
Currents

Changing of the Guard

With this issue, we welcome Ed Hudgins as the new senior editor of *Regulation* and as Cato's director of regulatory studies. Ed joins us after a tour on the minority staff of the Joint Economic Committee and as a member of the senior staff at the Heritage Foundation. He also brings to this position a doctorate in philosophy, a training that is bound to improve the tone if not the clarity of your favorite magazine.

Brink Lindsey has returned to his prior (and more lucrative) practice of defending innocent parties against bad trade law. We wish him the best, but we promise to maintain our commitment to reducing the number of parties injured by trade laws. Brink said that he would take that chance.

William A. Niskanen

Labor Pains

Total U.S. employment is now increasing by about 2.5 million a year. The unemployment rate has recently dropped to 6 percent, only slightly more than half the rate in Canada and Europe. Workplace safety and the relative earnings of women continue to improve, and the percent of workdays lost due to strikes has declined sharply since 1970. This is an encouraging record, but all is not right with the U.S. labor market or with U.S. labor law.

The most severe problem with the U.S. economy is that productivity has increased at only a 1.1 percent average annual rate since 1973—low by prior U.S. experience, low compared to the rate in many other nations. Average real wages have

increased at an even slower rate, in part due to the rapid increase in employer-financed health insurance costs, and the real wages of low-skilled males have declined substantially over this period. The U.S. labor market, in summary, continues to be a marvelous jobs machine but has not generated much real wage growth for two decades.

U.S. labor law reflects two problems. First, its basic structure reflects the corporatist perspective of the 1930s and was designed to address very different labor market conditions in an economy largely insulated from foreign competition. Second, most of the recent and proposed changes to U.S. labor law will or would weaken its job-creating record without addressing the productivity problem. The response of our political system to two recent issues illustrates this problem:

- Sometime this summer, Senate majority leader George Mitchell is expected to schedule a vote on the Workplace Fairness Act. This bill would broaden the National Labor Relations Act of 1935 (and reverse five interpretative decisions by the Supreme Court) to prohibit the permanent replacement of strikers. This ban, by reducing the cost of strikes to employees, would almost surely increase the frequency and duration of strikes. Unions now represent only 11 percent of private employees, but many work for the most trade-sensitive industrial firms. In the name of increasing the job security of strikers, this ban would probably reduce the total number of industrial jobs. This bill is the highest priority of the AFL-CIO and has been strongly endorsed by President Clinton. In this case, we face the prospect of a job-destroying change in labor law unless it is stopped by Senate Republicans.

- Many firms have recently experimented with various forms of employee participation, in which workers are encouraged to offer suggestions for ways to improve productivity, workplace safety, and other working conditions. A

series of decisions by the National Labor Relations Board, however, has ruled that many of these arrangements are illegal unless organized by a union. These decisions are lousy policy but may have been correct interpretations of the National Labor Relations Act; in that case, a change in the basic legislation is necessary. Although the Commission on the Future of Worker-Management Relations (the Dunlap Commission) recently endorsed broader employee participation, no legislative action has been proposed or scheduled on this issue. In this case, an opportunity for a productivity-enhancing change in labor law has been deferred pending an endorsement by the Clinton administration and congressional Democrats.

The broader pattern of changes in labor law has increased the security of employees in their current job at the expense of lower employment and higher unemployment. A series of state court decisions beginning in the early 1980s has progressively added conditions for which an employee may not be terminated without compensation. A 1988 federal act requires prior notice of major layoffs or plant closings. A 1993 federal act requires employers to grant unpaid leave for family and medical emergencies, continued health insurance coverage, and a guarantee of their job at the end of the leave. The political appeal of those measures is understandable: the benefits are more apparent than the costs. The effect of those measures is to increase the relative cost of hiring full-time labor, in effect making such labor into a capital good.

So far, the effects of such measures on the U.S. labor market have been small but significant. The additional job rights created by the state courts led to an explosion of litigation and may have reduced total employment by as much as 2 percent. And a combination of conditions has contributed to the increased use of part-time labor and a record peacetime rate of overtime in manufacturing. There is more reason for concern that a continued broadening of job security rights would lead to the high long-term unemployment rates that are now characteristic of Canada and Europe.

The Dunlap Commission released its fact-finding report on June 2 without conveying much information about the policy changes it will recommend sometime later this year. The charge to the Commission is to identify ways to improve productivity, enhance cooperative behavior, and reduce litigation and regulation—

commendable objectives. The membership of the Commission suggest that it is likely to favor only minor reforms to the basic structure of U.S. labor law. Those of you who favor more fundamental reform have a few more months to make your case to the Commission. We will make our case for principled reform of U.S. labor law in a future issue of *Regulation*. Stay tuned.

William A. Niskanen

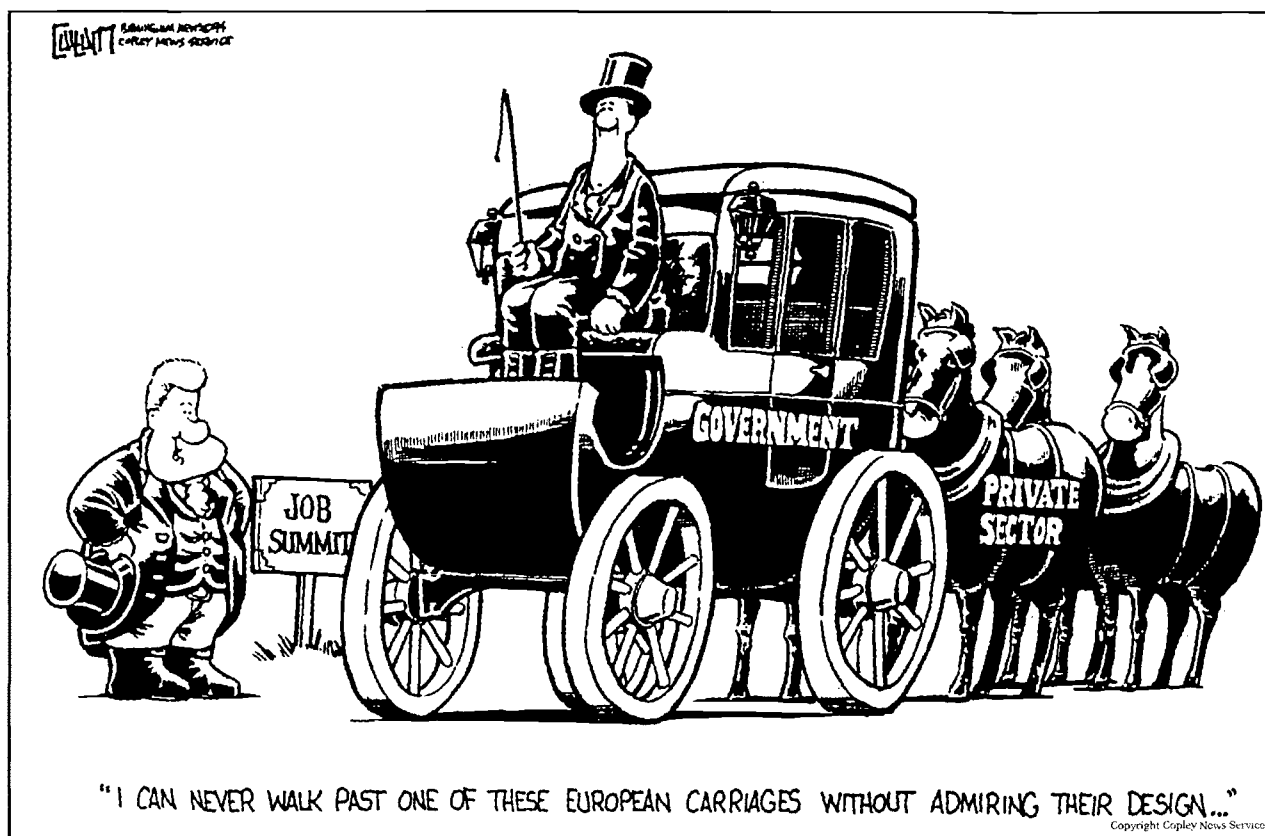
Senior Editor's Vision

It is an honor for me to assume the post of senior editor of *Regulation* magazine, working for editor Bill Niskanen. *Regulation* has a distinguished history of offering solid analysis of the effects of government laws and mandates on the private sector. I intend to continue this tradition and welcome input from you, the reader, on how this magazine might better meet your needs and interests.

When the first issue of *Regulation* appeared in July 1977, the United States was in the midst of an economic transition. The early part of the decade saw the country go off what was left of the gold standard. It was a decade of high inflation, high oil prices, and rising unemployment. The Great Society government spending, creation of new agencies, and heavy-handed regulation of the economy which began in the mid-1960s continued unabated. And American industries, which had dominated the post-war world, now faced real competition and were calling for more trade protectionism.

