Perspectives
on current developments

Truth vs. Provability at the FTC

Some regulations are so sacrosanct that even proposing to study them, let alone change them, is enough to put the hounds into full cry. Take the Federal Trade Commission's ad substantiation requirement, which is just ten years old. Commission Chairman James C. Miller III and Bureau of Consumer Protection Director Timothy J. Muris proposed last October, in a gingerly and respectful way, to study some of its applications. The indignation with which consumer groups and editorialists greeted this notion is not easy to understand in the light of the requirement's history and effects.

The substantiation doctrine was laid down in a 1972 case against Pfizer, Inc., and originally relied on the FTC's jurisdiction over "unfairness" instead of its jurisdiction over "deception." In the 1972 case, the FTC found Pfizer's ads to be unobjectionable, but it took the occasion to announce that, in the future, it would consider advertising "unfair" unless the advertiser possessed and relied on a "reasonable basis" for the claim it was making. Under the requirement, the truth or falsity of the challenged claim is in theory not at issue—in contrast to a typical "deception" case, where the commission alleges that an advertisement conveys a specific false or misleading message to consumers.

It is easy to see why the idea of substantiation appeals to law enforcers; it makes their job easier. Proving that an advertising claim is false may be a major undertaking; proving that it is unsubstantiated requires only a more limited inquiry into the evidence available to the defendant when the claim was first made. If it is inadequate, a violation is found without the need to gather more evidence or resolve all possible ambiguities. Perhaps for this reason, various private "regulators" rely on versions of the substantiation doctrine in setting their own rules. Television networks, for example, typically will accept only advertising that the sponsor can demonstrate is accurate. Similarly, the Better Business Bureau's self-regulatory National Advertising Division requires advertisers to produce evidence to support their claims.

The convenience of enforcement is a less compelling rationale, of course, for an agency with mandatory powers, and the commission has cited two other rationales for the rule. First, in *Pfizer*, it argued that unless substantiation was mandatory, advertisers would inevitably fail to provide as much information as consumers would like because of the "imbalance" of power between the two. But the commission had no evidence of the generalized market failure that this rationale hypothesized, especially considering the incentive competitors have—sometimes inadequate, perhaps, but surely sometimes not—to inform consumers of the superiority of their products. Thus the commission was, so to speak, making unsubstantiated claims for its theory.

Later the commission articulated a second theoretical justification for the rule, built on its statutory jurisdiction over "deception" instead of its jurisdiction over "unfairness." Although this deception analysis has become the usual basis for the commission's decisions on substantiation cases, the commission had never thoroughly explored the conceptual basis of the theory.

This is what Muris, director of the commission's Bureau of Consumer Protection, tried to do in November, when he wrote a memo on the doctrine. Muris argues that it is deceptive for an advertiser to claim or imply that there is evidence to support a claimed product quality unless he does in fact possess that evidence. For example, a claim of "29 miles per gallon," unlike a claim of "high mileage," implies that the car's mileage has been specifically tested and thus should in Muris's view be substantiated.

A claim of supporting evidence is likely to be material to many consumers, because con-

sumers value the seeming verification that tests provide of desirable product attributes. One used-car dealer, for example, may offer only generalized assurances that his cars "run like a charm." Another dealer might hire a reputable inspection service and post the results on each car for consumers to examine before they purchase. Some consumers are likely to prefer the second dealer, even if his prices rise to cover the cost of the inspection, because they value greater certainty of the quality of the car. If a dealer falsely claims to have conducted inspections, moreover, consumers who value inspections are injured, even if the car they actually purchased was a good one—much as the buyer of a fraudulent insurance policy is injured even if he never has reason to collect on it.

The market should be allowed to determine whether inspections for used cars are worthwhile, Muris says. It cannot do so, however, if sellers can claim to have conducted an inspection when they have not. Clearly, dealers should not be *required* to conduct inspections, but those who claim they did should be held to that standard. Thus, one rationale for a substantiation requirement is to allow the market for information to function more efficiently.

