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The Constitutional Protection of Economic Freedom

by Paul Craig Roberts

Brazil's new democratic government is currently writing a new constitution. Recently, the American Bar Association and the Institute of Brazilian Lawyers sponsored a "Symposium on the U.S. Constitutional Experience" in Rio de Janeiro. It is perhaps a sign of the changing intellectual climate that Paul Craig Roberts was selected over Harvard economist John Kenneth Galbraith to address the symposium. Roberts's speech, presented here in abridged form, was very enthusiastically received and is being distributed in Portuguese to everyone involved in the constitution-writing process. Paul Craig Roberts, a former assistant treasury secretary, is now William E. Simon Professor of Political Economy at Georgetown University's Center for Strategic and International Studies.

A person born in one of the Western democracies before the turn of the century was born a private individual. He was born into a world where his existence was attested by his mere physical presence—without documents, forms, permits, licenses, orders, lists of currency carried in and out, identity cards, draft cards, ration cards, exit stamps, customs declarations, questionnaires, tax forms, reports in multiplicate, Social Security number, or other authentications of his being, birth, nationality, status, beliefs, creed or right to be, enter, leave, move about, work, trade, purchase, dwell. He was born into a world where a person could travel anywhere on the face of the earth, except Russia and Turkey, without need of a passport, visa, or identity card. He was born into a world of freedom of movement of people, money, and ideas. A confident 19th-century futurology predicted that the 20th century would find him freer still.

> "The private individual is a recent and precarious invention. A central question of our time is whether he is a mere momentary caprice of history."

But by World War I, the world into which that person was born was already in decline. The period since then has been one of autonomy not of the individual, but of the state. He was born in a century that pulled down walls, and he lived out his life in the century of the wall builders. Whether made from iron, or from barbed wire, mine fields, and machine-gun towers, or from paper—the barbed wire of documents—20th-century walls are byproducts of the universal bureaucratization of life. In place of the 19th century's autonomous individual, to whom some romanticized that all things were permitted, we have the 20th century's autonomous state, to which, as Dostoevsky predicted and Lenin declared, all things *are* permitted.

The private individual is a recent and precarious invention. A central question of our time is whether he is a mere momentary caprice of history.

Many people take private individuals for granted, and they will find what I am saying farfetched. But private individuals do not exist in the Soviet Union, where the claims of the state are total and even art and literature must be subservient. Neither do private individuals exist in many of the emerging nations, where change consists only of replacing the subordina-

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Bowen Backs Health IRAs at Baby-Boom Conference

Dr. Otis R. Bowen, secretary of health and human services, said the government should explore medical IRAs as a solution to soaring Medicare costs.

Bowen's remarks came at a conference, "Tomorrow's Elderly: Planning for the Baby Boom Generation's Retirement," sponsored by Americans for Generational Equity and co-sponsored by the Cato Institute.

At a panel on the future of Social Security, Cato adjunct scholar Peter J. Ferrara argued, "Requiring such a huge [payroll-tax] investment only in Social Security, rather than allowing workers the freedom to choose from the broad spectrum of private alternatives, has now become one of the foremost restrictions on economic freedom in American life."

Ferrara presented his proposal for Super IRAs, which would offer better

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Surprise! Promising Developments in Washington

As the interminable debate over fiscal policy drags on with depressingly little progress in either controlling spending or simplifying taxes, it is refreshing to note an undercurrent of administration initiatives that are all very much on target for reducing the negative impact of government on the economy.

First, in antitrust, commerce secretary Malcolm Baldrige has made some bold policy moves that challenge the myths underlying much of the Clayton and Sherman acts. In an international marketplace, bigness is not bad and cooperation isn't anti-competitive. The antitrust reforms that are likely to flow from the Baldrige initiative will strengthen our worldwide competitive posture by ridding the marketplace of the shackles of archaic anti-competitive laws.

Also from the Commerce Department, with cooperation from Justice, are efforts to halt the destruction of our tort-law system. Under the direction of General Counsel Douglas Riggs, Commerce is pushing for limits on so-called pain-and-suffering judgments and, more importantly, is challenging the doctrine of joint and several liability. The latter concept, whereby a party peripherally involved in an incident may end up paying *all* damages if it has "deep pockets," is being used by egalitarian judges to pursue an ideological agenda.

A third promising development consists of various privatization initiatives. At the Department of Transportation, Secretary Elizabeth Dole has joined forces with such private organizations as Citizens for a Sound Economy to push through the sale of Conrail. At the Urban Mass Transportation Administration, Administrator Ralph Stanley has been demonstrating the superiority of private transportation service over public monopolies (as he did in the last issue of *Cato Policy Report*). And at the Energy Department, there has been talk of selling off government oil reserves and even Power Marketing Authorities.

Finally, although Bill Isaac and Todd Conover have left the FDIC and Comptroller's office, respectively, their push toward financial deregulation has clearly borne fruit. As the administration is well aware, the financial area is a case of the regulators simply getting out of the way of the market, which has, through technological advances, overwhelmed the regulatory process.

Since the Cato Institute is, as the *Atlantic* recently put it, "in the vanguard of market thinking," it should not be surprising that we are working actively in each of these four areas. In a new book for us entitled *Antitrust Policy: The Case for Repeal*, Adjunct Scholar D. T. Armentano takes some of Mr. Baldrige's assumptions to their logical, and correct, conclusions. Adjunct Scholar Richard Epstein, author of *Takings: Private Property and the Power of Eminent Domain* (Harvard University Press, 1986), will be advising the Institute on means of returning the judicial system to its traditional common-law respect for the sanctity of contracts. Senior Policy Analyst Catherine England is heading up a major new year-long project on financial deregulation that you will be hearing more about in the months ahead. Finally, our study calling for the privatization of the Bonneville Power Administration will be followed by a book by economist Douglas Adie calling for the privatization of the postal system. We will hold a conference on the postal-privatization issue, which we expect will receive important support from within the administration.

None of this good news should cause us to overlook the administration's rather lackluster record in many other areas, such as tax reform, monetary policy, natural-gas deregulation, and, especially, entitlements. Cato will continue to study and report on the feasibility of private-sector alternatives in these and other fields with the hope that this and future administrations will increasingly support the market option in public policy.

—Edward H. Crane

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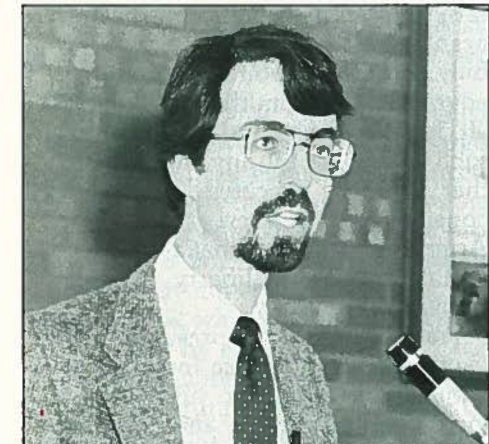
Impact of Government Income Transfers Examined

Cato News

The effects of income-transfer programs were examined at a conference sponsored by the Policy Sciences Program of Florida State University in March. Papers from the conference will appear in the Spring-Summer 1986 issue of the *Cato Journal*.

Charles Murray, author of *Losing Ground: American Social Policy, 1950-1980*, discussed the most visible form of transfers, payments to the poor, in the dinner speech. In the two years since his book was published, Murray said, "The debate on social policy has changed dramatically. . . . Everybody now agrees that an underclass is out there, is large, and requires attention." Murray warned, however, that the enthusiasm for such new programs as workfare and child support for enforcement will lead us down new dead ends, and we will discover in a few years that these programs—like the others—have created incentives to avoid work and responsibility.



Greg Duncan of the University of Michigan discusses the poverty population at Florida conference on the transfer society.

Cato chairman William A. Niskanen called for a constitutional approach to taxes and transfers that would "address the rules of the game, rather than the results of a specific play of the game."