The situation in the intellectual realm was not promising. While the theoretical works of Mises, Hayek, and others were well known to serious free-market advocates, applications of those theories to public policy issues were sorely lacking.

In this environment, *Regulation* was started, in the words of its first editor, Anne Brunsdale, as "a response to the extraordinary growth in the scope and detail of government regulation." Brunsdale understood the public-policy as well as economic problems caused by regulations. She observed that "because the extension of regulation is piecemeal, the sources and targets diverse, the language complex and often opaque, and the volume overwhelming, much of this



activity escapes public notice and therefore public debate. Partly in consequence, old regulatory agencies and programs remain and new ones are frequently launched with little analysis of the problems being addressed, of costs and possible side effects, and of alternative methods for achieving the same ends."

During the late Carter years and most of the Reagan era, the growth of regulations was slowed and in some cases reversed. With the tax cuts of the early 1980s, that resulted in an increase of economic growth and the high-tech revolution. As the world economy grew more integrated, American enterprise grew more productive.

Increased government control of the economy under the Bush and now the Clinton administration again endangers America's economic future. But the new regulation, documented in the pages of *Regulation*, occurs in a domestic and global policy climate that will make this path increasingly difficult to tread. Several indications of this situation, both globally and domestically, are offered here.

The West at the Crossroads. As the Republican views in the 1994 annual report of

the Joint Economic Committee (JEC) of Congress documents, "Western Europe and Japan are experiencing a slow-motion . . . version of what transpired in the communist world." The contradictions of welfare states have produced economic, political, and social crisis that no longer can be mitigated by the same kind of government policies that caused them to begin with.

On average, the governments of Western Europe control 50 percent of their countries' Gross Domestic Products (GDPs) directly. In addition to high tax rates and spending, governments regulate business and employment practices and actively intervene in the economy to support industries favored by bureaucrats and special interest groups.

The result is an average unemployment rate in Europe that is nearly twice as high as in the United States and no sign of strong job creation in the future. Most governments, no longer able to meet the massive unemployment and other welfare benefits, are cutting back. Italian voters recently installed a government that promised Reaganesque privatization, tax cuts, and deregulation. Other countries face political and social

turmoil as a result of economic problems caused by their governments.

The JEC report also focuses on an often overlooked result of government control of economies: corruption. More destructive of civil society than classical corruption, in which political officials exchange favors for cash or other material benefits, is institutional corruption. Says the report, "By its nature a welfare state breaks down the separation between government and the private sector and thus, between political and economic power. Government is expected to act directly to help this industry or that sector. The public good becomes, in fact, interest-group driven. This means that policies are often arbitrary and frequently contradictory. . . . Welfare states remain formally democratic but in operation grow oligarchical or even feudal." In other words, politicians dole out favors not only for cash but also for other coins of the realm: political support, influence, power, and prestige.

The JEC report shows that, while America has not gone down that road as far as Europe has, the Clinton administration is taking the country in that direction, especially with its health care proposal and employment policies, which are quite literally copied from European models.

Revolts Against Regulations. An indication of the growing concern among American policymakers over out-of-control regulators is found in one of the most important stories on Capitol Hill, a story that the dominant media have failed to report. The leaked minutes of a legislative strategy meeting of environmental groups revealed that they see their agenda frustrated by what they call the "unholy trinity" of legislative efforts in Congress. This trinity consists of requiring the federal government: (1) to pay compensation to victims of regulatory takings; (2) to pay for currently unfunded federal mandates on the states and private sector, and (3) to do risk assessment and cost-benefit analyses of regulations, especially in the environmental area.

The concern of those groups is based on a flurry of legislation from both Republicans and Democrats. Senator Bennett Johnston, a Louisiana Democrat, for example, was able to amend the bill that would raise the Environmental Protection Agency (EPA) to cabinet status to require risk assessment studies for many proposed new environmental regulations. A similar amendment in the House was pushed by Republican Congressman John Mica and Democrat Congresswoman Karen Thurman, both of Florida. The consensus of envi-

ronmental groups, revealed in the leaked memo, is that "the lobbyists generally felt that we should not now try to revive EPA cabinet." The measure, thus, is probably dead.

In the House, Louisiana Democrat Billy Tauzin is pushing a bill, which now has over 100 cosponsors, to require payments whenever a regulatory takings results in a loss of 50 percent or more of the value of property. Since the legislation likely will be bottled up by unfriendly chairmen, Tauzin probably will seek a discharge petition to force consideration of the measure by the full House. Tauzin also led a successful fight to prevent federal regulators from going on private land without the owner's permission to conduct a planned survey of biological assets. This measure was a barely disguised attempt to catalog private assets as a prelude to the continuing federal efforts to treat them as public property.

Various bills, notably those sponsored by Texas Republican Lamar Smith, would require the president to submit regulatory budgets of the mandates imposed on states and the private sector to Congress for explicit authorization. This idea was proposed by then JEC Chairman, now Treasury Secretary, Lloyd Bentsen in 1979.

The changing global economic situation and the recognition by some policymakers that the regulatory state is endangering the country's future, makes the work of *Regulation* magazine even more crucial today. Critical too is the need to explore strategies for extricating the country from its current situation. Americans face the same public choice dilemma faced in other countries: how to dismantle a failed system that employs hundreds of thousands of workers and funnels billions of dollars in funds and favors to special interest groups. *Regulation* will continue to act as a forum to explore these and related questions that must be answered if America is to enter the twenty-first century as the preeminent economic power in an economically prosperous world.

Edward L. Hudgins

The New GATT Agreement

On April 15, 1994, the United States signed the Final Act of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), the

multinational trade talks that were concluded successfully last December. The Uruguay Round consists of approximately two dozen specifically negotiated Agreements. Some reflect more strict or carefully detailed revisions of existing GATT rules, for example, covering subsidies, antidumping enforcement, and government procurement. Others are entirely new to the GATT's jurisdiction, such as those covering trade in services, protection of intellectual property rights, national treatment for investments, and agriculture. Finally, there are multiple agreements that lower tariffs worldwide on average by about one-third, eliminating them entirely in many sectors, and prohibit some recently invented restrictive trade practices, such as so-called "voluntary restraint agreements."

While last November the North American Free Trade Agreement was a major policy controversy, many observers assumed that the new GATT agreement would sail smoothly through Congress. After all, GATT is supported by broad sectors of American industry, since it opens markets for the rapidly growing international trade in services, and it better protects intellectual property, which is increasingly important to American business. The argument that "cheap foreign labor" threatens American workers is essentially absent from the current discussion. And there is no clear, definable "threat," like Mexico, on which opponents can focus their fears.

Yet as the congressional debate over the Uruguay Round implementing legislation begins, the outcome is far from clear. Both protectionists and some strong advocates of free trade are now mobilizing to defeat the legislation. Moreover, the controversial strengthening of antidumping and countervailing duty enforcement provisions in the Clinton administration's bill could produce overall higher barriers to trade worldwide, if other countries adopt mirroring provisions against American exporters, thus alienating even more free market GATT supporters.

Generally, GATT is seen as a process for reducing tariffs and other trade barriers. And indeed, thanks in large part to GATT, tariffs have fallen from an average 40 percent in 1948 to 4.7 percent now. In 1948, when the GATT was established, U.S. exports of both goods and services were \$17.5 billion, approximately 7 percent of gross domestic product (GDP). By 1993, \$598.3 billion in exports

represented 11.6 percent of U.S. GDP. One in six American manufacturing jobs is directly or indirectly related to exports.

But the GATT's most important role in the growth of trade has been to establish international norms, a kind of "rule of law" as described by Nobel laureate F.A. Hayek, under which governments voluntarily limit their controls over free trade between their own citizens and those of other countries. Some free trade advocates express concern that the new GATT agreement will create an international bureaucracy that will "manage" trade rather than free it up. But these critics should remember that free markets require the rule of law to protect the property and contractual rights of individuals, to limit government power, and to assure that governments only act in accordance with certain procedures and due process. GATT essentially does this, and thus deserves the support of market liberals.

Free Trade or Fair Rules for Trade?

GATT is the cornerstone of international trade law. It is a multilateral agreement, subscribed to by 123 member governments, which covers over 90 percent of world trade. Its basic aim is to lower trade barriers and create an open world trading system. GATT gives governments a strong incentive to play by the rules. If a government does not, it risks predictable trade retaliation by aggrieved countries, and obtaining the cooperation of other governments to reduce trade barriers that harm its own economy becomes more difficult.