In his memo, Muris outlines a second possible rationale for the rule. It is not feasible in all cases, he says, to determine whether a claim is true or false. For many energy savings claims, for example, there is no generally accepted methodology for determining how much energy a product will save. Rather than allow just any claim, we need some feasible proxy for the likely truth of the claim—and the "reasonable basis" standard fits the bill. Although it cannot be known for sure whether a particular claim is in fact true or false, it is unlikely that claims based on unreasonably biased test procedures will turn out to be true. The argument is a familiar one to economists: when measuring outputs (truth) is too costly, measure inputs (substantiation) instead.

Even if these theoretical defenses for the doctrine hold up, of course, commission action may not be justified in particular cases, since government, like the market, is not perfect. In practice, application of the doctrine is fraught with problems and uncertainties.

Implied claims pose one frequent problem of enforcement. The commission often challenges claims that are not made explicitly in an ad, but merely hinted at. The defendant may deny that consumers really construed its ad as the commission is charging. If the defendant did not realize it was making a claim, it is unlikely to have the required substantiation on hand—even if the claim happens to be true. And if it does have the substantiation, there is a further booby-trap, although the commission has not exploited it in practice. The substantiation doctrine requires an advertiser to "rely on" substantiation in making the claim, and if the advertiser denies making the claim, how can it then contend it relied on the existing substantiation?

Another vexing question is how to treat evidence discovered after an ad first appears. In theory, such evidence cannot get an advertiser off the hook. Indeed, the commission has an "exclusionary rule" that specifies that evidence not produced in response to a subpoena cannot be admitted later at a trial. But this exclusionary rule has not been strictly enforced at trial, either by administrative law judges or by the commission itself. Moreover, the staff and the commission have apparently never refused to consider evidence that was produced after an ad appeared, but before the commission asked for the support. In theory, however, it will still not help the advertiser to discover vindicating evidence after the complaint is filed.

The major problem in enforcing the doctrine, however, lies in determining how much substantiation is required in each case. Sometimes the FTC has required far more evidence than consumers were likely to expect in the circumstances. For example, it asked Kroger for evidence that the comparison-shopping prices in its informal market-basket survey ads were statistically valid—despite the commission's finding, much more relevant to the consumer, that Kroger's prices were broadly lower than those of the competition, as the ad claimed.

Indeed, the commission has sometimes challenged advertisements that accurately describe the evidence available to support the claim. Take the commission's 1974 challenge to Ford's gasoline mileage claims. Before Environmental Protection Agency tests became available, Ford ran ads reporting the results of a mileage test it ran itself. The ads described the test in considerable detail—how the drivers were trained, how fast they drove, what route

they took, and other pertinent details—and made the now-usual disclaimer that actual mileage may vary and that no two drivers or cars will get the same results. Nonetheless, the commission argued that the ad implied the average driver would get the advertised results. Because Ford could not substantiate *that* claim, the ad was effectively banned. (Ford's tests turned out to describe the mileage accurately.)

Muris's memorandum did not appeal to the *Washington Post*, which editorially described it as an effort to "cut the heart out of" the substantiation requirement by substituting a "reasonable basis" standard for the present requirement "to conduct detailed scientific tests to prove any verifiable claim." In fact, there has never been any such requirement, as Muris noted in his response to the *Post*. The substantiation rule has been construed to require scientific tests in some instances, but much less formal evidence in others. Moreover, the rule has always held to a "reasonable basis" standard; within the FTC, "substantiation" and "reasonable basis" have always been synonyms.

Miller says he supports the concept of substantiation, but he too raised questions about its application when he proposed in October 1982 that the commission solicit comments on the program and suggestions for improvements. And former Commissioner Robert Pitofsky, who normally holds different opinions from Miller, wrote in 1977:

> there is no reason that studies of effects could not be completed and published now that the program has been operational for several years. Until some follow-up analysis of the costs and benefits of the program is conducted, ad substantiation remains an appealing idea of uncertain value.

Despite the controversy, Miller is proceeding with his plans and is thought likely to receive enough support from the other commissioners to get such a study under way.