Discussion of transfer payments in this light may leave the impression that most transfers in our society are from rich to poor. In fact, however, as conference director James Gwartney of Florida State and Richard L. Stroup of Montana State University pointed out, of total direct income transfers of $475.6 billion in 1983, only $78.1 billion went for means-tested programs. And "if indirect transfers emanating from tariffs and other trade restrictions, occupational licensing, and other regulatory programs were counted, the share of transfers directed toward the poor would be even smaller. Three major types of transfers are likely in a democratic system, said Gwartney and Stroup: transfers from many unorganized individuals to concentrated groups of well-organized individuals, transfers from future to present voters, and transfers from the poorly informed and politically inactive to the better informed and more politically skilled.

Gordon Tullock of the Center for Study of Public Choice looked at the overall nature of political transfers and concluded, "No one looking at real world governments can doubt that they

(Cont. on p. 4)

No Industrial Policy in Space

The space-commercialization industry promises to bring tremendous economic and national-security benefits in the coming decades. Its advocates are making a critical mistake, however, in pursuing government-directed development because it is certain to doom all hope for a private-sector space industry, according to Alan Pell Crawford in a new Cato study.

"Federal control represents a serious obstacle to true commercialization—if by that one means a business environment in which the forces of the market, not the whims of the federal government, dominate," Crawford writes. The Reagan administration's budget for FY 1987 would provide $45.8 million for space commercialization and $9.6 million for NASA's Technology Utilization program. These allocations are viewed enthusiastically by the space-commercialization lobby, a group of current and prospective beneficiaries of federal contracts determined to reap the ultimately huge profits without assuming any of the initial risks.

Crawford also warns that establishing favored corporations while making the federal government a "bureaucratic middleman" would entrench existing relationships between government and industry in space endeavors. Subsequent development decisions would then be based on political, not market, conditions creating an industry that "could, in dollar value as well as in potential for mischief, rival the public works pork barrel of the 1960s and the synthetic-fuels and nuclear-power boondoggles of the 1970s."

Technological advancement does not create unemployment, but rather the opposite, according to another new study from the Cato Institute.

R. H. Mabry, professor of finance at Clemson University, and A. D. Sharplin, professor of management at Northeast Louisiana University, write, "Any potential unemployment problem . . . is not inherent in technological advancement, which is beneficial in the long run. There may be short-run problems when resource markets are less than perfectly competitive, but markets will eventually adjust to eliminate any involuntary unemployment resulting from technological advancement."

Technological advancement, the authors point out, has had positive long-run effects on employment: shorter workweeks, fewer working days per year, more persons employed, and rising incomes, for example. It creates new wealth for society, which in turn creates more jobs.

Technology can create unemployment only when markets are not free and competitive. Government interference, in the form of protectionism or other barriers to foreign or domestic competition, prevents markets from working efficiently, resulting in unemployment.

The two studies are part of the Cato Institute's Policy Analysis series and are available for $2.00 each.

Armentano Book Urges Repeal of Antitrust Laws

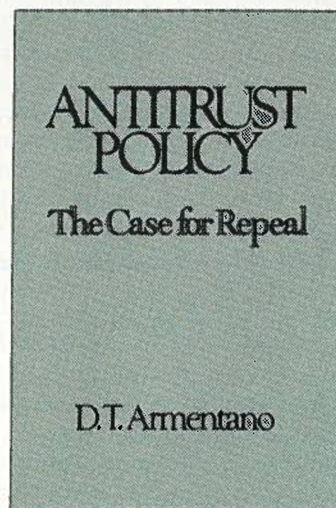
There is no longer any respectable economic theory or empirical evidence to support antitrust laws, argues economist D. T. Armentano in *Antitrust Policy: The Case for Repeal,* just published by the Cato Institute.

In his highly readable book, Armentano argues that the Reagan administration's proposed reforms are insufficient and that "the case against antitrust is strong enough to justify repeal of all the antitrust laws."

Commissioner Frederic N. Andre of the Interstate Commerce Commission writes, "Armentano's work is critically important to the current debate over antitrust reform. Rather than tinker with current dogma, he challenges it straight on, offering a thoughtful critique of its presuppositions and a cogent argument for thoroughgoing reform."

Armentano, professor of economics at the University of Hartford and author of *Antitrust and Monopoly: Anatomy of a Policy Failure* (1982), points out that "traditional antitrust policy has collapsed like a house of cards." Economists have rejected much of the theory and the empirical evidence underlying antitrust, and the regulatory authorities have begun to reflect this revisionist view. Most tellingly, the Reagan administration has proposed the most sweeping changes in the Clayton Act in 35 years.

But even most critics of antitrust remain convinced that there is some role for antitrust in a free-market economy, a position Armentano challenges directly. He criticizes the orthodox eco-



nomic theory of competition and monopoly, pointing out that antitrust theory seems to regard most manifestations of vigorous competition as attempts to monopolize.

Armentano cites such famous cases as Alcoa, Standard Oil, ready-to-eat cereals, Borden, and Brown Shoe to illustrate his contention that antitrust enforcement has more often than not punished genuine competitive behavior. He also reviews such recent cases as IBM, AT&T, and the Texaco-Getty merger.

In his final chapter, Armentano reminds us of Adam Smith's famous warning that "people of the same trade seldom meet together . . . but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." This statement has often been used to support antitrust laws. But, Armentano points out, antitrust's advocates omit Smith's next sentence: "It is impossible, indeed, to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice." Armentano contends that antitrust laws violate individual liberty as well as economic efficiency.

Fred L. Smith Jr., president of the Competitive Enterprise Institute, says, "Some day economic historians will look back at current antitrust policy with the same bemusement that is now reserved for false dogmas like the labor theory of value. Prof. Armentano has been in the forefront of efforts to expose the myths of antitrust. With this important new book he has surely delivered a fatal blow to the remnants of respectability still clinging to antitrust theory."

Antitrust Policy: The Case for Repeal is available in paperback for $7.95. ■

Income Transfers (Cont. from p. 3)

do to some extent generate genuine public goods. No one observing them can doubt that they also engage in a lot of transfers mostly the result of rent seeking. Indeed, Dwight Lee has argued that what public goods they do generate are normally a byproduct of rent seeking by the factor suppliers in those areas."

Other speakers and commentators at the conference included *Cato Journal* editor James Dorn, Anna Kondratas of the Heritage Foundation, June O'Neill of the Urban Institute, Terry Anderson and Peter J. Hill of the Political Economy Research Center, Cato adjunct scholar Peter Ferrara, Harvard economist Glenn Loury, and Bruce Gardner of the University of Maryland. ■

Richard L. Stroup of Montana State University explains his analysis of government transfer programs to Lisa Schiffren of the *Detroit News*.

Forums Look at Welfare, Foreign Policy, Development

Increased welfare payments have raised the poverty rate, contended Lowell Gallaway at a Cato Policy Forum.

Gallaway, an Ohio University economist, found that as welfare payments rose during the 1970s, poverty rates began to climb as well. Gallaway discussed several reasons for this reversal in the historical downward trend of U.S. poverty, including disincentive effects, structural poverty, and the role of children.

Welfare programs, Gallaway argued, create disincentives to work. The larger the payment, the greater the disincentive. For people near the poverty line, the disincentive effects of welfare programs have been greater than the income-enhancing effects. The programs have created what Gallaway described as "poverty by choice."

In her response, June O'Neill of the Urban Institute focused on possible econometric problems in the time-series analysis used by Gallaway and on the difficulty of making accurate calculations of non-cash benefits. Gallaway responded that his time-series analysis included over 40 different models with varying assumptions and that his research includes extensive cross-sectional analysis.

Gallaway's talk was based on his recent study "Paying People to Be Poor," published by the Dallas-based National Center for Policy Analysis.

The "Real Conservative Agenda in Foreign Policy" was the topic of a recent Policy Forum featuring Christopher Layne, a former NATO/West European analyst at the U.S. Army's Arroyo Center think tank, and Robert Osgood of the Johns Hopkins University.

Layne's remarks, based on his recent article in *Foreign Policy,* centered on his assertion that "real conservatives" are concerned about America's strategic overcommitment and the toll it exacts from "the fourth branch of national defense"—the domestic economy. Much to Layne's dismay, it is the neoconservatives who have gained the upper hand in influencing the foreign policy debate, successfully casting each issue in terms of a bipolar world with a dangerously fragile balance of power.

The logical policy for the neocon-

June O'Neill of the Urban Institute comments on Lowell Gallaway's research findings on welfare and poverty.

servatives is "to resist communism everywhere" because "a defeat of free institutions anywhere is a defeat everywhere," said Layne. This "Reagan doctrine," as Layne characterized it, is ill-founded because U.S. strength is declining relative to the rest of the world.