The equal application of rules to all players in an economic system is the central principle of a free market. But the GATT system is more modest. Some free traders maintain that America should simply drop protectionist barriers unilaterally, but for political reasons this seldom occurs. The important conceptual difference between complete free trade and the system of open, fair rules for trade that GATT codifies is that an open system of fair rules is a less perfect but still desirable subset of complete free trade. GATT, including the new agreement, should be judged on its success in moving the world toward more open markets. It has reduced trade barriers and helped avoid trade conflicts through arbitration and negotiations.

The first principle of the GATT, and the general rule of fairness in trade, is that governments should

not discriminate between other GATT members. The "most favored nation" (MFN) principle is that a government should allow its imports without offering special benefits to the producers of some countries and imposing penalties on others. The rules should be equal. An important corollary of the MFN principle is national treatment. Once imported goods and services are allowed into a country's markets, they must be treated no less favorably than equivalent domestically produced goods and services. If the principle of national treatment were consistently applied to all producers and consumers, both foreign and domestic, a nation would have free trade. Foreign producers would not pay a tax at the border that domestic producers are exempt from.

The second basic principle of the GATT system of equal rules is that whenever trade protection is granted to a domestic industry, it should be done by means of a customs tariff on imports and not through other measures, such as quotas. Unlike a tariff, which is a tax on imports that does not discriminate between importers, quota restrictions absolutely discriminate between those sellers who have access to the market, granted by government officials, and those who are barred from it.

Quota restrictions were the pervasive barriers to trade at the end of World War II. In 1948, the GATT agreement made a historic breakthrough by prohibiting import quotas in most sectors of trade. However, exceptions have included trade in textiles and agricultural products. High tariffs, of course, can be as prohibitive as quotas in keeping foreign goods out of a country. But at least tariffs are fair in the sense that they impose an equal rule against all importers, so that more efficient foreign producers can still offer goods in a protected market as long as they pay the tax. One very significant success of the Uruguay Round agreement is the elimination of quotas in agricultural trade, textiles, and in "balance of payments" cases with less developed countries.

Enforcing the Rules

One of the most important achievements of the Uruguay Round is the strengthening of the GATT's dispute settlement procedures and proposing the World Trade Organization (WTO) to establish a more streamlined and comprehensive system of fair, equal rules for trade. It is this proposed change in the GATT that is draw-

ing the most fire from opponents. Some protectionists portray the WTO as a sinister new international bureaucracy, infringing U.S. sovereignty, dominated by "third world dictatorships," and motivated by an anti-free market philosophy. To the extent the duties of the WTO are misrepresented as a kind of "world government" or trade-manipulative bureaucracy, advocates of the free market and free trade can be tricked into opposing the new GATT agreement just as they would oppose government intervention domestically.

None of the free-market critics of the Uruguay Round agreement have argued that GATT itself is a bad thing. The focus of criticism is against strengthening the dispute resolution process and establishing the ongoing agenda for trade policy review, which will replace the custom of negotiating "rounds" for new GATT rules with a regularly scheduled system to look at the restrictive trade practices of member governments.

The Uruguay Round was intended to be the most ambitious postwar expansion of international trade rules since GATT was founded in 1948, and to cover all the sectors emerging as points of dispute between trade partners. In particular, as tariff barriers have come down, non-tariff barriers such as subsidies and government regulations have grown increasingly troublesome. Extending procedural rules and the dispute settlement mechanism to discipline government subsidies, antidumping actions, government procurement, and agricultural trade will significantly enlarge the rights of American firms that expand their business in foreign countries.

The new provisions are a turning point for the GATT, which in the 1980s began to show increasing strain because of unresolved trade disputes that would not have arisen if the new Uruguay Round rules had been in effect. Just as economic and technological progress has changed the way business is done, the rules of trade have to be modernized and loopholes that allow governments to use new means to restrict trade must be closed to address problems that arise in a changing world economy. The Uruguay Round agreement is critical for the GATT to continue to play its role as arbiter and guardian of the rules of trade, which have served the world economy well for more than four decades.

What are our National Interests?

Extending GATT rules to trade in services, intellectual property, transnational investments, and agriculture will introduce a new, mediating step into trade disputes that will allow negotiations and reasoned arguments to play a role where today passion and political posturing are dominant. Under current procedures, trade disputes that are not covered by GATT rules are either resolved bilaterally, or left unresolved altogether. The important change in dispute settlement procedures is that governments challenged for violating the GATT rules must negotiate, and they may not veto the decision of a dispute settlement panel. In every case, the worst outcome for a party that loses a dispute is equivalent to the situation every country faces today, with the other government imposing unilateral trade sanctions.

Critics of expanding the multilateral system for arbitrating trade conflicts argue that the current system of bilateral negotiations, with unilateral sanctions if concessions are not forthcoming, is more in the national interest of the United States. This argument begs the question of what our national interests are. U.S. government trade sanctions against imports invariably benefit some Americans, and adversely affect the economic rights of others. "National interest" cannot be invoked to justify protectionist trade sanctions that benefit one narrow interest, and injure others, any more than such an argument can justify pork-barrel legislation for special interests domestically.

There is a concern that the WTO will become a powerful bureaucracy, dominated by the less developed countries hostile to the United States. This fear arises because all members will have equal representation in its Ministerial Conference, which will meet at least every two years and select the Director General, who appoints subordinate officials. The United States has often been in a minority position in other international organizations, and so this worry arises from numerous precedents.

The risk hardly exists in the case of the WTO, however, because its primary focus will be the resolution of disputes according to transparent and clearly written rules, as set down in the several Uruguay Round agreements. There is no grant of executive power to the WTO; it cannot rewrite the Uruguay Round agreements without

ultimate approval of the U.S. Congress. Moreover, the self-interest of less developed countries would be to resist costly environmental and labor standards, so this group of countries most likely will serve to block attempts by governments in U.S.-rival industrialized countries to use those controls to manage world trade to the detriment of U.S. companies and consumers.

The new dispute resolution process is not a threat to any government's sovereignty. Even if a government loses a dispute settlement panel decision, the prevailing parties do not gain any power to enforce a judgment in the losing government's courts. They only gain the WTO's permission to impose trade sanctions on goods and services that they import from the country found to have unfair trade practices. In reality, powerful countries, including the United States, do that today. Smaller countries will not have much economic impact on the United States, even if they exercised a right to impose a trade sanction against U.S. protectionism. The power of arbitration is primarily rational and moral, and serves to expose venality masked as public policy in protectionist countries, including, it is hoped, the United States.

The concern that U.S. sovereignty would be compromised by participation in the WTO is a dangerously confused argument, which is exploited by some opponents of open trade. Yet, the sovereignty argument cannot possibly be valid when it is used to justify the special privileges of a few against the economic interests of the whole population. The ultimate sovereignty that must be protected is the sovereignty of ordinary Americans to be as free as possible to make the economic and personal decisions that affect their jobs and families.

The GATT Codes and the essentially negative, disciplining, and restrictive authority the WTO will hold over 123 member governments are steps forward for individual rights and the free market, just as the U.S. Constitution is a charter for limiting the sovereign power of the government in favor of individual rights and private property. As Representative Dick Armey (R-Tex.), chairman of the House Republican Conference, has argued, to "take the power to block free exchanges between individuals—in the form of tariffs and non-tariff barriers—out of the hands of the government . . . restores the sovereign freedom of individuals to dispose of

their property as they see fit—e.g., to sell or buy from citizens of other countries without government interference. Restoring individual sovereignty is the most important benefit.”

The WTO promises to bring to the world economy the essentially fair “rule of law” system without combining it with the distorting pressures of a sovereign national political process. When evaluating the new GATT agreement, policymakers must not forget this essential separation between the personal economic interests of every citizen in a free market, and the political process, so heavily influenced by narrow economic interests. The rule of law is essential to economic growth and progress, but politics is often destabilizing and detrimental to progress. The GATT agreement, and the WTO it creates, seems well structured to keep economic freedom dominant over the interest-group political pressures that compete to influence governments.

Joe Cobb
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The Basle Accord and Bank Lending to Small Businesses

Over the past several years, the banking industry has witnessed a dramatic transformation. Commercial banks, traditionally the primary source of capital for small businesses, have reallocated their portfolios to concentrate more on government securities than business loans. That phenomenon has caused great concern within the media among politicians who worry that the reduction in small business lending has contributed to the recession and threatens the long-term health of the economy. Many people view several major recent changes in bank regulation as the culprits in the drop in business lending.

