers.

A more subtle and pernicious form of political competition is seen in the activities of Caspar Weinberger and other members of the Reagan administration. Weinberger asked Attorney General Smith to drop the antitrust suit against AT&T because the unity of the AT&T network was important to United States national security.<sup>11</sup>

Weinberger wants the government to protect the monopoly position of AT&T because the monopoly serves the interests of national defense (or at least the interests of the defense establishment). If the Defense Department needs a unified communications network, they could pay for one. By helping AT&T to maintain a monopoly, the defense establishment retains the network they want, and once again, the consumer pays for it in the form of monopoly prices.

### Conclusion

The AT&T antitrust suit, while it will not result in justice for either telecommunications producers (including AT&T) or consumers, nevertheless reveals some faults of regulatory and antitrust policy. The suit reveals that regulation is not merely ineffectual, it is also harmful, in that it makes governmental grants of monopoly more palatable. The suit reveals how little of market competition our policymakers understand. Market competition always excludes competitors and restrains trade. Were it not for the exclusion of inefficient competitors, market competition would not serve its function of benefiting the consumer. And the suit reveals how antitrust law and regulation shift com-

□ Alfred E. Kahn, formerly head of the Civil Aeronautics Board and a proclaimed advocate of deregulation, recently testified at a Joint Economic Committee hearing that Interstate Commerce Commission Chairman Reese H. Taylor Jr. is slowing the pace of trucking industry reform that began under the Carter administration despite the "proclaimed faith of the Reagan administration in free competitive enterprise." Kahn argued that "I... see clear evidence of retreat from free-market principles," because the ICC is now acting "in a more protectionist, anticompetitive manner." The ICC's stricter definition of operating authority, additional restrictions on price flexibility and closer examination of license applications were among the specific anticompetitive measures cited by Kahn at the hearing.

□ A U.S. Court of Appeals recently has ruled that churches and other religious organizations can be sued for violations of federal antitrust laws, even when they claim that their business conduct was motivated by religious concerns and thus protected by the Constitution. In a unanimous decision, the court rejected arguments from Roman Catholic groups that the First Amendment grants churches absolute immunity from antitrust laws. The case arose when Costello Publishing Co. of New York charged that church groups had discouraged Catholic book dealers from distributing its unauthorized version of a book entitled *Morning and Evening Prayer*.

□ A new study by Department of Agriculture economists has concluded that "fat cat" farmers still receive the bulk of the benefits from federal farm commodity support programs. For instance, an examination of the direct payments made in 1978 revealed that almost half of the \$2 billion paid out in subsidies went to the largest 10% of farms participating in the various USDA programs. Only a third of the nation's 2.4 million farmers participated in these programs at all. One area of abuse uncovered by this study was that limitations on payments to single farmers (usually \$40,000) were skirted by a variety of technicalities. The study uncovered at least 279 cases where the payment limits were circumvented, and in 52 of these cases, the farms collected over \$100,000 each.

□ Sources in Washington report that Senate Majority Leader Howard Baker (Tenn.) is exploring the idea of a huge, special national sales tax over the next few years to finance President Reagan's military buildup and to help reduce the federal deficit. Although such a tax is still in the planning stage, rumors indicate that the tax would be of limited duration but may be large enough to finance the entire defense budget (approximately \$180 billion this year). Although the tax rate would be high, certain "necessaries," such as food, might be exempted.

petition from the realm of the market (where competition benefits the consumer) to the realm of politics (where competition harms the consumer).

With these shortcomings in antitrust and regulatory policy in mind, the path toward a proper policy should be more readily apparent. What the law should do is prevent monopoly, i.e.,

prevent those grants of special privilege that allow some people to enter a field, while denying others. This unequal treatment before the law is the source of nearly everything that is wrong in the telecommunications industry. The elimination of this unequal treatment would restore the healthy competition to telecom-



## The AT&T Case (Cont. from p. 5)

munications that existed before monopoly grants.