"Reagan's foreign policy is not an expression of neoconservatism," countered Osgood. Citing the disparity between the president's rhetoric and his actual performance, Osgood said that current policy is marked by "extreme moderation in political action." The only two exceptions have been the Strategic Defense Initiative, "a remote vision without operational significance," and defense-budget expenditures aimed at redressing "past neglect."

Layne responded that the administration's rhetoric cannot be dismissed as insignificant. By stating that the country "can be safe only in an ideologically congenial world," it has tied America to an interventionist foreign policy fraught with risks and costs. It is essential that conservatives identify the limits of American power and determine our vital strategic interests in order to regain a proper perspective of America's role in the world, he argued.

(Cont. on p. 13)

Niskanen Briefs French Cabinet

Cato chairman **William A. Niskanen** has had a busy speaking schedule recently. Late in April he traveled to Paris to brief the new French government headed by Prime Minister Jacques Chirac on the success of the U.S. experience with deregulation under former president Carter and President Reagan. He also spoke on industrial competitiveness to the Foreign Service Institute and the Corning Management Committee; on Reaganomics, the subject of his forthcoming book, to the Midwest Economics Association; and on bureaucracy at a conference sponsored by George Mason University's Center for Study of Public Choice.

Cato president **Edward H. Crane** discussed the burdens of the baby-boom generation at Trinity College in Connecticut and at Columbia University, under the auspices of the St. Anthony Educational Foundation. His speech to the Cleveland Business Economists Club, "Beyond the Status Quo," was reprinted in *Vital Speeches of the Day.*

Vice president **David Boaz** spoke to the Heritage Foundation's Third Generation meeting on "Why I Am Not a Conservative" and to the student body of the Park School in Baltimore on libertarianism.

Cato Journal editor **James A. Dorn** was appointed a Research Fellow of the Institute for Humane Studies at George Mason University to enable him to complete his editing (with Leland B. Yeager) of the collected works of Clark Warburton. His paper "Industrial Policy and the Nature of the Firm: Comment" was published in the *Journal of Institutional and Theoretical Economics.*

Senior policy analyst **Catherine England** discussed the impact of debt financing on bank stability at a Hillsdale College colloquium on deficits. Among the other speakers were Federal Reserve governor Martha Seger and two Cato adjunct scholars: **James M. Buchanan,** director of the Center for Study of Public Choice, and **Thomas J. DiLorenzo,** who cited material from his recent book *Destroying Democracy* to explain why government spends too much. ■

The Takeover Controversy: Shareholders vs. Managers

The Cato Institute regularly sponsors a Policy Forum at its Washington headquarters where distinguished analysts present their views to an audience drawn from government, the media, and the public policy community. A recent forum featured Michael C. Jensen, LaClare Professor of Finance and Business Administration at the University of Rochester and professor of business administration at Harvard University. Commenting on Jensen's remarks was David Ravenscraft, an economist with the Federal Trade Commission's Line of Business Program.

Michael C. Jensen: I find myself in the unusual position of being on the other side from the Business Roundtable in this debate. I've spent a lot of time defending corporations and the CEOs that run them. Unfortunately, in this case the corporation is threatened by people on the inside, not the outside.

The concerns expressed by Berle and Means in their 1932 book *The Separation of Ownership and Control* have been turned upside down. There used to be great concern about the separation of ownership and control that resulted from widespread small stockholdings in large corporations. Corporations were criticized for being run by managers who were not owners, and large stockholders were considered desirable. Now large stockholders are pariahs in many quarters, and there is a great longing for someone called the "long term" investor, a person who knows little about the corporation and doesn't care—because he has small holdings—and who will thus let managers alone.

Transactions in the corporate-control market are generating large benefits for shareholders and for the economy as a whole. The corporate-control market generates these gains by loosening control over vast amounts of resources and enabling them to move more quickly to their highest-valued uses. It is a healthy market on both the takeover side and the divestiture side.

Obviously, takeovers threaten managers. The market for corporate control is best viewed as a major component of the managerial labor market. It is the arena in which alternative management teams compete for the rights to manage corporate resources. Understanding this is crucial for understanding much of the rhetoric about the effects of hostile takeovers. Managers whose jobs were formerly protected from competition, by antitrust and financing constraints that prevented takeover of the nation's largest corporations, are now facing a more demanding environment and a more uncertain future. It is not surprising that many executives of large corporations would like relief from this new competition for their jobs, but restricting the corporate-control market is not the efficient way to handle the problems caused by the increased uncertainty in their contracting environment.

Michael Jensen: "Transactions in the corporate control market are generating large benefits for shareholders and for the economy as a whole."

Policy Forum

Takeovers generally occur because changing technology or market conditions require a major restructuring of corporate assets. When the internal processes for change in large corporations are too slow, costly, or clumsy to efficiently accomplish this restructuring, the capital market, through the market for corporate control, brings about substantial and necessary changes in corporate strategy.

Takeovers are particularly important in bringing about efficiencies when exit from an activity is required. The oil industry is a good example of the control market as an instrument of change in such a situation. It is particularly hard for managers in an industry that must shrink to deal with the fact that some firms have to go out of business. Exit is often cheaper to accomplish through merger and the orderly liquidation of the marginal assets of the combined firms than by slow death in a competitive struggle in an industry with overcapacity. The end of such a process often occurs in the bankruptcy courts, with high losses and unnecessary destruction of valuable parts of organizations that could have been used productively by others.

In short, the external takeover market serves as a court of last resort that plays an important role in generating organizational change, motivating the efficient utilization of resources, and protecting shareholders when the corporation's internal controls and board-level control mechanisms are slow, clumsy, or break down entirely. The market does not, however, operate without cost. But I have no doubt that the benefits exceed the costs. Over $40 billion in tender-offer premiums alone has been earned in the last four years by target firm shareholders.

Divestitures are the subject of much unwarranted criticism. If assets are to move to their most highly valued uses, acquirers must be able to sell off assets to those who can use them more productively. Therefore, divestitures are a critical element in the functioning of the corporate-control market and should not be inhibited. Divested plants and assets do not disappear; they are reallocated. Sometimes they continue to be used in similar ways in the same industry, and in other cases they are used in very different ways and in different industries. But in all cases they are moving to uses that their new owners are betting will be more productive. These transfers are beneficial to society.

The takeover and divestiture markets provide a private market constraint against bigness for its own sake. The potential gains available to those who correctly perceive that a firm can be purchased for less than the value realizable from the sale of its components provide an incentive for entrepreneurs

to search out such opportunities and to capitalize on them by reorganizing such firms into smaller entities.

The mere possibility of a takeover motivates managers to avoid constructing uneconomic conglomerates and to break up those that currently exist. The defensive actions taken by many firms in the face of a takeover threat often lead to policy changes similar to the proposed actions of the potential acquirer. The reorganizations in the oil industry, the sale of "crown jewels," and divestitures carried out to liquidate large debt positions in order to buy back stock or to make other payments to stockholders are good examples. Unfortunately, the basic economic sense of these transactions is often lost in a blur of emotional rhetoric and controversy.

More than a dozen separate forces drive takeover activity, including deregulation, synergies, economies of scale and scope, taxes, managerial incompetence, and increasing globalization of U.S. markets. One major cause of takeover activity, however, the agency costs associated with conflicts between managers and shareholders over the payout of free cash flow, has received relatively little attention. Yet it has played an important role in acquisitions over the last decade.

Managers are the agents of shareholders, and because both parties are self-interested there are serious conflicts between them over the choice of the best corporate strategy. Agency costs are the total costs of coordinating the divergent interests that arise in such cooperative arrangements. They consist of the costs of monitoring and bonding managerial behavior, such as the costs of producing audited financial statements and implementing compensation plans that reward managers for actions that increase investors' wealth, and the inevitable costs that are incurred because the conflicts of interest can never be resolved perfectly. Sometimes these costs can be large: they have amounted to billions of dollars in the oil industry.

Free cash flow is cash in excess of that required to fund all of a firm's projects that promise to earn more than the cost of capital. Such free cash flow must be paid out to shareholders if the firm is to be efficient and is to maximize value. The problem is how to motivate managers to disgorge cash to investors rather than wasting it on organizational inefficiencies or low-return projects.