In particular, the Basle Accord, a set of capital requirements approved in 1988, stands accused of encouraging investment in government bonds over business loans. Richard Breen, chairman of the Securities Exchange Commission (SEC) under President Bush and one of Basle’s most vocal critics, argued that the Accord has “created a very strong and quite artificial incentive for banks to use their deposits to purchase government bonds. As a

result, in the United States, banks are becoming government bond mutual funds.” Moreover, he has cited Basle as “one of the major factors that caused a sharp drop in bank lending . . . known as the ‘credit crunch.’” The 1993 *Economic Report of the President* asserts that Basle “failed to mandate adequate reserves for government bonds in comparison with commercial loans, unintentionally providing an incentive for banks to shift their assets into government bonds and away from commercial loans.”

It is true that Basle is far from perfect. It measures risk in a crude and inconsistent manner and treats some assets far more sternly than other assets of equal or greater risk. Yet, despite its flaws, empirical evidence clearly indicates that Basle is not responsible for the decline in small business lending.

Bank Capital Regulation and the Basle Accord

Bank regulators in several countries, including the United States, have imposed capital requirements for many years. Traditional capital requirements have mandated that a bank maintain capital (the excess of its assets, such as loans, over its fixed liabilities, such as deposits) equal to at least a fixed percentage of its assets. The justification for those capital requirements has been the need to safeguard banks against insolvency, to protect taxpayers from liability through the deposit insurance system, and to offset the artificial incentive that deposit insurance creates for banks to engage in excessively risky activities (since the government pays the cost if a risky investment sours, but the bank’s shareholders reap the benefits if the investment is successful). Capital provides a cushion against shocks to a bank’s balance sheet and protects it from bankruptcy and a taxpayer-financed bailout. Unfortunately, those crude capital rules fail to account for the fact that different assets impose different risks on the bank. A bank for which the assets include only three-month Treasury bills is very safe even if it has virtually no capital. However, a bank with a large quantity of commercial real estate and third-world country loans could be at extreme risk of insolvency even with a large capital cushion.

In August 1988, responding to concerns about the adequacy of traditional capital regulations, the Group of Ten countries agreed to a new set of capital requirements, known as the Basle Accord, for

financial institutions. Named after the city in Switzerland where the standards were developed, the Accord represents a major shift in capital regulation. The new rules do not treat assets equally. Instead, they group assets into four risk categories, each with a different weight. For example, Treasury and GNMA bonds have zero weight, FNMA and municipal bonds have 20 percent weight, mortgages on 1-4 family residences have 50 percent weight, and commercial and industrial and third-world loans have 100 percent weight. A measure of risk-weighted assets is derived by multiplying the quantity of assets in each category by its weight and summing over all four categories. Basle also differs from former capital regulations by including off-balance-sheet items in its calculation of risk-weighted assets. The Basle Accord requires that a bank maintain capital greater than 8 percent of its risk-weighted assets.

While Basle is a clear improvement over traditional capital requirements with respect to reducing default risk, it is far from perfect. Each of the four risk categories contains assets with wildly varying risk characteristics. For example, the zero-weight category, which includes assets that do not require any offsetting capital, encompasses both U.S. Treasury bills, with little if any risk, and Greek 30-year bonds, with considerable risk both of default and interest rate fluctuation. Basle groups all commercial and industrial loans together in the highest risk category despite the fact that there is enormous variance in their riskiness, and many are probably less threatening to a bank's overall health than some residential mortgages, which require half as much offsetting capital. Notwithstanding those criticisms, Basle is probably as good a capital regulation as one can expect to emerge from an international conference of regulatory agencies. The main potential concern with Basle is not how well it achieves its intended purpose, but rather whether it has had unintended consequences for the economy.

How Could Banks Cope with Basle?

When the Basle Accord was announced in 1988, many U.S. banks were not in compliance with the new regulations. They needed to adjust their balance sheets to conform to the new rules by 1993, and to slightly less restrictive rules by 1991. The banks had three options: they could reshuffle their assets, their liabilities, or some combination of both.

One way for a bank to comply with Basle was to reduce its risk-weighted assets, by either divesting itself of high-risk assets, such as commercial and industrial loans, or by originating fewer such loans. The funds released by those actions could buy lower-weighted assets, such as Treasury bonds. While this method of compliance might be easy to implement, it does have the disadvantage of drawing the bank away from its area of specialization: lending to small businesses.

The second means of compliance with Basle is to increase the bank's capital. This can be done in two ways. First, a bank can issue new stock and use the proceeds thus raised to reduce fixed liabilities or acquire more assets, in either case increasing capital. This method is fairly easy to employ and does not alter the fundamental business of the bank. However, both financial theory and empirical evidence suggest that new stock issues usually erode the value of pre-existing equity.

A bank can also increase capital by artificially raising the value of the assets on its books. That can be done by selling assets that have appreciated in value, postponing the sale of assets that have lost value, and failing to adjust book values of unsold assets that have experienced price declines and should be revalued under Generally Accepted Accounting Principles (GAAP). While those strategies are relatively painless, there are clear limits to the extent to which they can be used, and they are only temporary solutions; the illusion will eventually dissolve. Furthermore, failure to adjust book values in compliance with GAAP can lead to an enforcement action by the SEC; note the plight of Presidential Life Corporation.

The Credit Crunch: Was It Real and Did Basle Cause It?

In the late 1980s, the United States experienced a dramatic slowdown in bank lending to businesses, a slowdown that has not yet been reversed. At the same time, banks accelerated their accumulation of U.S. government securities. There are two possible causes: either there was a shift in the demand for bank funds or there was a shift in the supply of bank funds.

One explanation for the shift in bank lending is that the demand for funds by businesses declined while the demand for funds by the U.S.

government increased. There can be no doubt that the government has dramatically expanded its appetite for funds during the past several years. Further, the initial decline in business lending coincided with an ailing economy. Weakness in the economy led to a reduction in the number of profitable investments available to private businesses; hence, their demand for bank loans should be expected to have declined. On the other hand, expansion in government borrowing is nothing new, and past recessions should have hampered business loan demand; however, no other recession in recent history has seen so large a shift from private to public sector lending by U.S. banks. Another problem for the demand-shifting hypothesis is that the decline in commercial and industrial lending continued through 1993, more than two years after the recession ended.

The magnitude of the recent change in bank lending has led many people to believe that a demand shift is an insufficient explanation and that a supply shift must have occurred also. Multiple changes in the bank regulatory regime occurred in the late 1980s in response to high failure rates and deposit insurance costs for both banks and savings and loans in the early to mid-1980s. A popular view is that those regulatory changes discouraged banks from making business loans that they otherwise would have made and that this shift in supply was a major cause of the drop in business loans, what has come to be called the "credit crunch" the United States is supposedly suffering. The credit crunch hypothesis further contends that the drop in bank lending to small businesses led to a decline in investment, since other sources of capital for small business are limited, and a contraction of the economy; hence, this hypothesis claims that loan contraction partially caused the recession rather than the reverse.

The three regulatory changes primarily accused of inducing the credit crunch are two recent laws—the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989 and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991—that impose heavy administrative costs on loan origination, and the Basle Accord with its formula that "rewards" banks for holding Treasury bonds instead of commercial and industrial loans. As mentioned earlier, Basle was a popular scapegoat for the Bush administration in explaining the recession, but both FIR-

REA and FDICIA received criticism as well. The fact that Bush focused so much blame for the country's economic problems on the credit crunch seems very odd since he signed both FIRREA and FDICIA and Reagan appointees negotiated the Basle Accord.

Basle Caused Banks to Shift Liabilities, Not Assets

The validity of the claim that Basle contributed to a credit crunch and harmed the U.S. economy hinges on the question of how banks responded to it. Banks could have reacted to Basle either by shifting assets or shifting liabilities. Basle contributed to a credit crunch only if the asset-shifting hypothesis is correct.

Superficially, the data seem to indicate that asset shifting occurred. In aggregate, banks reduced the share of their assets that were in high-risk categories and increased the share of assets in low-risk categories following announcement of the Basle standards. The problem with this analysis is that other events happened at the same time. The economy weakened and Congress passed FIRREA and FDICIA. Those events would have caused banks to change their asset holdings in the precise manner that they did, even without Basle.

The only way to produce a clean test of the asset-shifting hypothesis is to compare banks that were affected by Basle to banks unaffected by it. When the Group of Ten announced the new standards in 1988, most banks already had capital in excess of the level demanded by Basle. Those banks (henceforth referred to as the compliant banks) were relatively unaffected by Basle and could not be expected to react to it. The banks not in compliance in 1988 (henceforth referred to as the deficient banks) had no alternative to responding to Basle; the only question is how they reacted. If the asset-shifting hypothesis is correct, the deficient banks should have reduced their holdings of high-weight assets more aggressively than the compliant banks. If the liability-shifting hypothesis is correct, the deficient banks should have raised new capital more aggressively than compliant banks.