After a massive study of the telecommunications industry by Charles River Associates, the senior author of the study wrote:

While many pages are used in this monograph to "document" the case, the fundamental conclusion of this study can be stated rather succinctly: Let a free market decide the truth of present speculations about the size, nature and direction of this industry; with these decisions made in the marketplace, rather than in a regulatory proceeding, both the industry and its customers will almost certainly be better served.<sup>12</sup>

The point, exactly. Unfortunately, this is what the AT&T suit does not do. In the news release announcing the suit against AT&T, the Justice Department listed charge after charge levied against the company. Then in its last sentence it says: "The suit does not challenge the concept of exclusive franchises for the provision of local exchange telephone service." Here, in a nutshell, we see the fundamental flaw of the suit against AT&T. The Department of Justice does not challenge the one thing that would restore full and healthy competition to the telecommunications industry. ■

*The author wishes to thank Garret Vaughn for helping him to understand the ways and wiles of the telephone monopoly.*

<sup>1</sup>U.S. vs. AT&T, 1974, p. 13 of original complaint.

<sup>2</sup>Wall Street Journal, 30 January 1981.

<sup>3</sup>Wall Street Journal, 8 September 1981.

<sup>4</sup>Gabriel Kolko, *The Triumph of Conservatism* (Chicago: Quadrangle Books, 1963), p. 47.

<sup>5</sup>Kolko, p. 49.

<sup>6</sup>See Ida Walters, "Freedom for Communications," in *Instead of Regulation* (Lexington: D.C. Heath and Co., 1982), pp. 117-118. Walters has an excellent brief history and economic analysis of the telephone monopoly.

<sup>7</sup>See Wall Street Journal, 30 January 1981.

<sup>8</sup>Wall Street Journal, February 10.

<sup>9</sup>Wall Street Journal, February 11.

<sup>10</sup>Wall Street Journal, September 8.

<sup>11</sup>Wall Street Journal, April 8.

<sup>12</sup>John R. Meyer et al., *The Economics of Competition in the Telecommunications Industry* (Boston: Charles River Associates, Inc., 1979), p. xviii.

## Regulatory Watch

### FEDERAL COMMUNICATIONS COMMISSION

FCC Chairman Mark Fowler has recently asked Congress to repeal both the Fairness Doctrine and the equal-time rules that govern the nation's broadcasting industry on the ground that these provisions are based upon "bankrupt concepts." The commission voted 4 to 2 to make such a recommendation. Rep. Timothy Wirth (D-Colo.), chairman of a House telecommunications subcommittee, responded to Fowler's announcement by saying that the FCC is wrong to consider these issues as "simple deregulation measures," adding that the equal-time law and Fairness Doctrine are unlikely to be quickly abolished by Congress.

The FCC has postponed its previously scheduled date for accepting applications for cellular communications systems. Although the FCC announced in April that such applications would be considered in November 1981, the agency has received 25 petitions in the meantime asking that the rules and policies that apply to these communications systems be changed. The new date of acceptance for applications is now set at 30 days after these petitions are resolved.

The FCC has proposed new rules that would eliminate or modify the commission's previous requirements that broadcast stations disclose detailed financial information to the agency. If these rules are finalized, commercial stations will probably not have to report much more than their gross revenue and certain data on expenses. This proposal is currently open for public comment.

An amendment has been drafted by the FCC that would eliminate the requirement that all commercial broadcast licensees retain a disclosure file of all letters they receive from the public. The FCC has announced that unless public comments are able to demonstrate adequate justification for this rule, it will be abolished. This action came in response to an informal petition from the President of the Southern California Broadcasters Association Inc., suggesting that the requirement be eliminated as part of the commission's attempt to deregulate radio broadcasting.

The FCC has accepted 8 of the 14 applications submitted for the provision of new and experimental developmental direct broadcast satellite (DBS) services, which deliver video programming by satellite directly to home antennas. Six applications were rejected for failure to submit sufficient technical information and adequate information on the applicant's legal and financial qualifications. Although the future of DBS services looks promising, the building and launching of DBS satellites requires an investment of several hundred million dollars, and the satellites are not expected to be constructed until at least three years after the applications are granted.

Revisions of the FCC's standards for license renewal are being considered. A notice issued in the Federal Register seeks public comment on whether the FCC should adopt more specific standards for license renewals in order to place new applicants for licenses and incumbents on an equal footing. Under the present system, even incumbents with a meritorious record face a competitive disadvantage due to FCC diversification criteria.