Managers are generally reluctant to pay out resources to shareholders because it reduces managerial power and subjects them to monitoring by the capital markets when they must obtain new capital. Managers also have incentives to over-retain funds for growth because their compensation is positively related to growth. Moreover, the tendency of firms to reward middle managers through promotion rather than year-to-year bonuses creates a strong organizational bias toward growth to supply the new management positions required.

Managers with substantial free cash flow can increase dividends or repurchase stock and thereby pay out current cash that would otherwise be invested in low-return projects or wasted. However, managers are then left with control over the use of future free cash flows: promised cash payout in the form of a "permanent" increase in the dividend is a weak promise because future dividends can be reduced.

Debt has important control effects in reducing the agency costs of free cash flow. Buying back stock with newly created debt enables managers to effectively bond their promise to pay out future cash flows in a way that cannot be accomplished by simple dividend increases. Through such debt creation, managers give shareholder-recipients of the debt the right to take the firm into bankruptcy court if they do not maintain their promise to make the interest and principal payments. Debt-for-stock exchanges reduce the waste associated with free cash flow by reducing the cash available for discretionary spending by the managers. Debt also creates organizational incentives to motivate managers and gives them the threat of crisis (bankruptcy) to help overcome normal organizational resistance to the retrenchment that the payout of free cash flow often requires; programs must be canceled, careers must change, and layoffs are frequently required. Moreover, debt-for-stock exchanges create tax advantages at the corporate and personal levels.

The evidence from takeover activity in the oil industry supports this argument. Radical changes in the energy market since 1973 simultaneously generated large increases in free cash flow and required a major shrinking of the petroleum industry. In this environment, the agency costs of free cash flow were large, and the takeover market played a critical role in reducing them.

Following the 10-fold increase in crude-oil prices, the consumption of oil and expected future increases in oil prices fell. Real interest rates and exploration and development costs also increased, so that the optimal level of capacity in the industry fell. By the late 1970s, the industry had substantial excess capacity in crude reserves, refining, and distribution. At the same time, cash flows were huge. For example, in 1984 the 10 largest oil companies generated cash flows of $48.5 billion, 28 percent of the total cash flow of the top 200 firms.

Consistent with the theory of agency costs of free cash flow, management did not pay out the excess resources to shareholders. Instead, the industry continued to spend heavily on exploration and development activity even though average pre-tax returns were low, substantially below 10 percent according to an estimate by Bernard Picchi of Salomon Bros. Oil managers also launched unsuccessful diversification programs to invest funds outside the industry. These programs did, however, generate social benefits because the resources were paid out to target-firm shareholders rather than wasted on uneconomic drilling programs.

Mergers in the oil industry, motivated largely by T. Boone Pickens, have led to large increases in debt, payouts of large amounts of capital to shareholders (albeit target shareholders), reduced expenditures on wasteful drilling programs, and reduced capacity in refining and distribution. The benefits have been huge—total gains in the Gulf, Getty, and Conoco takeovers alone exceeded $17 billion—and more is possible.

Actual takeover is not necessary to induce the required retrenchment and return of resources to shareholders. For example, Unocal's defense in the Mesa tender-offer battle resulted in a $2.2

(Cont. on p. 8)

Takeovers (Cont. from p. 7)

billion (35 percent) gain to shareholders. Unocal paid out 52 percent of its equity by repurchasing stock with a $4.2 billion debt issue. The successful Unocal defense, incidentally, caused the company's shareholders to lose the $1.1 billion-higher Mesa offer.

Arco's voluntary restructuring resulted in a $3.2 billion (30 percent) gain in market value. It involved a 35–40 percent cut in exploration and development expenditures, repurchase of 25 percent of its stock for $4 billion, a 33 percent increase in its dividend, withdrawal from gasoline marketing and refining east of the Mississippi, and a 13 percent reduction in its workforce.

Diamond-Shamrock's reorganization announcement on July 10, 1985, was in marked contrast to the efficiency-generating retrenchments of the two firms just mentioned. Diamond-Shamrock's market value *fell* 2 percent on the announcement day and continued falling. The company's restructuring involved *reducing* cash dividends by 76¢/share (–43 percent), creating a master limited partnership (MLP) to hold 35 percent of its North American production, paying a 90¢/share annual dividend in partnership shares, repurchasing 6 percent of its shares for $200 million, selling 12 percent of its MLP to the public, and *increasing* expenditures on oil and gas exploration by $100 million a year. It did exactly the wrong things.

The free cash flow theory I am illustrating predicts that value-increasing takeovers occur in response to breakdowns in internal control processes in firms with substantial free cash flow and with organizational policies, including diversification programs, that are wasting resources. It predicts hostile takeovers, large increases in leverage, dismantlement of empires that lack economies of scale or focus to give them economic purpose (e.g., many conglomerates), and much controversy as current managers object to the loss of their jobs or to changes in organizational policies forced on them by the threat of a takeover. The CBS and Union Carbide restructurings to avoid takeover are further examples of this trend.

Mergers and acquisitions can be a mixed bag. Free cash flow theory also predicts which mergers and takeovers are more likely to destroy, rather than create, value; it shows how takeovers are both evidence of the conflicts of interest between shareholders and managers and a response to the problem.

Acquisitions are one way managers spend cash instead of paying it out to shareholders. Therefore, the theory implies that managers of firms with unused borrowing power and large free cash flows are more likely to undertake low-benefit or even value-destroying mergers. Diversification programs generally fit this category, and the theory predicts they will generate lower total gains. The major benefit of such transactions may be that they involve less waste of resources than if the funds had been internally invested in unprofitable projects.

Acquisitions made with cash or with securities other than stock involve the payout of resources to (target) shareholders, which can create net benefits even if the merger generates operating inefficiencies. To illustrate the point, consider an acquiring firm that has substantial free cash flow that the market expects will be invested in low-return projects with negative net present value of $100 million. If the firm acquires a target that generates zero synergies but uses up all of the firm's free cash flow (and thereby prevents its waste), the combined market value of the two firms will *rise* by $100 million. The market value increases because the acquisition eliminates the expenditures on internal investments with negative market value of $100 million. Extending the argument, acquisitions that have negative synergies of up to $100 million in current value will still increase the combined market value of the two firms. Such negative-synergy mergers will also increase social welfare and aggregate productivity whenever the market value of the negative-productivity effects on the two merging firms is less than the market value of the waste that would have been incurred by the firm's internal investment absent the merger.

Low-return mergers are more likely to occur in industries with large cash flows whose economics dictate that some firms should exit. Horizontal mergers within declining industries will tend to create value because they facilitate exit, and mergers outside the industry are more likely to result in low or even negative returns. Oil and tobacco both fit this description. Tobacco firms face declining demand due to changing smoking habits but generate large free cash flow and have been involved in major acquisitions recently. Takeovers have also been occurring in forest products, another industry with excess capacity.

The broadcasting industry generates rents in the form of large cash flows from its licenses. It, too, fits the theory. Regulation limits the supply of licenses and the number a single entity can own. Thus, profitable internal investments are limited and the industry's free cash flow is spent on organizational inefficiencies and diversification programs—making the firms takeover targets. The CBS debt for stock exchange and restructuring is a good example.

Free cash flow theory predicts that many acquirers will tend to have abnormally good performance prior to acquisition attempts, and that is in fact the case. This exceptional performance generates free cash flow, facilitating the acquisition. Targets are of two kinds: firms with poor management and poor results prior to the merger, and firms that have done exceptionally well and have large free cash flow that they refuse to pay out to shareholders.

It is important to recognize that the new restrictions on takeover activity imposed by the Federal Reserve's margin regulations, New York's anti-takeover law, and the "poison pills" authorized by the Delaware courts will prevent the realization of the productive gains from some acquisitions and reorganizations that would otherwise occur. An important reason bidders earn so little is the substantial advantages the current rules of the game give targets. The SEC 13d disclosure requirements are one such major imperfection in the current law regulating takeover activity.