Using balance sheet data from call reports for all U.S. commercial banks with assets of at least \$100 million, I have used a variety of statistical tests to discriminate between the two hypotheses. These tests compare the behavior of defi-

cient banks in the four years following the Basle announcement (June 1988 to June 1992) with the post-announcement behavior of compliant banks of similar size. One test involves linear regressions of portfolio changes on bank size, the change in state economic conditions, the capital-asset ratio, and the risk-based capital level. Throughout the post-Basle period, the coefficients on risk-based capital are negligible. A series of nonparametric tests comparing the two samples of banks confirms that result while overwhelmingly supporting the hypothesis that deficient banks raised more new equity than compliant banks.

That banks chose to respond to Basle by shifting liabilities instead of assets should not be surprising. Indeed, the cost of raising new equity in the stock market is relatively low. It is true that a stock offering typically provides a negative signal to the market about the firm's prospects and causes the company's stock price to fall, since a firm that knew it would do well in the future would not want to share its prosperity with new stockholders and would not want to issue equity, while a firm with poor prospects would desire to share its losses with new shareholders. However, if a bank issues stock in response to a government mandate, the issue provides no signal to the market, and no decline in stock price should result. (That is not true if the existence of the mandate is revealed by the stock issue since the mandate itself can have a negative effect on the stock price; however, the Basle rules and banks' risk-based capital levels are public information, so a stock issue would not reveal any new information about them.) Hence, the only cost of raising new equity is the batch of fees that must be paid to lawyers, accountants, and investment bankers. In addition, banks can increase their capital without selling stock by using accounting tricks. That method is very cheap and is responsible for at least 20 percent of the difference in capital acquisition between deficient and compliant banks.

Retain Basle but Improve It

Since banks responded to the Basle Accord by raising their capital, the new standards are not responsible for a credit crunch. The fears of the Bush administration and others that Basle contributed to the recession appear unfounded. The only costs to the economy due to Basle are tran-

sition costs to the banks. Those are sunk costs that will not be recovered if Basle is repealed. Instead, the repeal of Basle would dissipate the benefits of improved security of the deposit insurance system.

That is not to say that Basle is perfect. Indeed, there are many flaws in the standards that deserve attention, especially the relative risk-weightings of various assets that do not correspond to their true relative risks. More disturbing, the standards attempt to assess only credit risk and completely ignore interest-rate risk. A concern is that an inflation burst, such as occurred in the late 1970s and early 1980s, would cause a large number of banks that are currently passing Basle's standards to become insolvent due to large holdings of long-term government bonds and residential mortgages. However, this problem is probably not as serious as it appears. Most large banks have adopted sophisticated hedging strategies to insulate themselves from interest-rate risk, and recent empirical studies have noted a decline in bank sensitivity to changes in interest rates. However, it is likely that many small banks are not adequately hedged and could be vulnerable. Therefore, a high priority for bank regulators should be to develop a system for evaluating a bank's interest-rate risk and integrate it into the Basle standard.

U.S. regulators should not wait for international negotiations to integrate interest-rate risk into Basle. Since the purpose of risk-based capital requirements is to safeguard deposit insurance, the United States has an interest in imposing them on American banks regardless of whether foreign deposit insurance systems are similarly protected. The main argument in favor of an international accord is the notion that capital requirements in one country put that nation's banks at a disadvantage in international capital markets. However, in light of the empirical evidence presented above that suggests that banks are able to respond to capital requirements by raising equity inexpensively, that argument is groundless.

Although Basle is not guilty of causing a credit crunch, there is good reason to believe that other government regulators, primarily FIRREA and FDICIA, have done so, and slowed the economy by increasing the administrative burden on all banks of originating loans to small businesses. Unfortunately, given the interven-

tionist mentality of the congressional banking committees, it is unlikely that they will remove those obstacles in the foreseeable future.

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Creeping Privatization: The Present and Potential of Alternative Dispute Resolution

Few government employees will admit that their bureau does a bad job. But over the past two decades, a number of judges have harshly criticized the public courts. Those critics include Chief Justice Burger, Judge Posner of the 7th Circuit Court of Appeals, and Justice Neely of the Supreme Court of West Virginia. That alone should establish a *prima facie* case that the public courts aren't working very well, and the critics' lengthy documentation of the court's failures yields a conclusive verdict. The public courts' pricing system leads to massive overdemand and waiting in line; trivial cases use court time better spent on serious offenses. The legally well-armed often use those delays to defeat their opponents by financial exhaustion. Legal blackmail, or "nuisance suits," discourages production and innovation. The courts use unpaid jurors to resolve minor civil cases, and layman jurors to weigh complex technical issues. Perhaps most importantly, since victory tends to go to the legally well-armed, both sides to a dispute race to outspend each other, but in the end such efforts cancel each other out (though their legal bills assuredly do not).

What can be done about this? Critics often focus on specific reforms within the public courts, but a growing consensus is looking to the private sector, both profit and nonprofit, for answers. Some economists might scoff at this: after all, isn't adjudication a public good? Surprisingly, the answer is no. The benefits of dispute resolution are basically exclusive, since the end of a dispute for either side spares both sides extra legal expenses. And, as every judge would agree, the services are rivalrous with a vengeance: indeed, one of the chief problems with the current court system is that there aren't nearly enough courtrooms to go around.

Private alternatives to the courts have been

around for a long time: the American Arbitration Association (AAA), still the market leader in private alternatives to the courts, was founded in 1926. Last year it handled about 60,000 disputes. Commercial claims predominate, followed by construction cases, and smaller but growing number of securities, international, and computer cases. The AAA has always been run as a nonprofit organization, though its arbitrators and mediators frequently charge a fee. (To help settle disputes quickly, it is a common policy to begin charging only after the first day of negotiations.)

Until the late 1970s, the AAA dominated the Alternative Dispute Resolution (ADR) market. Since then, new and innovative competitors—most operating for profit—have sprung up: J.A.M.S. (Judicial Arbitration and Mediation Services, Inc.) in 1979, EnDispute in 1982, Judicate in 1983. Competition among the new firms has been fierce: each is trying to expand into new geographic regions and hire big-name judges to attract wary customers. The large and growing cost of lawsuits appears to be the major explanation of the increase in demand: legal costs as well as unreasonably large awards are the major factors cited by executives of companies that use ADR.

J.A.M.S. has become the number-two ADR firm, usually catering to a business market. It handled 12,500 disputes in 1992. J.A.M.S. probably owes its market position to its innovative hiring policy: all of its clients get to present their cases before retired or former judges. When an ADR firm hires former judges, it hires more than an employee; it is also renting a name brand for honesty, accuracy, experience, and legal expertise. Many firms first try ADR when they see that the familiar faces behind the courtroom bench have gone private.

Most ADR falls into two categories: mediation and arbitration. In mediation, the neutral party tries to help the disputants reach their own solution. He has no power to decree a final answer, he can only put forward suggestions and try to probe the parties to find out what is negotiable and what isn't. Mediation is popular because it usually leaves no hard feelings: both parties feel that they gained more than they gave up, so it is easier to resume a profitable working relationship afterwards. Arbitration is different: while an arbitrator will try to work out a mutually agreeable solution, his job is to decree the final outcome if one or both disputants are uncooperative.

Within those two broad categories, we see great variety. There are "community dispute resolution

groups" that mediate neighborhood and family conflict. Usually the mediators are volunteers, with the centers funded by donations or charitable organizations like the National Institute for Dispute Resolution. At the other extreme, groups like J.A.M.S. operate for profit, targeting legally burdened industries. They emphasize quality service: cases are heard within four to six weeks, the facilitators are former judges, the parties can pick their own court date, and clients enjoy the help of both an account executive and a judicial assistant. J.A.M.S. also sells prophylactic legal services: they help their clients write customized ADR clauses into their contracts to handle difficult technical issues. J.A.M.S. naturally takes standard contract, construction, and insurance problems, but also works in lender liability, maritime law, medical malpractice, personal injury, product liability, real estate, discrimination, and other areas. The costs can exceed other forms of ADR, but are still much less than court battles. Lying in the middle we have the AAA: clients pay \$300 to file a normal case, and facilitators usually receive a payment. The wait between filing and settlement runs about eight months; the facilitators may be business experts, lawyers, former judges, or academics. While the service package isn't quite as lush as J.A.M.S.'s, a large majority of clients (87 percent) find AAA's administrative services "good" or "excellent."

Alternative Dispute Resolution: The Process

How does the ADR process work? In mediation, the procedures are fairly informal. Under AAA mediation rules, the AAA appoints a mediator after the two parties agree to use ADR. If they like, the parties may select a particular mediator, or agree on their own neutral procedure for selecting one. They then arrange a meeting date, when the mediator can help the two parties settle. If the negotiations aren't going well, the mediator may separate the parties and speak with them privately to help reach a decision. If all this fails, the parties can opt for the more formal procedures of binding arbitration.