## Foreign Aid: An Obstacle To Economic Growth

by Philip R.P. Coelho

Foreign aid is once again a subject for newspaper headlines and political debate. Influential voices in the media and in politics advocate increased aid as a moral obligation of the United States. Descriptions of children from the Third World living in abject poverty are contrasted to the typical American. Some suggest that Americans, as an affluent people, have a duty to alleviate poverty in the Third World. The Reagan administration is less sympathetic to these contentions than its predecessors.

President Reagan's intuition is correct; foreign aid is neither a necessary nor a sufficient condition for economic development. Foreign aid, rather than improving living conditions, has actually increased misery, reduced living standards and allowed significant misallocations of economic resources in recipient countries. Furthermore, by almost all standards of fairness, it is inequitable.

"Foreign aid" is defined as a unilateral transfer of economic resources from one nation to another on a continuing basis. This definition excludes military aid, for which some *quid pro quo* is assumed, and one-time transfers, usually for a catastrophe not likely to be repeated, such as disasters or wars. Third World or less developed countries seek aid, theoretically to either begin or hasten their economic development.

A rational argument for foreign aid is seldom made; advocates of aid simply assume that the unilateral transfer of financial resources from developed nations to underdeveloped nations is desirable.<sup>1</sup> In any attempt to

Philip R. P. Coelho is chairman of the Department of Economics at George Mason University.

justify foreign aid it must be assumed that: (1) financial resources are the bottleneck in the development process; (2) sufficient funds cannot be raised within the underdeveloped country; (3) transferring capital to the govern-

**"The aid process itself with its emphasis on plans and government intervention contradicts the basis of a market-oriented economy."**

ment of the underdeveloped nation will alleviate the financial bottleneck; and (4) it is in the self-interest of the developed world to transfer these resources. All of these assumptions must be correct for foreign aid to be logically defensible. However, these assumptions are demonstrably false.

Our understanding of how an economy works has advanced a great deal from the 1950's when foreign aid was first advocated and logically justified. It was assumed that because Western Europe had recovered so rapidly from its wartime devastation, the Marshall Plan (which channeled American aid to these countries) could be credited for the European recovery. Analogies were drawn between war-devastated Europe and traditionally low-income countries (today's Third World). Arguing that the Marshall Plan was responsible for Europe's recovery is itself a demonstration of the "post hoc ergo

propter hoc" fallacy. "Miracle" recoveries from devastation by either war or natural calamity are the rule rather than the exception. John Stuart Mill pointed this out in 1848.<sup>2</sup>

Economic research has not only proven the analogy between post-war Europe and low-income countries to be false, research has undermined the assumptions necessary to make a rational case for aid. Yet the advocates of aid are either unaware of these results or have ignored them.

First consider the idea that lack of capital is a bottleneck to economic development. Actually, capital is not the key to development, but the result of development.<sup>3</sup> Consider it logically: Suppose that capital were the *sine qua non* in the development process and could only be furnished externally. Then how did the developed nations develop? All countries were at one time at least as poor as the poorest country today. The necessary economic infrastructure and capital were acquired in the development process. Today, however, the underdeveloped world can use the knowledge and skills learned by developed countries; it does not have to expend its efforts in rediscovering ways to use these resources.

With all this knowledge to draw upon, one cannot contend that the Third World nations are too poor and too overpopulated to utilize their resources. Hong Kong and Singapore demonstrate that lack of natural resources is no major impediment to economic growth, as do the Japanese, Taiwanese and South Korean peoples. The developed world (essentially North America, Europe, Oceania and Japan) was much poorer 500 years ago than the Third World nations today.

(Cont. on p. 9)



## Washington Update

✓ With the approval of President Reagan, Interior Secretary James G. Watt has urged Congress to reject a bill that would give Watt the power to grant rights-of-way for coal pipelines. Watt said he opposes the bill because it runs counter to the Reagan administration's policy of returning such powers to state governments. The backers of this bill contend that it would break up the railroad monopoly in the coal-hauling business by encouraging the construction of coal-slurry pipelines that could carry coal eastward from western mines.