It has become popular to argue that there is too much takeover activity. Yet the opposite is more likely true because of free-riding problems caused by current regulations that require the disclosure of purchaser holdings and intentions in SEC 13d reports. These reports must be filed within 10 days of acquiring 5 percent or more of a company's shares and must disclose the number of shares owned, the identity of the owner, and the purpose of the acquisition. Current rules allow the acquiring firm to buy as many additional shares as it can in the 10-day period between the time the 5 percent level is reached and the time of filing. This rule has allowed buyers to acquire shares averaging 7.6 percent of the target firm.

Since market prices quickly adjust after the 13d announcement to the expected value of the takeover bid, the acquirer's profits are made almost entirely on the difference between the price paid for the shares purchased prior to filing the 13d and their value after the acquisition. A wedge is thereby driven between the private benefits earned by the acquirer and the total social benefits of the acquisition: the acquirer pays 100 percent of the acquisition costs and, on average, captures less than 10 percent of the benefits. The remaining benefits go to the other shareholders.

Consider an acquisition that promises total expected gains of $100 million. If the acquirer expects to capture only $7.6 million of it if the bid is successful, the bid will occur only if the legal, investment banking, and other costs, including the required risk premium, are less than $7.6 million. No acquisition that is expected to cost more will be made, and shareholders and society are thus denied the benefits of those reorganizations. Expected costs of $10 million, for example, will cut off the bid, and the $90 million social benefit will not be realized. The solution is to either significantly relax the SEC 13d reporting requirements or significantly increase the current SEC 13d trigger point of 5 percent.

I expect that the pressure to increase the regulatory restrictions on takeovers will decrease somewhat as the sharp rises in stock prices and renewed expectations of growth change the nature of the business environment. I have little doubt, however, that the pressures will continue, if only at a low level, and that they will become intense again as corporate-control activity picks up.

David Ravenscraft: First of all, I should note that my views do not necessarily represent the views of the Federal Trade Commission or any of its commissioners. I should also confess that, despite the title of the talk, I'm not here to represent management's side in the takeover controversy. I agree with Professor Jensen that management often has both the incentive and the discretionary power to act in ways that may not be in the interests of the corporation, the shareholder, or society. But I would like to dampen some of the enthusiasm that Jensen has generated for mergers—I see mergers as the *sympton* of a problem, rather than the solution. That is, the negative synergies that Jensen mentioned deserve emphasis over the positive benefits arising from cash reallocation.

David Ravenscraft: "Energy, money, and time have been wasted on the merger game that would have been better spent rebuilding America's industrial base."

My view is based partly on a study of mergers and divestitures that F. M. Scherer and I have been working on for about four years. We have gathered information on some 5,000 mergers made by 451 large corporations between 1950 and 1976. By using the Federal Trade Commission's line-of-business data we were able to compare profit, loss, and balance-sheet information for business units that arose substantially through acquisition with the same information for business units that underwent little or no acquisition activity.

We found that the typical acquired company was highly profitable before the merger, with an average operating-income-to-assets ratio of 20 percent, while the industry average was 10.9 percent. If we ignore the premium paid to the acquired firms, post-merger profitability declines to normal or to 3 percent above normal, depending on the terminal year. If we include the premium, post-merger profit drops to approximately 3 percent below normal. So we begin with a 10 percent supernormal profit and drop to normal or below normal, depending on how you consider the assets. The decline was more pronounced for acquired units that were unrelated to the acquiring company's line of business than for related or horizontal acquisitions. The profit/loss figures that Scherer and I have observed are inconsistent with efficiency gains.

F. M. Scherer and I have also compiled a list of some 450 businesses that were divested between 1974 and 1981 in order to determine which factors influenced the decision to divest a line of business. Consistent with Jensen's argument, the change in top management is a significant determinant of sell-offs. Furthermore, high company profits deter sell-offs in general and divestitures of unprofitable lines in particular; thus, high profits protect unprofitable investments. Management change is one means of correcting this. But the management-change variable we employ is one that occurs naturally, not as a result of takeovers. In addition, by far the most important determinant of sell-offs is low business-unit profitability.

This raises a critical issue. The corporate system does work. Unattractive investments get terminated and management shakeups occur without drastic measures such as takeovers. On the other hand, the system is surely not perfect. The issue is, are there alternative means to improving it, and is the cost of these solutions worth the marginal improvements that they provide? Our sell-off analysis reveals one additional insight: next to profits, merger intensity is the most important determinant of divestitures. Between one-quarter and one-third of acquisitions are subsequently sold off.

Jensen points out that divestitures are important for moving assets to more productive uses. I agree. But the other side of the coin is that divestitures often represent failures, and to a large extent the failures were due to mergers. It seems strange to recommend mergers as a solution to managerial

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tion of the person to his tribe or caste with subordination to the modern activist state.

The Private-Property Revolution

Private individuals did not exist in ancient Egypt, and they were not prevalent in the Europe of the Middle Ages. Private individuals were the creation of the social revolution that created private property. This social revolution and the reaction to it comprise the social, economic, political, and intellectual history of Western civilization from the 12th century through the present. The revolution began with the Inclosures in the 12th century and attained its greatest flowering in the 19th century. Prior to the appearance of private property and private individuals, there were only the rulers and the ruled, the lords and the serfs.

A serf was a person who did not own his own labor. Although he was not himself owned by another—that is, he could not be bought and sold like a slave—the feudal state had rights over the serf's labor. A serf owed a certain amount of his working time to the state. Over time and regions this obligation seems to have averaged about one-third of a serf's working life.

In turn, the serf had use-rights in the land. The social revolution that abolished the serf's use-rights in the land abolished the state's use-rights in the serf's labor. The social revolution that created private property in land and capital created private property in labor. Serfdom disappeared as wages appeared. As Karl Marx recognized, "Wages and private property are identical."

Reaction to this great social revolution began immediately, and over most of the course of the revolution, reaction was identified with conservatism. But what was really happening was that as different groups—landowners, merchants, capitalists, and laborers—attained specific private-property rights in land, trade, capital, and labor, respectively, each group had an incentive to gain control of the state as a means of advancing its specific property rights at the expense of others. A "reactionary" was merely whoever had control of the state at a given point in time and was defending his interests against the interests of others. As different groups in different times gained control of the state, each in turn passed from the offensive to the defensive and automatically became conservatives, which meant they wanted to conserve their interests. But no group trusted the state as such; no group felt its property rights secure unless it controlled the state. Each group identified progress with the advancement of its own property rights.

Historians have often confused this strife among property interests with an alleged reaction of property against democracy. But whichever property group was in power, it tended to see democracy as the right of others to vote away its property. Democracy was thus limited to voting by members of the groups whose property interests were dominant. This greatly limited the power of government because any claim to act in the public interest was quickly recognized for what it was—a cover for the dominant private interests.

Although each property group had an accurate assessment of the threat of government to its interests, each group mistakenly saw its interests as divergent from the interests of others. However, despite the strife among its beneficiaries, the social revolution of private property was inexorable, and the real reactionaries were swept aside.

> "The guarantees of economic liberty in the U.S. Constitution have not held up as well as the guarantees of civil liberty."

Marx's Counterrevolution

But the revolution was never quite completed. Just as, through the influence of Adam Smith and others, the various property groups began to realize their common interests and unite against government per se, Karl Marx began a new counterattack against the ongoing revolution. Marx knew exactly what he was reacting to: private individuals. According to Marx, man is individualized only through the creation of private property: "Man originally appears as a generic being, a tribal being, a herd animal." Private property "makes the herd animal superfluous and dissolves the herd."

According to Marx, the private individual is rootless, powerless, alienated, and unfree. As an individual actor, he must bear the consequences of his own action; yet he has no control over his life because he is affected by, but has no control over, the actions of others. Thus, the divergent actions of private individuals produce consequences beyond the control of all, and a private individual is the victim of his own individuality. He only appears to be free.

Marx's solution was to do away with the private individual and reduce him to a herd animal. Herd animals do not act as individuals and therefore do not have to bear uncontrolled consequences of private actions. Instead, they act as a community, or the state acts for the community.

Marx's counterattack provided the basis for political movements in the 20th century that have rolled back economic freedom. As Marx and his followers translated his argument for the masses, it came out: "It is not government that exploits, but private property." To Lenin, to Mussolini, to Hitler, to European socialists and statists of all hues and to their counterparts in the United States, this meant that progress could be realized only through government. The strife this century between the various statists has overshadowed their agreement that government action is the instrument of progress.