In binding arbitration, a party files his case with a regional office of the AAA. The AAA then assigns a case administrator and notifies all parties to the dispute. The case administrator prepares a list of qualified arbitrators (usually ones well-informed about the technical aspects of the dispute) and sends it to the parties. The parties in turn numerically rank the potential arbitra-

tors; the AAA selects an arbitrator that both parties can accept. (If the parties' preferences diverge too much, the AAA appoints an arbitrator.) The case administrator then works out a suitable time and place. The hearing is semi-formal: the arbitrator receives testimony, documents, and other evidence. The parties usually bring a lawyer. The disputants can call witnesses, who may be examined and cross-examined. While the procedures are looser than in a regular trial, the pattern is the same. Once both sides have made their case, the arbitrator issues a decision, fixes the binding award, and sends notices to the disputants and the case administrator.

Advantages of Alternative Dispute Resolution: Theory and Experience

The problems that ADR firms try to solve are the same problems that plague the public courts. Most obviously, ADR firms try to find market-clearing prices for their services. Not only is this better for the firm: it also makes it possible to handle urgent cases quickly and separate serious from trivial complaints.

A second and related problem is that the public courts foster unchecked but futile legal struggle. ADR firms handle this in two ways. First, they get the dispute to trial more quickly, so there is less time for both sides to struggle to outspend each other. When a case takes more than a year to go to trial, both sides may find it necessary—in mutual legal self-defense—to hire legal teams for the duration of the wait. Cutting the waiting time down to a matter of weeks helps a lot. On top of this, ADR firms often limit their clients' use of legal services. Of course, this is precisely what the parties want, so long as they can precommit to it in an arbitration clause when relations are still friendly. The problem is that after a quarrel starts, hard feelings and a confrontational atmosphere make it difficult to strike a deal to limit needless legal competition. By relaxing strict procedures, an ADR firm can make legal competition less productive. Alternately, an ADR firm can directly limit or forbid the use of lawyers, attacking the problem directly.

But what is so bad about legal competition? Isn't it just the same as any other kind of market competition? Not really. While market competition spurs all competitors to try to produce



more efficiently, thereby increasing everyone's standard of living, legal competition is more like a tug-of-war. Both sides struggle over a fixed payment; by spending more on legal services, a side can increase its chance of winning. But unfortunately, so can the other side. So if each side has a 50/50 chance of winning without any legal expenses, they might both spend \$100,000 in legal fees—only to find that since both parties tried to gain the upper hand, the probabilities are still 50/50. Imagine a one-on-one tug-of-war, in which each party kept hiring helpers to pull on his side of the rope. It costs a lot, but it isn't very likely to change the final outcome.

Other benefits of ADR are a little more subtle. Commercial disputes often concern detailed, technical matters. Computers, securities, and biotechnology are good examples. But even in those cases, the people who make the ultimate decision are usually jurors. They just don't have the expertise to make a sensible judgment. Expert testimony can help, but again, jurors have trouble evaluating technical testimony. This is a serious failure in the court system that can leave innovative industries in perpetual legal limbo. But while the courts ignore the problem, ADR firms do not. The AAA has 50,000 neutral parties to hear cases, with backgrounds in every branch of business and technology. So when a

dispute breaks out, the parties naturally request a qualified professional to hear their case, rather than a layman. J.A.M.S. uses former judges, rather than industry experts; but they nevertheless try to assign judges to areas where they have the most experience.

ADR customers have a lot more freedom to choose their judge than litigants in the public court system. Under AAA rules, both sides get to choose from a list of suitable arbitrators; if the sides agree, they can even request someone who is not a member of the AAA. While it isn't possible for both sides to get their first pick every time, this is a serious check against bias and incompetence. J.A.M.S. and other for-profit firms also give clients considerable discretion when assigning a judge to a case.

ADR also reduces costs by getting rid of unneeded rules and procedures. Disputants often prefer more flexibility and informality for their own sake, but it is the cost savings that win them over. For example, J.A.M.S. limits discovery and pretrial motions. Current rules regarding discovery can be particularly onerous, placing a heavy burden on defendants (and making legal blackmail, known as "nuisance suits," quite attractive). The public courts are slow to reform those rules, but ADR firms, eager to attract new customers, are always looking for a new problem to solve.

ADR firms also promise to respect their clients' privacy. They see each dispute as a private matter, and don't publicize trials or outcomes. That appeals to large corporations that have to worry about bad public relations whenever they go to trial. Potential abuses of confidentiality are worrisome: if arbitration discovers a design defect in a product, that fact would not necessarily be revealed to the general public. Another victim of the same design defect would have to argue the case all over again, since the records of earlier cases would not be available. On the other hand, privacy helps prevent nuisance suits based on the threat of negative publicity and preserves the valuable business reputations of innocent firms. So while private proceedings surely benefit the parties to a dispute, their effect on the general public is mixed.

Complaints about Alternative Dispute Resolution

A common complaint about ADR is that it is inconsistent with judicial neutrality. Public court judges, even if they aren't perfect, are more likely to give an honest judgment because they aren't being paid by

the disputants. They are free to rule as their conscience dictates, because their pay is strictly separated from their rulings.

ADR firms are aware of this problem, and have solved it in a number of ways. When an arbitrator works for pay, his pay does not depend on how he rules. J.A.M.S., for example, carefully isolates its judges from the moneymaking side. The judge does his job, and another division collects the payments. Overall, ADR firms have a strong incentive to maintain a reputation for honesty: since both parties must agree on a firm, a consistently biased firm would have trouble getting any business.

Judge Richard Posner and Professor William Landes have pointed in their writings to a potentially far more serious defect in ADR. They argue that private firms would have no incentive to produce new rules of law. Like other types of intellectual property, rules of law require research and development of sorts; and the legal thinker who develops such rules bears the costs. But if someone develops a more efficient rule of law, everyone can benefit from it. Usually, we give an incentive to produce intellectual property by giving the innovator a patent or copyright. But this is extremely difficult to do for rules of law, because it would be possible to use another firm's rule of law covertly, without citing it. It would be pretty easy to ignore intellectual property rights in precedents and other legal innovations. Therefore, conclude Posner and Landes, despite its benefits for dispute resolution, ADR is decidedly inferior to government courts for producing rules of law.

As convincing as that argument seems, it overlooks other important incentives for innovation. Foremost among these is the long-term reputation that an innovative firm can win for itself by pioneering new methods. It is very common for the first firm to introduce a major innovation to remain the industry leader for decades, even though imitation is perfectly legal. By establishing a reputation for innovation, a firm can often reap the rewards of legal research and development even without formal intellectual property rights. That seems to be precisely what is going on in ADR today. The AAA—still the market leader—has produced an extensive body of procedural law relating to arbitration. Those rules specify the proper channels for initiating a dispute, selecting an arbitrator, submitting evidence, changing a claim, recordkeeping, admitting evidence, and so on. While the AAA's procedures vary only slightly from industry to industry, they differ substantially from those of the

public courts. They are shorter, simpler, and looser—particularly with regards to evidence. Under AAA rules, an arbitrator has far more discretion to admit evidence or even visit the site of a dispute if that would be helpful.

Nevertheless, up to now confidentiality has hindered the production of new precedents via arbitration. But perhaps as competition in the arbitration industry grows fiercer, and more dispute resolution falls into private hands, arbitration firms will decide to record the outcomes of cases while keeping the names of the parties secret. Finally, we should note that the public courts do quite a bit of free-riding themselves. Public courts often defer to industry practice when they make their rulings—a case of the public sector free-riding off of the private sector's rule creation rather than the other way around. So while private rule creation has problems, it works in some cases and has brighter prospects in the future as ADR waxes and public resolution wanes.

Opening up the Legal System

In the past, there were serious obstacles to extending the scope of ADR. Courts were often reluctant to enforce arbitration clauses except in commercial disputes. Other times, courts discouraged ADR not by positively overruling it, but merely by creating an atmosphere of legal uncertainty about its permissible uses. Firms are unlikely to try arbitration if they have no idea if the courts will accept its use. In consequence, they default to traditional legal channels.

For example, courts have long been reluctant to enforce arbitration of employer-employee contracts. The notion persisted that arbitration could only reflect unequal bargaining power. Thus, in *Alexander v. Gardner-Denver Corporation*, the Supreme Court ruled that in the case of an employment dispute, an arbitration clause could not bar a subsequent federal court claim. At least that is how most businesspeople interpreted the ruling—which was actually more complicated because it involved a union employee who was already covered by a collective bargaining agreement.