✓ Energy Secretary James Edwards has announced that the Reagan administration has decided not to remove all price controls from natural gas until next year. The new plan for decontrol calls for President Reagan to propose next March that price controls be phased out from 1 January 1983 through 1 January 1986. This schedule actually extends controls on some gas for longer than the decontrol timetable of the 1978 Natural Gas Policy Act. Edwards said that the main reason for delaying decontrol was the 1982 congressional elections, which would make many congressmen hesitant to vote for price increases for the nation's most widely used heating fuel.

✓ President Reagan has again postponed his decision about turning the Department of Education into a large, subcabinet foundation, in order to have additional time to sound out Congress on this idea. Although Reagan considers this proposal the most politically attractive of his alternatives, it is generally conceded that it would satisfy neither the critics nor the supporters of the Education Department. Under this plan, the new "foundation" would keep \$11 billion in education programs, \$1.5 billion would be transferred to other departments, and several small programs totaling less than \$150 million would be eliminated.

✓ The House Energy and Commerce Committee has recently approved a bill that would start daylight savings time in March (two months earlier than at present) and have it run for eight months of the year. Proponents of this bill claim that it would save about 100,000 barrels of oil a day, result in approximately 200 fewer traffic deaths a year and reduce violent crime more than 10%. The measure is expected to run into strong opposition from the nation's farmers.

✓ The Department of Energy has proposed reducing the scope of its residential energy conservation program to the minimum levels required by Congress and transferring the rest of the program to state and local governments. This would give state governments the power to set standards for materials used in insulation and relax the rules on the home energy audits that many utilities now offer. This proposal also suggests that the Residential Conservation Service be shut down because private-sector initiatives have filled the conservation gap that this program was designed to alleviate.

✓ The Senate has beaten back another attempt to abolish the Legal Services Corporation (LSC) by voting down most of the major proposed cuts in the LSC budget. As a result, the LSC will survive, with only a 25% cut in budget. Although President Reagan wants to eliminate the LSC, the Senate allocated \$241 million for 1982. Opponents of the LSC did succeed in severely limiting the organization's power to engage in politics, lobby, or file broad-based class action suits.

✓ The Customs Service has just proposed rules that would implement its 1978 amendments to the Endangered Species Act. If finalized, these rules would make it legal to import antique items made from animals on the endangered species list as long as an item was made prior to 1830 and not

modified after 1973. In most cases, the age and origin of the item must be thoroughly documented by the importer. These documentations will be subject to close scrutiny by the Customs Service labs located in most of the ports where these imports must be cleared.

✓ In addition to threatening to dispose of the Treasury Department's Bureau of Alcohol, Tobacco, and Firearms, the Reagan administration is considering budget cuts for the Justice Department's Drug Enforcement Administration and the FBI. It is possible that the DEA may have to cut \$1 million from its budget and eliminate 211 of its 1,896 agents, while the FBI might have to reduce its special agent force from 7,700 to 7,200 as part of a larger cut of 2,000 employees.

✓ The Treasury Department has liberalized its regulations governing the sale of corporate tax shelters so that companies on the verge of bankruptcy will have a greater chance to sell their investment credits and depreciation rights. This revision has already prompted widespread last-minute changes in a host of previously pending tax sale deals. Perhaps the best known of these deals is when Ford sold all of its tax breaks on equipment purchases to IBM for between \$100 million and \$200 million. Much of the pressure to liberalize the Treasury rules came from Chrysler Corp., which felt the previous regulations were too restrictive.

✓ Although the Office of Management and Budget has recommended that all federal agencies be required to follow the same contracting procedures, the Department of Defense has strenuously objected to this idea. House-Senate conferees have recently acceded to a Pentagon request and approved a provision that would exempt the DOD from all OMB contracting regulations.

## Foreign Aid (Cont. from p. 7)

Poverty is a handicap, but a handicap that can and has been overcome.