The Success of the Reactionaries

The success of the reactionary forces in this century can be summed up in simple economic terms. By 1929, government in the United States had established a claim to 12 percent of the national income. By 1960, the government's claim had grown to 33 percent. By 1984, it had expanded to 42.5 percent. In relative terms, the position of a U.S. citizen today is worse than that of a medieval serf who owed the state only one-third of his working time.

The statists owe their success partly to capital accumulation and technological change, which raised national income over time. If people are better off in absolute terms, they may not notice that they are worse off in relative terms. But statists owe their success mainly to the power of reaction in the 20th century. It is striking that it has required little more than a half century to reverse a social revolution that has been in motion since the 12th century. When a "progressive" says that we cannot repeal the 20th century, all he is saying is that 20th-century statist reactionaries have repealed the 19th and 18th centuries and have us on the road back to serfdom.

Many may reject this parallel. They may say that the United States has a democratic government controlled by the people and that high taxes and big government merely reflect the voters' demands for public goods in the public interest. Such an argument is reassuring but problematical; the income tax, for example, was voted in under one guise and retained under another. Furthermore, it was the action of a past generation. For us it is an inherited obligation, as were feudal dues for others, and it is seen that way by the Internal Revenue Service.

When the U.S. government brought in the income tax in 1914, it gave assurances that it would fall only on the rich. Initially, the personal income-tax burden rested on only 357,515 people—less than one-half of 1 percent of the population—whose incomes were much greater than average. The tax rates ranged from 1 percent to 7 percent. Only income in excess of $186,500 (in today's dollars) encountered the first surtax bracket of 2 percent, and the top tax bracket of 7 percent was encountered only by income in excess of $4.6 million (in today's dollars). The personal income tax soon found its way into the lower brackets as income thresholds were lowered and tax rates were raised. The growth of the personal income tax can be summarized succinctly: between 1914 and 1982, the population grew 137 percent but the number of individual tax returns grew by 26,666 percent.

For the past decade and a half, taxes in the United States have grown much faster than wages or prices. From 1970 to 1983, the average wage rose 148 percent, the consumer price index rose 157 percent, and the tax burden rose 241 percent. The 241 percent growth in the tax bite exceeded the 233 percent growth in the total production of goods and services (GNP) and the 226 percent growth in total national income. Taxes far outpace the growth in real income. During 1984, federal receipts grew by 12.4 percent. The entire economy grew by 7.2 percent, and 3.9 percent of that growth was a result of inflation rather than an actual increase in the production of goods and services. Last year, U.S. taxpayers paid $151.4 billion more in taxes than they spent on the three basic necessities of food, clothing, and housing.

All of us have been born to the statist gospels. As recent experience under the Reagan administration has shown, clamors for tax reduction are translated into proposals for tax reform, which are further transformed into proposals for securing more revenues for government.

> "A constitution that prohibited the direct taxation of income and placed a limit on the government's claim to the national income would be a wondrous document."

Constitutional Protection

Even in a real democracy there is a great deal of propaganda in the term "self rule." Wise people know this, and they endeavor to protect themselves from their government by constraining it with a constitution. The U.S. Constitution provides protections for civil liberties and economic freedoms.

Unfortunately, the guarantees of economic liberty have not held up as well as the guarantees of civil liberty. Over time, the courts have emasculated many of the economic guarantees; and regulation and control of the economy have become commonplace as barriers to government growth have fallen. The constitutional amendment that made possible the personal income tax in 1914 provided the government with a source of enormous revenues. This mechanism, together with the government's assumed regulatory powers, has produced such a strong central power that who controls the government is often a matter of economic life or death.

Many people, especially intellectuals, mistakenly believe that the encroachment of the state on economic freedom is synonymous with an increase in economic justice. They have this illusion because they believe, perhaps erroneously, that whereas the feudal state redistributed income from the poor to the rich, the modern democracy redistributes income from the rich to the poor. They overlook the fact that in neither conception of the state does the individual own the fruits of his own labor.

Any doctrine of progress that depends merely upon which income class is being exploited suffers from serious moral deficiencies. Indeed, the progressive income tax—the mainstay of "economic justice"—seems almost atavistic in permitting discrimination on the basis of size and source of income and marital status when all other forms of personal discrimination, such as race, sex, and age, are strictly prohibited.

It would be a mistake to interpret the position taken here as one of cynicism and hopelessness. It is no more cynical than the position taken by the Founding Fathers of the U.S. Constitution, who knew that government, whatever its form, is by nature rapacious and that even a limited government must be bound by a carefully crafted constitution. They went wrong only in not anticipating the income tax.

In the late 18th century, when the U.S. Constitution was drawn up, the idea of an income tax would have been dismissed as feudal. The notion that a constitutional democracy would enserf its citizenry with an income tax was too farfetched to warrant specific constitutional protection. Nevertheless, although the income tax was not banned specifically by name and by constitutional provision, efforts to enact an income tax prior to 1914 were ruled unconstitutional, and it required a constitutional amendment in the United

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Economic Freedom (Cont. from p. 11)

States to reestablish a feudal relationship between the people and the state.

Taxes and the Constitution

Today, having witnessed constitutional governments grow in size and power far beyond the scope of the absolute monarchies of the past, we have learned that taxation should be treated explicitly as a constitutional issue. An income tax should be explicitly prohibited on the grounds that it is a direct violation of economic liberty. At the same time, the demands of the modern rapacious state for revenues must be acknowledged. The Constitution should specify both the form and the amount of taxation that are permissible. I would recommend a uniform value-added or expenditure tax, and I would specify that at no time could the revenues of the state exceed 20 percent of the national income.

Such constitutional protections do not preclude the redistribution of income. When governments are large, as modern governments are, income redistribution takes place primarily through the expenditure side of the budget. It is certainly possible to design government spending programs or income-transfer and income-support programs such that only the poor can qualify for them. A proportionate tax paid by all but spent only on the poor is redistributive. Indeed, even a regressive income tax can, through the expenditure side of the budget, result in the redistribution of income from rich to poor. Therefore, there is no honest reason for the ideological left to resist the constitutional protection of economic liberty.

Indeed, there is every economic reason for the left to support it. During most of our history, we had no income tax and no social safety net. Nevertheless, we absorbed wave after wave of penniless immigrants while the poverty level in the United States simultaneously declined. Today, we are being overrun by illegal aliens, who, not being citizens, do not qualify for welfare benefits or income-redistribution programs. They come and work and prosper. They have gained enough political clout to have bills introduced in Congress that would grant them citizenship. Sooner or later, these bills will pass. There are millions of illegal aliens in the United States, and none of them have found income redistribution necessary for their success. The people who cannot get anywhere seem to be that part of the native population that is born into welfare programs.

Of course, a government could always evade a constitutional limit on revenues by running budget deficits and financing them by borrowing or printing money. Therefore, it could be appropriate to constitutionally limit expenditures in addition to revenues and to specify that borrowing be limited to capital projects that add to productive social investment.

A constitution that prohibited the direct taxation of income and placed a limit on the government's claim to the national income would be a wondrous document. It would displace the U.S. Constitution as the model for the free world. It would revive the spirit and culture of freedom everywhere in the worn-out West, and it would infuse the country so blessed with principles that could make it the greatest nation on earth. ■

Health IRAs (Cont. from p. 1)

retirement prospects for today's young workers while easing the tax burden of Social Security in the long run. Most of the other panelists—including Brookings Institution economist Henry Aaron, chairman of the 1979 Advisory Council on Social Security; John Rother of the American Association of Retired Persons; and Robert Ball, former commissioner of the Social Security Administration—concentrated their fire on Ferrara's proposal.

Cato adjunct scholar Peter Ferrara speaks on Social Security reform at conference on baby-boom retirement issues. Ferrara is flanked by John Rother of the American Association of Retired Persons and former Social Security commissioner Robert Ball.

Another Cato adjunct scholar, John C. Goodman of the National Center for Policy Analysis, presented the case for medical IRAs at a panel on health-care issues. Goodman argued that medical IRAs would relieve the long-term financial crisis of Medicare while making individuals responsible for their own health care during retirement.