Although many leaders of the advertising industry have complained bitterly over the years about the commission's application of the substantiation rule and support Miller's call for study, they also ardently support the concept of substantiation, presumably to avoid being characterized as soft on lies. This has created the impression that advertising groups oppose Miller's call for study, but they do not. Some economists, incidentally, speculate that darker motives may explain the ardent support the advertisers give to the concept. Since it is something of an art to determine exactly what constitutes a "reasonable basis" for a particular claim, large advertising agencies and advertisers, with large legal staffs to follow developments in FTC law, may have a competitive advantage over their smaller cousins. The volatile advertising business may become a bit less volatile as it begins to resemble a regulated industry.

A Taxing Approach to Protection

This past year has been a bad one for American consumers who want to buy foreign-made products, from autos and sugar to mushrooms and clothespins. In all these areas, and quite a few others besides, domestic industries have been demanding and more often than not obtaining tariffs, quotas, and other trade barriers to keep out Asian and other foreign competition.

Economists tend not to see any redeeming features in this new wave of protectionism. On the hopeful side, however, they would probably admit, if pressed, that things could have gotten a lot worse by now for the consumer. The auto import quotas, after all, are ostensibly voluntary and temporary; and "local content" legislation was stopped in the Senate last year. Sugar quotas were widely viewed as an exceptional political case, not applicable to other farm commodities. Mushrooms and clothespins are rather minor sectors of the economy. Last year Congress voted (over President Reagan's veto) to require most books and magazines to be printed domestically, but this was an extension of an old protectionist measure rather than the imposition of a new one. In most of these cases, the import controls either expire automatically or at least are subject to executive branch liberalization in the future.

Now, however, a protectionist initiative is on President Reagan's desk that combines what are to most economists the worst features of all these measures and others besides. It invokes an obscure, never-used provision that may not even have been intended to apply to ordinary trade complaints and thus lacks the measured and temporary remedies of most trade laws.

It is based on a rationale vague and wide-ranging enough to keep out almost any foreign product. It has a powerful political lobbying effort to back it up, and has already been endorsed by that supposed citadel of free-traders, the Senate. And finally, it would restrict imports in an industry that is not only large in itself but is also a crucial supplier to nearly every other major industry—which means that the proposal would endanger the competitiveness of a wide sector of U.S. industry and lead to an across-the-board step-up in the pressure for protection in those other industries.

This economists' bad dream got its start last May, when Houdaille Industries, a sixty-two-year-old Florida company, filed a formal petition with President Reagan. The petition asked him to bar U.S. firms from taking the usual 10 percent investment tax credit on their purchases of Japanese-made numerically controlled machine tools. Houdaille, which makes the same kind of machines, claims Japan has unfairly promoted its exports of the items. (Machine tools are machines that cut and shape metal parts; "numerically controlled" means that the machine is "told what to do" by being fed computerized data, instead of set up and calibrated by hand.)

The petition cites section 103 of the Revenue Act of 1971, which allows the President to deny investment tax credits on imports from a country that "engages in discriminatory or other acts (including tolerance of international cartels) or policies unjustifiably restricting United States commerce." Section 103 gives the President complete discretion to allow the tax credit even if he decides that the country's acts or policies have indeed been "discriminatory." On December 21 the Senate passed a nonbinding resolution urging the President to grant Houdaille's petition, and his decision is expected soon.

Complainants like Houdaille already have a number of other administrative weapons available to use against "unfair" import competition. For example, they can ask the Commerce Department to assess countervailing duties under the Trade Agreements Act of 1979 to offset any direct or indirect subsidy Japan may provide to toolmakers, so long as the International Trade Commission finds that the imports threaten material injury to U.S. competitors. Economists tend to dislike these countervailing duties, but they do at least have several advantages over the protection afforded under section 103. They are in theory tailored to the exact amount of the offending subsidy; the complainants have to show that it was imports, not just recession or other factors, that harmed them; the countervailing duties stop once the foreign subsidy is eliminated; and the scheme conforms with the current international accord on the subject, the General Agreement on Tariffs and Trade. If such a petition failed, Houdaille could fall back on such provisions of federal law as section 301 of the Trade Act of 1974, which authorizes the executive branch to take steps to offset "unfair" foreign government practices.