Research in economic history indicates that the developed world prospered not through some *deus ex machina*, but through the persistent efforts of the people to improve their individual lives. Economic history has ignored important factors in the development process, such as new technology (i.e. railroads, canals, spinning jennys),<sup>4</sup> the exploitation of colonies,<sup>5</sup> slavery,<sup>6</sup> and virtually all other conditions unique to one area or time period.<sup>7</sup> Advocates of development have ignored these findings; however, this is not their greatest error.

The most egregious fallacy in the argument for foreign aid is the belief that it will improve the material conditions of life for the poor in those countries and increase the output of the recipient economy. Aid is given by governments to governments. Most Third World nations are ruled by one man through one political party. To believe that the individual that rules the country will act in the best interest of the nation as a whole is like believing in Santa Claus. Modern economic and political theory has rejected the idea of a benevolent despot acting in the public interest and replaced it with the concept of *utility-maximizing individuals* ruling nations (acting in their own interests).<sup>8</sup> The distinction between the concepts is crucial. Most advocates of aid to the developed world would vigorously object if resources were transferred, *carte blanche*, to *their* political leaders. Yet this is what the developed world does to the underdeveloped world. The results are grandiose projects meant to glorify and enhance the clique currently in power, a military budget enlarged out of all proportions to the country's requirements, and an internal security system replete with the very latest technology. These expenditures have the effect of keeping the current regimes in power, regimes which, besides being repressive and

corrupt, are a hindrance to economic development.

These statements may seem too sweeping since aid is usually tied to a specific project. However, an analogy should reveal the transparency of the "tying aid." If you give me money and insist that I spend it on food, I *will* spend it on food; but the money I

### "We have middle-class taxpayers in donor countries giving aid to the wealthy of the recipient country."

would have spent on food I will now spend on whatever I wish.

The granting agencies (the World Bank, the International Monetary Fund [IMF], the Agency for International Development [AID], etc.) are themselves run by utility-maximizing individuals. In order to justify agency requests for larger operating budgets (as distinct from foreign aid budgets), the agencies have to show donors that they are providing valuable services. So rather than just doling out funds, they insist on a plan. The preparation of the plan is assisted, of course, by experts from the granting agency. These plans usually ignore any economically rational allocation of resources. Resulting projects are typically huge because it is easier to plan one large project than 1,500 small ones. In general the plans are wishful thinking,<sup>9</sup> resulting in uneconomical steel mills that must import both fuel and ore to operate (Burma), collectivization of agriculture that reduces the farmer's incentive to produce (Tanzania), and a host of projects designed to replace imports with domestically produced goods, but which often result in a product that is a negative gain. This makes the coun-

tries poorer for having received aid. Also, the foreign exchange saved is frequently used to import more military equipment. The entire concept of import substitution is suspect. Underdeveloped nations are establishing their own industries in television and "irons, mixers and all the other things of the good life."<sup>10</sup> Subsidizing small, inefficient markets in a country that has a comparative disadvantage in the production of these items contradicts over two centuries of economic theory and a millennium of economic history.

Involvement by the developed world in these projects may benefit contracting companies and the favored few that are the recipients of government largess in the underdeveloped country, but it will certainly impede material progress. That progress may actually be reduced, rather than merely slowed, if the aid given requires an on-going infusion of resources to sustain it. For example, if a steel mill built with foreign aid cannot operate without subsidies, then not only is the money wasted but the recipient of this generosity is made poorer.

The aid process itself with its emphasis on plans and government intervention and control contradicts the basis of a market-oriented economy and impedes economic growth. Presumably the United States is a proponent of free, market-oriented economies, yet we insist on planning documents, detailing what actions the recipient government will take to insure success. This gives bureaucrats with both the donor and recipient countries the illusion that the plan is a set of directions for economic growth. A bureaucratic apparatus is set up to see that it is implemented, and unforeseen events can require even more government intervention if the plan is to be carried out. The result is a "Sovietization" of the economy; inefficiencies abound, bureaucratic despotism and corruption prevail, and there is no progress in the economy. These



observations are not unique. Even widely-read news magazines have concluded that a recipe for rapid development is: "Don't draw western aid... (because it) will generally shift expenditure towards non-entrepreneurial large projects from which civil servants can draw graft."<sup>11</sup> Yet in the debate over aid, open consideration of these objections brands the objector as an uncaring ideologue.