But a recent decision from the Supreme Court suggests a major change in the area of employment dispute arbitration. In *Gilmer v. Interstate/Johnson Lane Corporation*, the Supreme Court ruled that an agreement to arbitrate any dispute arising out of employment or its termination was indeed enforceable. The majority's ruling noted that unlike the

Alexander case, the employee in *Gilmer* did not belong to a union. If he did, then one could argue that the union, rather than the employee, had the right to decide whether or not he could sign an arbitration agreement. But since he was a nonunion employee, he had the sole power to decide whether or not to commit to arbitration.

Today, the prospects for ADR seem better than ever. The *Gilmer* case is indicative of a sweeping judicial trend towards the universal tolerance of arbitration agreements. Recent rulings indicate that not only employment disputes (like termination) may be arbitrated, but also discrimination, sexual harassment, and almost everything else. The next step is for arbitration firms to spread the word among the business community, hammer out a transition plan to get current employees to switch to arbitration without hard feelings, and then make arbitration agreements into a part of standard hiring procedure. The results will be predictable: lower legal costs for both sides, more informed and constant rulings, and fewer malicious and nuisance lawsuits.

Now that the Supreme Court has cleared the path for ADR, we should expect it to continue its steady growth. That American society is too litigious is a cliché, but it is nonetheless undeniably true. Most critics of our legal system seem to want it to reform itself. It might be more realistic to hope that private alternatives will find it in their interest to locate the most serious failures of the public courts, then offer their customers a new and improved package of much-needed reforms.

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Bicycle Safety: A Case Study in Regulatory Review

Over one-half million bicyclists are seriously injured each year, and nearly 1,000 are killed, despite a bicycle safety standard that the Consumer Product Safety Commission (CPSC) promulgated nearly 20 years ago. The CPSC estimates that bicycle-related injuries and fatalities cost \$8 billion annually, and that bicycle accidents cause more injuries and deaths than almost all other products under its jurisdiction.

Parts of CPSC's bicycle regulation—such as per-

formance tests for brakes and requirements that control cables “not abrade over fixed parts”—seem sensibly related to safety concerns. But since consumers can typically examine and test ride a bicycle before purchase to determine the performance of the brakes and whether its cables unduly rub against part of the bicycle, the necessity of such regulation is unclear.

Other sections of the standard bear no discernible relationship to improving safety. A federal court of appeals struck down a broad prohibition on “protrusions,” a heat test for hand, but not foot, brakes, and specifications concerning pedal treads and handlebar widths. Many other design specifications covering such areas as the strength of the spoke holes in the wheel and hub integrity are still part of the standard today, despite the lack of evidence that any appreciable number of accidents are caused by failures of those components.

Sparked by the number of fatalities still associated with bicycle use despite existing CPSC oversight, the agency recently established its “bicycle project” to “evaluate bicycle use and hazard patterns, and to assess alternative strategies for injury reduction.”

Unfortunately, the CPSC's search for “alternative strategies” did not mean searching for alternatives to its burdensome and often nonsensical standard. Its vested interest in that standard and product standards in general makes it an inappropriate agency for impartially analyzing alternatives for improving safety, especially nonregulatory alternatives. The report of the bicycle project clearly demonstrates that bias and exemplifies three general rules that apply to regulatory reviews conducted by agencies themselves responsible for the regulation.

The “Elephant Repellent” Rule

In a classic joke, an inventor announces he has invented something that will absolutely repel elephants. The skeptic cynically asserts that there are no elephants for hundreds of miles, causing the inventor to triumphantly exclaim: “See how well it works!” In a similar vein, the CPSC bicycle project was carefully constructed not to question the effectiveness of its safety standard.

Past studies of the standards' effectiveness—including a study by the CPSC economist in charge of the bicycle project—failed to show that it has had any favorable, statistically significant impact on bicycle-related injuries. Although the CPSC announced that its standard would cure 17 percent

of all bicycle-related injuries, that estimate was based on a biased sample. Product failure likely causes less than 10 percent of bicycle-related injuries, and improper maintenance of older bikes, rather than defective design or assembly of new bikes, accounts for most product failures. Therefore, the CPSC standard only had the potential to reduce injuries by 2 percent or less. That may explain why there are relatively few product liability lawsuits involving bicycles.

The CPSC bicycle project arguably confirms the limited usefulness of the safety standard. The project concluded that "there was no significant mechanical failure patterns that warranted amendment or revision to the mandatory bicycle standard." Since the original prestandard CPSC study of bicycle injuries found that 8 percent may have been caused by product failure and the current study found that 10 percent of all injuries may be so caused, this suggests not that the elephant repellent is working but that there was never any need for it at all.

The "If They Don't Yell Loudly Enough that It's Broke, Don't Fix It" Rule

There is only one thing worse than a safety regulation that burdens manufacturers and limits innovation in design standards, but does not improve safety—a standard that exacerbates a safety problem. The plaintiff who challenged the bicycle safety standard after it was initially promulgated in federal court has long argued that the standard's requirement that bicycles be fitted with 10 reflectors is inadequate for nighttime cycling. A time series analysis of the safety effects of this rule found a possible negative relationship—the rule may have increased rather than decreased the bicycle injury rate.

The explanation of that result may be that the CPSC-mandated reflectors cause bicyclists to think they can safely ride at night when in fact all states require a front headlight for night riding. The CPSC has repeatedly noted an increase in the proportion of nighttime injuries and fatalities associated with bicycling. The bicycle project report noted that over 20 percent of the injuries and 46 percent of fatalities occur between 6 P.M. and 6 A.M., but only about 12 percent of riders report that they ride at night at least some of the time. A study by the John Hopkins Injury Prevention Center finds that 18 percent of all bicycle trips were made between the hours of 7 P.M. and 6 A.M. It further noted that the

highest risk of death occurred from 10 P.M. to 6 A.M. when 5 percent of all bicycle trips were made, but 26 percent of all bicyclist deaths occurred.

The main CPSC report does not relate its finding of nighttime deaths and injuries to its safety standard except to recommend that "the use of bicycle headlights and reflective clothing should be encouraged. Night riders should also make sure their bicycles are equipped with reflectors, as required by the CPSC standard." A specialized report on injury, hazard, and risk patterns within the main project report noted that less than 8 percent of the bicycles in nighttime accidents had lights, but over 90 percent had reflectors. In an apparent attempt to minimize the damning nature of this evidence, the report then noted, "It was beyond the scope of this study to determine the adequacy of the mandatory standard's reflector requirements."

Thus, despite long-standing criticism of its reflector standard based on investigation of the level of nighttime conspicuousness of the required reflectors and time series data suggesting the standard exacerbates safety problems, the CPSC staff did not recommend or perform a review of the adequacy of the reflector requirement under actual working conditions. In short, given past criticism and its own findings, the CPSC appears negligent in not investigating whether its reflector standard is deceiving bicyclists into falsely thinking they can ride safely at night. At least two recent product liability suits have followed this reasoning to hold bicycle companies liable for failing to clearly warn that the CPSC-mandated reflectors are inadequate and that a headlight is needed. Had the CPSC been willing to consider amending their standard to require clear warnings about the need for a headlight for nighttime riding and no longer requiring 10 reflectors to mislead riders, it might actually create a standard that improves safety, instead of one that may cause more injuries than it prevents.

The "To Avoid Further Scrutiny, Stir up Trouble Elsewhere" Rule

Although the report urges informing bicyclists about several different risks, it steadfastly fails to recommend changing the standard to require manufacturers to provide risk information with the bicycle. Instead, it recommends that the CPSC disseminate the study's findings and evaluate and possibly improve upon existing legislative proposals for requiring child bicyclists to use helmets. This latter recommendation was

made without considering either the cost or effects of such a requirement.

Perhaps the most interesting diversionary finding in the CPSC study is that riding on streets is seven to eight times more dangerous than riding on bike paths separated from streets. That finding not only appeals to motorists but also contradicts studies done 20 years ago finding that experienced bicyclists have an accident rate on bike paths 2.6 times their accident rate on streets.

While it is possible that the CPSC finding is accurate and bike path design, behavior, and overall safety have improved dramatically in the past 20 years, CPSC data does not support its conclusion. Its findings are based both on accident occurrences and those bicyclists who say they predominantly ride on bike paths, yet there is no attempt to measure amount of bike path use. Those bicyclists who use bike paths are likely to be low-mileage, occasional bicyclists, so there are few accidents on bike paths because there is only occasional riding there compared with riding on streets.

While it may be time to reexamine the safety of bike paths, the CPSC conveniently "overreports" its findings to play upon a well-known split among bicyclists: those who favor bike paths versus those who advocate riding in streets. The report focuses the attention of the bicycling community on the bike path issue and away from the deficiencies of the CPSC safety standard.