Japanese machine tool producers have penetrated the U.S. market remarkably quickly. In one category of products, numerically controlled machining centers, Japan's share of U.S. sales rose from 3.7 percent in 1976 to 59.6 percent in the first quarter of 1982. Other high-tech machine tool categories show similar increases. That Japanese machines are increasingly popular, of course, hardly proves that they gained their popularity through unfair dealings. In fact, according to an analysis by Sanford C. Bernstein & Co., their success owes more to Japan's skill in delivering goods more quickly than their American competitors. Market share figures taken alone are deceiving, by the way, because the market itself is growing so rapidly. Even as the U.S. producers were losing market share in the last five years, they were more than doubling their annual dollar sales.

If the tax credit were denied, the effective price of Japanese tools would rise by 10 percent in the short run, for every firm that pays taxes (later adjustments in demand and supply would pare the increase somewhat). Some firms would switch to American-made machine tools, even when those tools were less well suited to their technical needs. In a high-tech field like this, on the other hand, quality is important enough that many U.S. firms might buy Japanese anyway. But all the possibilities—higher taxes, higher costs, or lower quality—would harm the competitiveness of these firms' products on world markets. Among those products are metal parts and the many things manufactured from them, including industrial machinery of all sorts. Thus such industries as

autos, farm equipment, and aircraft would suffer—the last of these being a major exporting industry—and so, of course, would consumers.

The radiating effects on competitiveness would be likely to increase pressures for protection in other industries. These other industries could also petition under section 103, since the charges that Houdaille levels against Japan could just as easily apply to French computers or German steel. (In fact, most of them could even be applied to—dare we say it?—American grain.) The bill of specifics includes encouraging joint research and production planning, restricting the number of competitors through "administrative guidance," observing a cartel-like floor on export prices, protecting the domestic market from imports in various ways, and giving companies special tax concessions and loans at favorable terms. About the only specifically Japanese practice on the list is that of letting the industry pocket the proceeds of betting funds on quasi-governmental bicycle and motorcycle races—which hardly seems a good ground on which to start a trade war. Houdaille has been unable to quantify just how much all these activities amount to as a subsidy per machine and Japan has apparently stopped some of them. Houdaille does not explain, incidentally, how the Japanese firms can both maintain cartel prices and undersell American firms unfairly.

In other words, section 103 makes it easy to impose tax penalties on almost any U.S. trading partner, since they all offer tax credits and loans to some extent. Once the dam cracked, politics would make it extremely difficult to draw the line at one instance, and soon a queue of industrial petitioners would form. The semiconductor industry, which has lost market share to Japanese competitors and has been supporting the Houdaille petition, may be first in line—which would threaten to lock U.S. computer makers permanently into high-cost sources of supply.

Selective denial of investment tax credits, like requirements for "local content," arguably violates the terms of the General Agreement on Tariffs and Trade—two separate terms, in fact. GATT's rule on national treatment provides that imports "shall not be subject, directly or indirectly, *to internal taxes* . . . in excess of those applied, directly or indirectly, to like domestic products." The agreements' most-favored-nation clause adds that any "advantage, favor, privilege, or immunity" given to imports from one GATT signatory must be given to imports from all—including imports from Japan. Violating the terms of the pact would undercut this country's efforts to liberalize the GATT rules on services (which would help expand a positive component of the U.S. balance of trade). Much more likely than any such dismantlement of barriers to U.S. exports, if the petition succeeds, is a continuing, mutually destructive spiral of retaliation between the world's two leading market economies, the United States and Japan.

OMB's "Wall of Separation" against Tax-Funded Advocacy

At least since the creation of the Office of Economic Opportunity in 1964, the federal government has operated programs aimed not so much at providing goods or services as at organizing coalitions, filing landmark lawsuits, and often carrying on outright lobbying and political campaigning. These so-called advocacy programs operate by giving out grants, rather than conducting advocacy themselves—an essential feature, since federal agencies are forbidden by law to lobby the federal government, and many of the other consciousness-raising activities would be too hot to handle politically. About a year ago, the Reagan administration declared its opposition in principle to advocacy funding, and now the Office of Management and Budget has published proposed regulations to crack down on the use of funds for political persuasion.