Finally, we have to ask whether it is in the self-interest of the donor countries to contribute aid. As noted above, the real beneficiaries of foreign aid typically are the bureaucrats, military, and governing elite of the recipient country, a group that would not be considered poor even by the donor country's standards. Thus, we have middle-class taxpayers in donor countries giving aid to the wealthy of the

recipient country. It would be wonderfully ironic except for the side effects: unpopular, despotic and corrupt regimes; vast expenditures on the military and "internal security"; grandiose projects that, at best, will be completely useless (as distinct from a continuing drain); and the imposition of a planning process that results in retrogression and the stultification of the economy. Is this in our self-interest? Do we want more Central African empires, Bolivias and "Big Daddy" Amins?

Foreign economic aid has been justly criticized. There may be unique circumstances whereby aid is justified, but they are rare. The engine of development in the developed nations has been entrepreneurial capitalism. Capitalism in the past two centuries has, as Marx and Engels wrote, "...created more massive and more colossal productive forces than all preceding generations together."<sup>12</sup> Should we not allow the underdeveloped nations of the world to experience the benefits of capitalism as opposed to the central planning that foreign aid inevitably entails? The United States is proof of the enriching benefits of capitalism. Let this legacy be our gift to the Third World; it will be more lasting and productive than any port, steel mill, or airport. ■

<sup>11</sup>See Howard F. Smith, "International Tax: An Idea Whose Time has Come?" *The Collegiate Forum*, Winter 1980-81, p. 10; and "A Survival Summit," *Newsweek*, 26 October 1981, pp. 36-56.

<sup>12</sup>John Stuart Mill, *Principles of Political Economy* (London: Longmans Green and Co., 1891), p. 47.

<sup>13</sup>For elaboration, see: Douglass C. North and Robert P. Thomas, *The Rise of the Western World* (Cambridge: Cambridge University Press, 1973), p. 2.

<sup>14</sup>See Robert W. Fogel, "Railroads and American Economic Growth" and Robert B. Zevin, "The Growth of Cotton Textile Production After 1815," in *The Reinterpretation of American Economic History*, eds. Robert W. Fogel and Stanley Engerman (New York: Harper and Row, 1971).

<sup>15</sup>See Robert P. Thomas, "A Quantitative Approach to the Study of the Effects of British Imperial Policy upon Colonial Welfare: Some Preliminary Findings," *Journal of Economic History*, vol. 25, no. 4 (December 1965); Robert P.

Thomas, "The Sugar Colonies of the Old Empire: Profit or Loss for Great Britain," *Economic History Review*, 2nd ser, vol. 21 (April, 1968); and Philip R.P. Coelho, "The Profitability of Imperialism: The British Experience in the West Indies," *Exploration in Economic History*, vol. 10, no. 3 (Spring 1973).

<sup>16</sup>See Robert P. Fogel and Stanley Engerman, *Time on the Cross* (Boston: Little Brown and Co., 1974); Robert P. Thomas and Richard Bean, "The Fishers of Men: The Profits of the Slave Trade," *Journal of Economic History*, vol. 34, no. 4 (December 1974); and Alfred H. Conrad and John R. Meyer, "The Economics of Slavery in the Anti-Bellum South," *The Journal of Political Economy*, vol. 66 (April 1958).

<sup>17</sup>North and Thomas, op. cit.

<sup>18</sup>See Anthony Downs, *An Economic Theory of*

*Democracy* (New York: Harper Brothers, 1957); and James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962).

<sup>19</sup>Examples of the misuse of economic aid and planning are abundant. See P.T. Bauer, *Dissent on Development* (London: Cox and Wyman, Ltd., 1971); and Wolfgang Stolper, *Planning Without Facts* (Cambridge: Harvard University Press, 1966).

<sup>20</sup>Alan L. Otten, "Pilot Plant Tests and Trains Aiding Third-World Industry," *The Wall Street Journal*, 27 February 1981, p. 21.

<sup>21</sup>*The Economist*, vol. 281, no. 7210 (7 November 1981), p. 44.

<sup>22</sup>Karl Marx and Friedrich Engels, *The Communist Manifesto* (Baltimore, Md.: Penguin Books, 1967), p. 85.