The conference was designed to consider the political and economic impact of the retirement of the largest generation of Americans ever. The baby boomers will begin retiring in just 22 years, and little attention has been given to whether Social Security and Medicare will be sufficient for their retirement. Many of the conferees discussed questions of "generational equity"—whether today's young workers are being overburdened by the demands of the elderly.

The Cato Institute's involvement in the conference was an outgrowth of two of its long-term interests. The Institute has long had a special interest in Social Security reform, beginning with the 1980 publication of Ferrara's *Social Security: The Inherent Contradiction.* Cato has also, in the words of Rep. Jack Kemp, "taken the lead in examining the way baby boomers will affect elections in 1988 and in years to come." Its activities in this area include a 1985 conference, "Reassessing the Political Spectrum," and its new book, *Left, Right, and Babyboom: America's New Politics.* ■

Reagan Administration Backs Privatization, Moore Says

Thomas Gale Moore of the Council of Economic Advisers, an adjunct scholar of the Cato Institute, discussed the Reagan administration's privatization proposals at a Cato Policy Forum. Moore, head of the president's task force on privatization, delivered his remarks to a capacity audience of nearly 85 policy analysts, administration officials, journalists, and congressional staffers.

Cato adjunct scholar Thomas Gale Moore, a member of the president's Council of Economic Advisers, discusses the Reagan administration's privatization program at Cato Policy Forum.

Privatization is a much-discussed topic among policymakers striving to live within the budgetary limits of Gramm-Rudman. Moore reminded them, however, that the proper objective of privatization is "not to raise money for the budget." Privatization is a desirable goal because a large number of services currently provided by the government could be more efficiently delivered by the private sector. Private firms are more adept at controlling costs and more responsive to concerns of service and quality because they must please the public in order to make money. "The government does not have the right incentives," according to Moore. Politicians gain from creating government jobs and inflating wages; politically powerful groups reap the benefits at the expense of other sectors of society.

Moore discussed the British experience as an instructive model for privatization initiatives. The key is "to identify the beneficiaries of a particular government activity and confer benefits on those groups that would lose by privatization." The sale of British Telecom stock was used as an example of what to do with the Northeast corridor of Amtrak: sell it, at a discounted price, to Amtrak's employees so that they will gain, not lose, from the sale while also giving them a stake in the railroad's efficient operation. "The government should not be in the railroad business," said Moore.

Contracting out services to the private sector is a good intermediate option between government provision and the outright sale of assets, according to Moore. Refuse collection, fire fighting, and the delivery and sorting portions of the Postal Service would be provided more efficiently by private firms. ■

Forums (Cont. from p. 5)

The assumptions behind conventional development economics were assailed at a recent Policy Forum on achieving economic growth in developing countries. The speaker was Devinda Subasinghe, an economist at the World Bank and a Ph.D. candidate at the School of Advanced International Studies at the Johns Hopkins University.

Subasinghe, a Sri Lankan, began by examining the presumption that classical economic analysis has no relevance to development economics. The claim is, "markets don't work and the substitute should be government," said Subasinghe.

The resulting emphasis has been on planning, trading controls, and a demand for a global transfer of resources from rich nations to poor. The assumption is, "infant nations cannot make it on their own" and need the terms of trade altered in their favor. The failure of this analysis in the face of economic successes in Sri Lanka, Hong Kong, and Singapore has brought about a reexamination of the state-oriented development model. "We in the developing nations have paid a dear price" for these failed policies, Subasinghe observed.

Nick Eberstadt of the American Enterprise Institute followed Subasinghe by highlighting some "unpleasant truths." He suggested that it would be wrong to overlook the Asian economies' deviations from the free-market model. The Hong Kong government, for example, controls a larger share of GNP than the U.S. government and subsidizes such critical commodities as housing and rice. South Korea has a demonstrated hostility to the private sector, Taiwan is still a planned economy that accepts Soviet assistance, and Singapore currently has a "eugenic" population-control program.

At another Forum, Bill Strauss of the National Taxpayers Union discussed a class-action lawsuit NTU is bringing against the U.S. government on behalf of America's 60 million children.

The suit, *Bonner* v. *Baker*, charges that the current pattern of federal deficit spending denies today's children their constitutional right to equal protection of the laws. As Strauss explained in his remarks, the Supreme Court has ruled in a number of cases that a law that imposes discriminatory burdens on a class of people is unconstitutional unless it bears a rational relationship to their relevant characteristics or serves "a compelling governmental interest."

Attorney Bill Strauss of the National Taxpayers Union explains why deficits are an unconstitutional burden on future taxpayers.

In the past, Strauss explained, the government sometimes had a justifiable, "compelling" interest in borrowing huge sums of money, for example, some economic or military emergencies. Even more, historical cases of borrowing are notable because they were all undertaken with the intention that the money would be paid back. That is no longer the case: "There is no intent or ability to repay the debt principal." But much of today's borrowing is undertaken without sufficient reason; it is "unlawful" and ought to be declared unconstitutional. ■

How Trade Leads to International Stability

The Rise of the Trading State: Commerce and Conquest in the Modern World, *by Richard Rosecrance (New York: Basic Books, 1986), 269 pp., $19.95.*

In this intriguing book, Cornell University political scientist Richard Rosecrance argues that two contradictory impulses have shaped international relations since the advent of the modern nation-state.

The military-political impulse has stressed the advancement of national power through military conquest or domination. Attempts at economic autarky, recurring arms races, and the emergence of antagonistic power blocs characterize international relations dominated by the military-political set of values.

Its competitor is the commercial impulse, exemplified by the trading state. Here, the assumption is that national well-being is more readily achieved through internal economic development, sustained in part by external markets, than by pursuing territorial conquest or political imperialism. The incentive to wage war is absent because armed conflict disrupts trade.

Rosecrance acknowledges that no nation has ever adopted either strategy in pure form and that one approach has never entirely dominated the international environment. It has always been a matter of emphasis and degree. On the whole, the military-political style has prevailed, although the commercial ethic has occasionally been adopted with considerable vitality, especially during portions of the 19th century. The first half of the 20th century, however, saw a virulent upsurge in the former, culminating in the rise of two global military superpowers.

World War II represented the apex of the military-political impulse, but the resolution of that conflict also set in motion trends that now undermine its dominance. Outside the communist bloc, a relatively open commercial environment reemerged, encouraged by the United States. Germany and Japan, two previously quintessentially militaristic countries, were disarmed and compelled to redirect their energies toward economic expansion.

Conversely, the United States and the Soviet Union continued to embrace the military-political approach even as the advent of nuclear weapons and the resulting balance of power sharply reduced its efficacy. The result, as Rosecrance sees it, is supremely ironic. Both World War II victors have become muscle-bound giants, unable to use the power they have amassed, while expensive military establishments erode their ability to compete economically

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with the predominantly commercial nations. A decline in Soviet and American influence is foreshadowed and prospects for peace enhanced as trade becomes the dominant factor in world affairs.

Rosecrance marshals a solid array of historical and contemporary evidence to support his argument. His principal thesis, that a foreign policy based on peaceful commerce enhances international stability while maximizing domestic well-being, is difficult to refute.

One may quarrel, however, with some subsidiary conclusions. For example, Rosecrance regards America's assumption of global military responsibilities after World War II as virtually inevitable. Yet perceptive noninterventionists, such as Robert Taft, advocated more benign alternatives, and had they been adopted the current world situation would be vastly different. Moreover, Rosecrance exhibits an annoying philosophical agnosticism regarding economic systems. Although he acknowledges the virtues of liberal trade practices, he perceives no special merit in free-market economics. Indeed, Rosecrance seems to favor greater "co-operation" among business, labor, and government and praises manifestations of "social corporatism."

Despite these flaws, *The Rise of the Trading State* is a useful and frequently insightful book. It demonstrates anew the wisdom of Thomas Jefferson's admonition that America's policy should be one of "peace, commerce, and honest friendship with all nations—entangling alliances with none." Rosecrance is correct when he concludes that the United States, burdened with massive global military commitments, is undermining its own long-term best interests.

—Ted Galen Carpenter

The Economist's View of the World: Government, Markets, and Public Policy, *by Steven E. Rhoads (New York: Cambridge University Press, 1985), 416 pp., $39.50/$12.95.*

In *The Economist's View of the World,* Steven Rhoads draws from a wide range of sources to survey the views of mainstream economists on how the world works.