The controversy is not really a new one. By 1967 Congress had already banned OEO grantees from carrying on partisan politicking and voter registration drives with agency funds and significantly restricted (but did not ban) grantee lobbying with such funds. In 1974, a year after the Nixon administration's unsuccessful attempt to abolish OEO, Congress split the agency into the Community Services Administration and the quasi-independent Legal Services Corporation, and since then, Congress has passed a number of amendments in an effort to limit the latter's activism.

Nevertheless, advocacy funding began to metastasize throughout federal grant programs during the 1970s, a trend that picked up speed in later years. By the 1980s federal funds made up a significant share of the budgets of many well-known advocacy groups. In fact, agencies themselves began ignoring the existing anti-lobbying statutes with greater and greater abandon. A 1981 brochure listing the member groups in a coalition formed to fight Reagan education policies, for example, included two federal entities, National Public Radio and the National Advisory Council on Adult Education.

The opponents of advocacy funding view the activity as much more than a budgetary issue, although the amounts at stake are far from negligible. (From 1977 to 1980, according to internal estimates, advocacy funding made up from $50 to $100 million of the Community Services Administration's budget.) Their chief complaint is that it is unfair to force taxpayers to support the systematic promotion of views they may dislike by organizations they may dislike even more. Some critics describe the system as an "advocacy pork barrel." It could also be called an "advocacy iron triangle"—for it differs from the traditional triangle of agencies, lobbyists, and congressional committees only in that the subsidies go not to building dams or buying grain, but to swaying public, legislative, and judicial opinion.

Of course, the Constitution does not protect individual taxpayers from having to support federal programs they dislike—and, therefore, having to support the viewpoints those programs embody. But in our constitutional system such viewpoints are endorsed in law only by surviving the obstacle course the Founders built to discourage laws for which there is no general consensus. Advocacy funding, by contrast, commits official support to one side of precisely those issues that are not settled, or to the minority side of an issue on which the democratic verdict would go the other way. Its critics may be resigned to paying the costs of ordinary programs that have already been enacted; what they object to is having to pay for however big a public relations effort is needed to convince legislators (or judges) on the next unsettled issue.

These are considerations not merely of fairness, but of First Amendment constitutionality. As Justice Hugo Black said:

> Probably no one would suggest that Congress could, without violating [the First] Amendment, pass a law taxing workers, or any persons for that matter (even lawyers), to create a fund to be used in helping certain political parties or groups favored by the Government to elect their candidates or *promote their controversial causes* [italics added]. Compelling a man by law to pay his money to elect candidates or advocate laws or doctrines he is against differs only in degree, if at all, from compelling him by law to speak for a candidate, a party, or a cause he is against. . . .
>
> . . . And the First Amendment, fairly construed, deprives the Government of all power to make any person pay out one single penny against his will to be used in any way to advocate doctrines or views he is against, whether economic, scientific, political, religious or any other.

Both the critics and supporters of advocacy funding say they do not want a "spoils system" in which each successive administration subsidizes just its own ideological confreres. The other extreme would be to subsidize the advocacy efforts of any and all contending sides, and put both Gloria Steinem and Phyllis Schlafly on the federal payroll. Whatever gain in fairness this might bring would be bought at a high price in absurdity, making the general uneasiness already felt about subsidizing both tobacco farmers and antismoking campaigns look mild indeed. It would also be impractical, for it would invite endless numbers of would-be advocates to line up for subsidies.

That leaves the alternative of ending advocacy funding. The Reagan administration's efforts to do this have met with only moderate success. VISTA, one agency that drew fire for advocacy, has been scaled back; and the Community Services Administration was folded into the Department of Health and Human Services in 1981, its programs now funded through block grants (with Congress stipulating, however, that nearly all the money continue to go to the old group of grantees). On the other hand, the effort to rein in the Legal Services Corporation and the class action suits of its grantees is stalled.