Because of a computer error, it appears that some *Policy Report* subscribers may not have received the December issue. We are attempting to determine which subscribers missed the issue, and their subscriptions will be extended one month. If you do not receive the December issue, please write to *Policy Report*, 224 Second Street, SE, Washington, DC 20003, for a replacement copy. We are sorry for the error.

## GOVERNMENT RECEIPTS MONITOR

A quarterly feature of *Policy Report*, the "Government Receipts Monitor" summarizes the latest levels and sources of the federal government's income.

RECEIPTS (annual rate in millions of \$, unless otherwise stated)

	1981 3rd Q	1981 2nd Q	1981 1st Q	Average for Last Year
Total Receipts	626,848	634,108	625,292	602,612
Surplus or Deficit	-58,780	64,964	-128,208	-64,061
Total Individual Income Taxes	320,272	434,840	309,340	332,850
Gross Corporate Income Taxes	60,632	116,816	59,376	73,733
Employment Taxes and Contributions	167,200	188,308	172,056	162,993
Social Insurance Taxes and Contributions	191,648	222,212	189,432	186,426
Unemployment Trust Fund	16,528	26,780	10,036	16,128
Excise Taxes	46,580	47,724	40,056	40,839
Highway Trust Fund	6,788	6,164	6,640	6,455
Estate and Gift Taxes	7,432	6,652	6,384	6,787
Customs Duties	9,296	8,284	7,420	8,082
Miscellaneous	16,224	13,560	12,388	13,788
Holding of Public Debt Securities (current total)	997,855	971,174	950,498	957,397
Holding of Agency Securities (c.t.)	6,086	6,176	6,339	6,283
Federal Securities Held by Public (c.t.)	794,434	775,973	763,449	763,579

SOURCE: Monthly Treasury Statement of Receipts and Outlays of the United States Government.

## PR Reviews

*Bureaucracy vs. Environment: The Environmental Costs of Bureaucratic Governance*, eds. John Baden and Richard J. Stroup. University of Michigan Press, Ann Arbor, 1981, 238 pp. \$15.00.

Baden and Stroup introduce this volume with a note: "The essays in this volume share a theme. Although this theme is important, clear, and compellingly valid in a large and varied set of cases, it is only slowly becoming understood. Specifically, we are increasingly convinced that both the environmental and the economic costs of bureaucratic management of natural resources are excessively and unnecessarily high. These social costs are generated by perverse institutional structures that give authority to those who do not bear the responsibility for the consequences of their actions."

Rather than blaming self-interest and the profit motive, these essays convincingly demonstrate that poorly defined and enforced property rights are the real cause of our environmental problems. The topics include federal natural gas policy, coal gasification, water development projects, land grazing policy and timber management. The book also contains several discussions on general public choice and property rights theory. Contribu-

tors include such well-known names in environmental economics as Terry Anderson, M. Bruce Johnson and Bernard Shanks, as well as Baden and Stroup.

A good example of the approach used by many of the essays is in Stroup's article, "The Policy-Induced Demand for Coal Gasification." Stroup shows how price controls on natural gas have created gas shortages and led to the production of synthetic natural gas, an environmentally hazardous substitute.

The book, which includes a selected bibliography, should be useful to those interested in free-market solutions to the environmental problems created by public-sector activity.

*Antitrust and Monopoly: Anatomy of a Policy Failure*, by Dominick Armentano. John Wiley and Sons, New York, 1982. \$22.95/\$12.95.

After an additional 10 years of observing the failure of antitrust theory and policy, Professor Armentano of the University of Hartford has revised and expanded his *The Myths of Antitrust: Economic Theory and Legal Cases*, published in 1972. Armentano's new book provides an even more thorough documentation of his thesis that antitrust laws do not protect the consumer from monopoly. Quite to the contrary, antitrust laws actually reduce competition and tend to pro-

mote inefficiency and a misallocation of resources. Antitrust suits themselves are often used as an important instrument for punishing efficient competitors at the expense of inefficient competitors.