Most economists, Rhoads observes, have a high appreciation for markets and their efficiency. The important role of such concepts as marginalism, opportunity costs, and the role of incentives in individual and corporate decision making is widely recognized. Government intervention in the marketplace is frowned upon and recommended only as a last resort.

The differences among economists surface over the normative aspects of public policy. Is equity a legitimate goal of government policy? Does government have a responsibility to mitigate negative externalities?

The evidence, Rhoads finds, overwhelmingly supports the market as an allocator of scarce resources and an engine for economic progress. However, the economists' focus on the dollar causes them to overlook nonmonetary aspects of human behavior—rights, ethics, "goodwill," political activism—and thus limits the value of their policy recommendations, according to Rhoads.

All in all, *The Economist's View of the World* is a wide-ranging and cogent exposition of the state of economics and its relationship to public policy. While not an avid proponent of the free market—Rhoads considers himself a moderate—the author is objective, making his book thought-provoking for both expert and non-expert alike. ■

Takeovers (Cont. from p. 9)

problems that allow unprofitable investments to continue, when mergers were the cause of many of the unprofitable investments in the first place.

Our results suggest additional problems with Jensen's analysis. Aside from some interesting examples, his main evidence comes from stock-market studies, an approach that he and many others have employed in analyzing the conglomerate-merger wave. In general, these analysts conclude that mergers during the 1960s yielded a net positive gain to shareholders and therefore were efficient. Our analysis, the business press, and the companies themselves through large divestiture programs suggest that the 1960s merger wave was largely a bust. The most plausible explanation for this apparent contradiction is that there was not, in fact, a net gain to shareholders from the acquisitions, at least in the long run. Work by Ellen Magenheim and Dennis C. Mueller has shown that the shareholders of the acquiring companies experienced an abnormally negative return several years after the acquisition. The point is, using short-term stock results to predict long-term behavior can be hazardous.

Thus far, I have focused attention on mergers, acquisitions, and divestitures because I think they are an important consequence of the problems Professor Jensen discussed. Although Jensen has acknowledged that the free cash flow theory can be applied to acquisitions, he focuses on tender offers as the means for reallocating the unproductive cash. Tender offers, however, are not that distinct from acquisitions, at least in one important respect: they both involve a change in managerial control, often in areas where the new management has little specific expertise. This transition is not easy to make, particularly in a declining or problem industry, and the alienation involved in a hostile takeover hardly helps. An analysis of previously successful tender offers by Scherer and myself confirms that the financial impact of tender offers is not substantially better than that of acquisitions. If anything, their performance is slightly inferior.

Jensen's free cash flow theory clearly applies in some circumstances. But how general is it? It makes a few clear predictions: the target, acquired, or acquiring firm must have high cash flow, low leverage, and low growth opportunities. The problem lies in determining what is actually explained by the theory and what should be attributed to tax incentives and other potential explanations instead. If the free cash flow theory does explain a large part of the motivation behind current mergers, acquisitions, leveraged buyouts, and share repurchases, well, that is very depressing. It would suggest that, as in England at the turn of the century, it is time to cash in the chips on many U.S. industries.

Genuine solutions to current business problems are not easy to suggest, and, like tender offers, they often come with drawbacks that may make matters worse. True reform is more likely to result from fundamental changes in macroeconomic policy affecting the cost of capital, the value of the dollar, and tax laws that favor interest payments over dividends.

There do, however, exist some straightforward means for merging management and shareholder interests. Encouraging management to have a significant equity interest in the company is one such means, capturing the basic advantage of the leveraged buyout without the dangers of increased leverage. Mechanisms that improve the orderly change in senior management that occurs outside of acquisition and tender offers, such as improvements in shareholder-voting mechanisms and "golden parachutes" that encourage inefficient managements to step down, are other alternatives.

If tender offers are to be used to discipline management, proposals that reduce the distortion caused by two-tier tender offers should be considered. Professor Bebkuck of Harvard has proposed that the decision to vote for a tender offer be kept distinct from the decision to tender one's shares. But given the track record of acquisitions and tender offers, I hesitate to suggest them as a solution. I cannot help but feel that a significant amount of energy, money, and time has been wasted on the merger game that would have been better spent rebuilding America's industrial base.

Michael C. Jensen: Much of our difference of opinion comes from the fact that Ravenscraft and Scherer concentrate their analysis on a sample of 5,000 mergers, all before 1976 and half before 1967. That was a very different phenomenon. It was the conglomerate era, and what was occurring was the opposite of the free cash flow kind of problem. In their sample, the median-size target firm was valued at about $2.5 million, a far cry from the billion-dollar takeovers of today. Conglomerates were being built from small operations, and a lot of them were motivated by the antitrust laws against horizontal acquisitions. Drawing inferences from that data about what's going on today is like studying measles and making inferences about AIDS. ■

Daniel Good of the E. F. Hutton Co. discusses business interest in privatization of government services at a conference on privatization co-sponsored by the Cato Institute and five other think-tanks. Cato president Edward H. Crane and Martin Lyons of E. F. Hutton listen.

"To be governed..."

For the Washington Monument Budget Cut Award, the winner is . . .

Hit by budget cuts, the Library of Congress yesterday announced it will slash the hours that its general reading rooms are open to the public by one third.

—*Washington Post*, Feb. 4, 1986

Better late than never

"Of course, I would not ever again permit anyone, in any neighborhood, to drop any kind of explosive device on a house," [Philadelphia Mayor Wilson] Goode said. "I would not ever again let anyone permit a fire to burn."

—*Washington Post*, March 11, 1986

Keep your hands off our Amendment

The judge ordered that, henceforth, there would be no . . . "picketing, distributing written or printed material regarding . . . abortions" or any other kind of demonstrating within 500 feet of the clinic. . . .

The ACLU claimed that the injunction deprived the pro-life defendants "of their constitutional rights of free speech and free assembly." . . .

The Detroit Branch of the National Organization for Women has accused the ACLU of having been " 'Skokied' again by the Right [which] doesn't hesitate to use our own weapons against us."

—*Washington Post*, Feb. 7, 1986

I'm shocked . . . shocked to discover that there's gambling going on here

Stating that they were "shocked" by former president Ferdinand Marcos' accumulation of hidden wealth, some of his key allies in the Philippine National Assembly announced a definitive break today with the former leader.

—*Washington Post*, March 16, 1986

It's payday in America

"Are you missing out on SDI opportunities?" So asks Pasha Publications in inaugurating a newsletter on the Strategic Defense Initiative, more commonly known as SDI or Star Wars. . . .

Pasha, which already publishes Military Space newsletter, warns arms makers that "opportunities to play an active part in the Strategic Defense Initiative will not fall out of the sky. . . . Your company may miss out on the best contracts."

—*Washington Post*, Feb. 21, 1986

What's so unusual?

An unusual alliance has emerged. Critics of the [Rajiv Gandhi] government's plans for [deregulating] the economy include leftist politicians . . . , businessmen who prospered in a closed economy, bureaucrats made less powerful by diminished controls and members of Mr. Gandhi's own party who find themselves less able to manipulate economic largess to their own advantage.

—*Wall Street Journal*, April 2, 1986

Guess we're stuck with the market, then

Vice President Bush and Saudi King Fahd . . . failed to agree on a desirable price for a barrel of oil.

—*Washington Post*, April 7, 1986

Which is also why we're beefing up our enforcement staff

The IRS has historically tried to keep its records private. "If we make the IRS into an information lending library for government agencies, we are likely to undermine our tax system of voluntary compliance," said former IRS commissioner Donald Alexander.

—*Washington Post*, March 17, 1986

Let them eat bread

Leonard Kuzman, director of the Oregon Department of Agriculture . . . sent a letter to the state's 650 retail bakeries last January reminding them that under state law, the only legal bread sizes were the "standard loaf" of 15 to 17 ounces, the "standard large loaf" of 22.5 to 25 ounces and the "standard extralarge loaf" of 30 to 34 ounces. Any other loaf—specifically the 8-ounce French baguette—was outlaw bread. . . .

June Reznikoff, chef at L'Auberge Restaurant in Portland and a baguette buyer [said,] " . . . I believe in separation of church and state and bakery."

—*New York Times*, March 26, 1986

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