Ending the most prominent advocacy agencies would solve only the easier half of the problem, because so many other government programs contain a mix of advocacy and non-

advocacy elements. Short of abolishing these programs, the surest way to curtail advocacy is through additional regulation. The Reagan administration's first shot at this came in an April 1982 memo from Office of Management and Budget chief David Stockman urging all federal departments and agencies to stop using federal funds for lobbying and advocacy. But the memo specifies that this objective must not be accomplished by banning organizations that engage in advocacy from getting any federal funds. Since most grantees, from the Harvard physics department to the Honolulu city council, have some central function other than lobbying, to demand that they withdraw from all public debate would be unattractive in itself, and on First Amendment grounds as well. The problem is that an effective attempt to keep advocacy-oriented grantees from using federal funds for advocacy is likely to "chill" the advocacy they carry on with their own funds—and the very activities that are improper when federally funded are perfectly proper, indeed constitutionally protected, when privately funded.

Putting these principles into practice is therefore a matter full of controversy. Last summer the Education Department got its grantees upset when it began circulating a draft proposal to bar them from carrying on certain "propaganda" activities with department funds and to require special approvals before it gave discretionary (as opposed to formula-based) funding to advocacy-oriented grantees.

The Reagan administration's proposal was announced January 20 by OMB and the three main federal contracting agencies: Defense, the National Aeronautics and Space Administration, and the General Services Administration. It is of wide-ranging significance for three reasons: the number of grantees affected, the scope of the definition of advocacy, and in perhaps the greatest departure, the requirement of a complete separation between advocacy and grant money.

The proposal would apply to all grantees and contractors, government-wide, with the broad exceptions of universities, hospitals, and local governments (which OMB audits under a different set of published "cost principles"). It would bar recipients from using federal funds to pay for any "political advocacy." That term is defined in the proposal as taking part in campaigns and referendums, lobbying on legislation or regulations, filing amicus curiae briefs, and contributing money, goods, or services of value to "an organization that has political advocacy as a substantial organizational purpose, or that spends $100,000 or more per year on activities constituting political advocacy." Whereas almost all the existing statutes and appropriations riders ban only lobbying aimed at federal legislation, OMB would halt the funding of lobbying aimed at state and local issues as well, and also at federal regulations, both rulemakings and adjudications. Moreover, OMB would cut off funds for "grass-roots" as well as traditional lobbying. This sort of blanket prohibition is logical, if the intent is to oppose advocacy funding on constitutional principle, and it may prove easier to enforce than a half-way ban riddled with exceptions.

Even so, OMB's categories would not cover all forms of advocacy. Grantees could still be subpoenaed to testify before legislative committees, could file comments on proposed agency rules, and could conduct "technical or scholarly studies" (so long as they were not written or distributed in such a way so as to constitute disallowed advocacy). In practice, however, most advocacy organizations would be drastically affected.

The difficulty with the existing rules against misappropriating grant money is that recipients meet them by maintaining an accounting—but not a real—separation between their federally funded and their privately funded activities. Currently a group may use the same employee and the same desk for both grant work and lobbying, and allocate overhead costs 90 percent to the former and 10 percent to the latter. Of course, this makes the anti-lobbying rule almost impossible to enforce. More to the point, even if the letter of the anti-lobbying law is obeyed, its spirit is not, since paying for overhead frees up the recipient's resources to do more lobbying than it ever could otherwise. This is the logic, at least, that courts have used to ban state aid to even the most secular activities of church schools.

To deal with this problem, OMB wants to erect a "wall of separation" between advocacy and grant money. It proposes not to let federal funds pay for any equipment, like copying machines, that is used even part-time for political advocacy. (A 5 percent *de minimis* exception is made for buildings.) Other specific costs OMB

says it will disallow in their entirety are "meetings and conferences devoted in any part to political advocacy" and "publication and printing allocable in part to political advocacy." Nor will it pay any of the salaries of employees who lobby. Perhaps the most controversial provision of all is one disallowing the salaries even of employees who lobby on their own time if their employer "required" or "induced" them to do so.

The proposal would enfang a particularly toothless feature of existing enforcement practice: when a federally paid employee is now discovered to have lobbied illegally, all that the federal auditors can do, after proving the violation in court, is take back the percentage of that employee's salary that was devoted to lobbying. (Even this is almost never enforced.) The OMB proposal, in contrast, provides that the grantee will forfeit the entire salary of the employee who lobbies illegally.