Before discussing the practice of antitrust, Armentano devotes the first two chapters to an analysis of the theory behind antitrust policy. There is a brief development of a market process view of competition, which sees monopoly as the product of state intervention and views rivalrous behavior as the essence of the competitive process. Armentano then provides a history of the Sherman Act and carefully examines many of the most important antitrust cases in American history. Price conspiracy, price discrimination, tying agreements and mergers also are closely examined from both a theoretical and historical perspective. In many cases, Armentano uses the court's own words to prove that the indicted corporations were not engaging in anticompetitive behavior. He concludes that antitrust laws cannot be legitimized and should be replaced because they hurt the interests of consumers and producers alike.

*Antitrust and Monopoly: Anatomy of a Policy Failure* is probably the best existing critique of American antitrust policy. Clearly written and nontechnical, it is highly recommended for all readers. ■



# "To be governed..."

## Rules are made to be broken, for some people

Late one night in Kansas City, [Nelson] Rockefeller couldn't find his Water Pik. "He had dental work that debris would catch in sometimes," recalls Hugh Morrow, the former Rockefeller spokesman. "So with the aid of the local police, [aide] Joe [Canzeri] broke into a drugstore, got the Water Pik and left the money on the counter—including the local sales tax. . . ."

During the 1968 New York City garbage strike, Rockefeller was once in all-night negotiations with the union. By 5 a.m. the group was tired and hungry. Canzeri broke a kitchen lock at the nearby Gotham Hotel, then made bacon, scrambled eggs, coffee and toast for the group of 30.

—*Washington Post*, Dec. 1, 1981

## Is that anything like "We're going to raise taxes after the election"?

[Sen. Howard] Baker, appearing on "Face the Nation," said that although tax increases next year should be ruled out, "I'm willing to consider revenue enhancement in out years."

—*Washington Post*, Oct. 26, 1981

## Pork barrel subsidies—Irish style

Smuggling of farm animals and consumer goods is the new international sport along the border between Northern Ireland and the Republic of

Ireland, says John Conroy in the newsmagazine *Maclean's* of Toronto (Oct. 5). It is attracting a lot of fans since Britain joined the Common Market.

"Smugglers began taking Southern pigs into the North legally, collecting their subsidies, and then illicitly moving the same pigs back to the South to repeat the process. And Northerners smuggled their pigs into the Republic, only to bring them back home masquerading as Southern pigs eligible for subsidy."

Trade statistics suddenly showed the importing of more pigs than there are in all of Ireland. Border crossing is easy, and pigs have no identifying marks. So the sport goes on.

—*World Press Review*, December, 1981

## Pro-family government

Sixteen relatives of a [Chicago] city alderman draw a total of about \$355,000 in city salaries, it was reported.

—*Washington Post*, Nov. 19, 1981

## No kidding?

Milk production has continued to rise, and so has the cost of buying and storing all the surplus butter, cheese and powdered milk the Government now buys. . . .

"It doesn't do a dairy farmer any good to cut back production when he can sell all he wants to the Govern-

ment," an Agriculture Department official, who asked not to be identified, said Wednesday.

—*New York Times*, Nov. 27, 1981

## Austerity bureaucrat-style

At a time when the White House is forcing the Consumer Product Safety Commission to make drastic cuts in its staff and budget, the agency's new chairman is busy preserving the perks of her office.

First Nancy Harvey Steorts, who took office two months ago, ordered her chauffeur to wear a suit whenever he drives her around town—or risk being fired.

Then, despite President Reagan's directive urging his appointees to refrain from redecorating their offices, Steorts has spent \$8,000 to \$10,000 to refurbish her office.

What's more, at a time when the government is trying to cut down the use of outside consultants, Steorts has hired three—at rates that amount to a total of \$84,000 a year—to give her advice on media relations, industry and business relations and how to use the commission's office space.

Steorts hired the consultants about the same time she reminded all 663 CPSC employees that they must take annual leave for any lunches that last more than a half hour to help save the agency money.

—*Washington Post*, Oct. 8, 1981

**POLICY REPORT**  
224 Second Street SE  
Washington, D.C. 20003

**SECOND CLASS**  
POSTAGE PAID  
AT WASHINGTON, D.C.

**CATO**  
INSTITUTE