Probably the most serious practical criticism of the proposal is simply the inconvenience ordinary grantees and applicants may suffer in complying. It would be difficult to begin writing exceptions for grantees considered less prone to advocacy without inviting the charge of selectivity—a very serious charge in this context. OMB says audits will be less intrusive than before, because there will no longer be as many jointly attributed costs. It is also true that the burden will be on the government to launch an investigation if it suspects they have misstated anything. Incidentally, OMB does not address the question of whether matching funds from nonfederal sources can be spent on advocacy. The case could logically be made that taxpayer funds should not be used to raise funds for private advocacy.

The agency will doubtless have to go through a process of trial and error before it can strike a fair balance between the contending claims of grantees and contractors on the one hand, and taxpayers on the other. But it should remember that the balance is not between order and liberty, but between liberty and liberty—and that the taxpayers who wish not to subsidize advocacy have an even more legitimate liberty interest than do the grantees. The latter can throw off their shackles at will by giving up federal funds; the former have no such choice in paying their taxes.

Is HHS Deadening the Pain of Competition?

The virtues of deregulation aside, it is inevitable that government will control one big chunk of the economy: the specifications of the products and services it buys. General regulatory philosophy provides little guidance on how an agency should steer between laxity and stringency to fulfill its duties as a "prudent purchaser." The problem is compounded when the government buys enough of a product to influence the whole market, as it does in the case of health care, where the federal government pays more than 40 percent of all hospital bills and more than 20 percent of doctor bills. And when the payments are on a cost-reimbursement basis, as they are in Medicare's hospital payment program, the exercise of government purchasing power may have a highly regulatory effect, whether intended or not. A recent proposal to change the way Medicare pays for anesthesia services is a case in point.

The tax law passed in August 1982 included a requirement that the Health Care Financing Administration change the way Medicare pays hospital-based physicians, a category that usually includes pathologists, radiologists, and anesthesiologists. Because the problem had been on HCFA's collective mind for a long time, a highly detailed proposal could be drawn up within a month. After cursory study by Health and Human Services Department officials, it was published in the *Federal Register* October 1.

The proposed rules define when hospital-based physicians are providing a professional service directly to a patient and when they are instead working for the hospital in a primarily administrative capacity. Direct services to patients are billed under Medicare's relatively generous physician-reimbursement program, which, for example, allows doctors to charge more than Medicare will cover and to bill the patient for the remainder (which hospitals may not do). Services rendered to hospitals, on the other hand, are billed under Medicare's relatively stingy hospital-reimbursement scheme, which, for example, reimburses only costs that are "reasonable," and HCFA is steadily putting downward pressure on this ceiling. Perhaps coincidentally, physicians tend to consider the

patient-reimbursement program more "professional" and dignified, and, as shall be seen, fight hard to remain a part of it.

Under the HCFA proposal, doctors who anesthetize patients personally would, as now, bill Medicare's physician-reimbursement program. The dispute concerns doctors who supervise teams of "certified registered nurse anesthetists" who do the actual injecting, mask-arranging, or whatever. These doctors could bill under the physician-reimbursement program only if they directed no more than two nurses simultaneously; if they supervised three or more, they would have to charge through the hospital-reimbursement system. (Some officials within HCFA have argued for a 4:1 instead of 2:1 ratio, but as of this writing the agency is sticking by its original proposal.)

To the apparent surprise of HCFA officials, the proposal has drawn strong protests, particularly from practitioners in the Southeast where the team approach to anesthesia is widespread. In North Carolina, for example, about 200 trained anesthesiologists serve 757 operating rooms, using assistants intensively. Unlike pathologists and radiologists, however, they maintain direct personal contact with the patient, explaining the procedures in advance and appearing at crucial points to check up on the patient.

HCFA believes that its change will save money and perhaps improve the quality of anesthesia as well. The cost-saving claim rests on the indisputable fact that it costs less to administer anesthesia using the team approach than directly by a doctor. Reimbursing team-administered service at what is expected to be a lower rate would reflect this lower cost. Allowing anesthesiologists to bill at higher professional rates for several simultaneous procedures certainly increases their income, and richer MDs might seem to mean emptier Medicare coffers—except that the MDs are displacing a larger number of their other high-paid colleagues. HCFA worries, however, that unethical anesthesiologists will "milk" the Medicare trust fund by employing "stables" of nurse assistants while charging the same fees as colleagues who offer hands-on physician care.

But the prevailing charges for anesthesia are in fact dramatically lower in the Southeast than in places where anesthesiologists supervise patients directly, according to Medicare's own calculations. What has happened, apparently, is that the southeastern doctors simply charge lower prices to reflect their low-cost method of practice—a rather heartening sign that the current health payment system does not entirely prevent cost savings from being passed on as lower prices.

The damaging thing about the HCFA proposal is that it will, by penalizing low-cost providers, push practice back toward doctor-intensive anesthesia. Many anesthesiologists who currently direct more than two nurses are not likely to file meekly for hospital reimbursement, but will instead simply hire more MDs and perhaps fire some nurses so as to lower their ratios enough to stay in the physician-reimbursement program. HCFA's avowed intention to crack down on hospital reimbursements for anesthesia makes this shift even more likely.

Even if it does not happen, it is unclear that HCFA would realize the $45 million in savings it projects for 1984. For one thing, patients pay 20 percent of reasonable physician charges but none of the hospital-based charges, and it is not obvious why 100 percent of reasonable hospital costs for anesthesia would not exceed 80 percent of allowable physician fees.

If anesthesiologists do hire doctors and fire nurses, they would be substituting a higher-cost input (MD time) for a lower-cost input (nurse time), with obvious implications for overall costs. Although the agency's regulatory impact statement does not seem even to consider this possibility, a classified ad in the December issue of *Anesthesiology* is enough to tell the story:

> ALABAMA: Group of eight anesthesiologists and twenty-two CRNA's seeking four additional M.D.'s. Board certification preferred. All types of cases except heart. Large obstetric epidural practice. . . .

As a bit of long division shows, adding four MDs will bring the group just below the magic 2:1 ratio, with an extra doctor thrown in for a safety margin.

Increasing the demand for anesthesiologists would inevitably raise their fees and salaries—which would worsen the cost problem and raise the prevailing charges for one-on-one anesthesiologist services, which are supposedly unaffected by the new rules. After some lag,

Medicare would end up paying *all* anesthesiologists a premium based on the scarcity created by its own regulations.

This may be one reason the HCFA proposal has to date drawn no protests from the American Society of Anesthesiologists. To be sure, most critics of the scheme are members of that society, some of whom practice team anesthesia, and others of whom say they fear Washington is trying to tell them how to conduct their practice (despite a provision in the Medicare law forbidding officials to exercise "any supervision or control over the practice of medicine or the manner in which medical services are provided"). But another strong faction of the ASA has long held that doctors should be the ones who provide all anesthesia services. The antitrust laws probably would stop any direct efforts by professional protectionists to stamp out the nurse assistants by, for example, disciplining anesthesiologists who employ them. But under the proposed rule such a tactic might be unnecessary.

Perhaps the most dubious aspect of HCFA's case is its vaguely hinted hope to improve the quality of care by intensifying the supervision of the nurse anesthetists. Empirically, quality has never been shown to be lower in the Southeast than it is elsewhere. Opponents of the proposal also claim that it could lead to artificial distortions in patient care because it would be difficult to maintain an arbitrary ratio of doctors to nurses on a day-to-day basis. But more fundamentally, the whole notion of regulatory quality control seems inappropriate here. Elsewhere in the Medicare program, consumers are usually charged with trying to buy services whose quality is too high. If one-on-one anesthesia is a Cadillac and team anesthesia only a Chevy, then patients—knowing that the government will pick up the tab—hardly need regulatory help to push them toward the former. Government quality control is typically invoked when consumers either have inadequate ways to deter or redress egregiously poor quality, or when they are not aware of poor quality until after the fact. On the former point, malpractice suits fully (if not over-fully) deter bad actors. On the latter, if there is any example of a service where it is usually instantly apparent when something has gone wrong, it must be anesthesia.