Conclusion

If the CPSC is going to spend money studying bicycle safety, it should objectively examine both the need for, and deficiencies of, its bicycle safety standard. Instead, it only asked the self-interested question whether the standard needed to be augmented to further regulate mechanical hazards. It did not examine the alleged deficiencies of its reflector requirements. Nor did it consider adding information warnings to its standard. The CPSC further failed to consider the most fundamental question, whether the standard does any good.

It is meaningless to ascribe intent to an organization like the CPSC, but economic theory predicts it would act in just this manner when conducting regulatory reviews. If this result is generalizable to other reviews and other agencies, then a new system of regulatory review

should be developed to protect against agency self-interest. Perhaps a watchdog agency, like the Office of Management and Budget, should conduct such reviews. Furthermore, the burden of proof should be placed on the agency to justify its current regulation.

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Yahoo Justice

Until recently, workplace cultures freely evolved from within. The values and personalities of the owners, managers, and employees, and the type of business, determined the social relations that occurred. Some businesses permitted intraoffice dating, some did not. Bars and restaurants did not require the same level of decorum as, say, a law office or hospital. Temperamental immigrant chefs could bellow and swear, and whoever could tolerate them would stay.

Now it's different. Since the passage of the 1991 Civil Rights Act and a recent Supreme Court decision, social interactions, once the province of Miss Manners, can easily become a federal case. Workplace behavior standards are now to be enforced from the outside, with the boss as the designated censor.

The Supreme Court that recently issued the *Harris v. Forklift Systems* decision against harassment in the workplace sits in the middle of a city under siege. Justices, who pronounced the nation's employers liable for "permitting a hostile environment" to exist in the workplace, cannot walk within six blocks of the courthouse without being confronted with the most hostile of environments. Visitors to the nation's capital plan their monument tours around the schedules of street hustlers, muggers, and murderers who own the streets after sunset, impelling Mayor Sharon Pratt Kelly to request the National Guard. Instead of grappling with the mayhem outside, Congress and the nation's criminal justice system have turned their attentions to something far more manageable—workplace harassment and speech control.

"This decision is only a blow to Yahoos," said Burke Stinson, an AT&T spokesman. Mr.

Stinson and other Fortune 500 guys who have spent big bucks on shiny new sexual harassment brochures and seminars are not worried. With their fleets of expensive in-house lawyers, they are confident they can negotiate sticky situations.

The Yahoos, though, many of whom are small business owners and their employees, are about to get it big time. Those business owners are subject to fines of hundreds of thousands of dollars for "permitting a hostile environment" to exist in their workplaces.

A Yahoo, says the *American Heritage Dictionary*, is "a crude or brutish person, derived from a race representing humanity at large in *Gulliver's Travels*." The Yahoos I know are the hardworking guys with the rough edges who are running the auto body and pizza shops. Though they may sometimes look like the people from *Deliverance*, they create a sizeable chunk of the new jobs in America.

The Yahoo is a man who has not had his attitudes adjusted and filtered through the paradigms of Yale. He does not know it yet, but his personality has been criminalized. He is considered by the politically correct and their lawyers to be a racist, sexist, homophobe. God help him if he has worked hard, played by the rules he thinks exist, and owns a home and business of his own.

Yahoos have never heard of the "Hostile Halls" study, a report on sexual harassment in school. While Senator Edward Kennedy (D-Mass.) busies himself investigating minutia like the pig-tail pulling and depantsing that is said to be going on in kindergartens throughout America, businesses are being demoralized and destroyed by armed robbers who come through their back door and lawyers who come through the front.

The employees that the Yahoos hire are a wild and wooly breed themselves. Dean, a chef/manager of a restaurant kitchen on auto body row, is an example. He regularly laughed wildly as he chased waitresses with a three-foot-long filet mignon hidden under his apron. The restaurant owner who was financially responsible for Dean's antics became nervous when he heard tales of how Dean, working alone on the nightshift, hid under tables and grabbed the ankles of the waitress he wanted to date. Scared out of her wits, did she sue? No, but she could have. Instead, she married him.

Charles Hardy, president of Forklift Systems, Inc., in Nashville, Tennessee is the latest Yahoo to be captured. "You're a woman, what do you know?" Hardy said once to his female manager. Another time he called her "a dumb-ass woman." After complaints from one of his employees, Teresa Harris, Hardy apologized and promised to cease his offending behavior. But after later slipping into a similar remark, he was eventually dragged, probably to his everlasting amazement, before the Supreme Court of the United States for creating a hostile work environment. Justice Clarence Thomas did not offer a dissenting opinion even though he, too, had been dragged through the mud for 10-year-old allegations that he had said there was a pubic hair on his Coke can, and that he told Long Dong Silver stories to a Yale lawyer.

Violent chaos continues in the streets, but if there is anything askew in the workplace, an inappropriate pattern of jokes, belligerent sexist comments, too many requests for dates, the government wants to know about it, and the appropriate fines will be levied. Senator Kennedy has promised to have the caps removed from those fines, which can now be as high as \$300,000 per incident, to even bigger jackpots for women who have shown that they have worked in an abusive environment.

Though profound censorship issues underlie hate speech and hostile environment laws, the recent Supreme Court harassment ruling came down fast and unanimous, and without apparent controversy. "It is as simple as requiring everyone on the job to treat everyone with decency and respect," editorialized the *Washington Post*. How incredibly simple. Why didn't we think of this before? If such a law is good for the workplace, why could it not be passed over the whole nation, requiring everyone to treat each other with decency and respect at all times of the day or night? We could all have the fundamental right, as Carol Mosely Brown (D-Ill.) argued in the Senate, to an environment free from insult. If such a law were passed, we could eliminate divorce and crime in the streets.

The new standard to eliminate hostile environments in workplaces will instead turn them into hostile environments—for employers. The litigious minefield that the boss must walk can seem as fraught with danger as the streets outside. Outside, the criminals run the show. Inside the workplace, and inside the manager's

head, the litigious kooks are in charge. He who offends the most dignified and prudish among us can lose his job, or his business. He has already lost his rights to free speech. The prim elite have taken control. As Wayne State Law Professor Kingsly Brown points out, "You've got employers censoring workers' speech out of fear of being held liable by the government. It is still censorship, even if the mechanism is a civil action by private parties."

"What I'm seeing lately is that companies are overreacting," says Ellen Wagner, an attorney and author writing in *Fortune*. "Accusers are believed on the basis of very little evidence or none at all. And the ultimate punishment, termination, is a first resort rather than a last one."

"As for men," says Ann B. Fisher in *Fortune*, "the majority of whom wouldn't dream of harassing anybody, they are terrified of being falsely accused."

The employers need also be wary of the flip side of this tightrope: being sued for wrongful discharge if they fire someone who is innocent of alleged harassment. In contradiction to the statement from AT&T's spokesman that only Yahoos are worried, *Investors Business Daily* reports that in the current sexual harassment minefield both male and female managers are becoming "confused and skittish." Nine out of 10 Fortune 500 companies report that they have been sued for harassment, at an "average cost of \$6.7 million per year to a large employer."

Allowing the government to micromanage verbal behavior between men and women in the workplace is giving it a huge amount of power, generating widespread stifling effects due to the sheer numbers of people the laws affect. We have empowered the government to regulate the speech of most of the people in America for half of their waking hours.

A man coming out of a bad marriage may express anger and bitterness to a coworker friend. Should his emotional venting and excessive generalizing about women be considered an appropriate reason for the FBI or other thought police to derail his career? We simply cannot squelch dialogue at this point, putting a permanent gag rule on doubts, fears, anger, questions, or stupid statements regarding blacks, women, or any other minority. Backlash and arrested development will be the inevitable results of such social protectionism. Is it ever possible for white Americans to express questions or anger

about the epidemic of black crime, particularly if they have been personally victimized by it, and not be presumed a racist? One can only wonder how much damage has been done by the muzzling of free discussion about the collapse of the black family and related issues over the last 30 years. It is as David Bolt, editor of *The Philadelphia Inquirer*, said: "I have this vision of America, with all 250 million of us standing up to our chins in sewage and everyone's saying, 'Don't make waves!'"

What should a free society which has always celebrated diversity do with outspoken employers like Andy Rooney, Marge Schott, Spike Lee, Howard Stern, Rush Limbaugh, lesbian bookstore owners, Whoopi Goldberg, Hooters Restaurant, Jimmy the Greek, or feminist bar owners?

Under current law, could a macho rebel like Axl Rose of Guns N' Roses feel safe hiring a woman with the delicate demeanor of, say, Justice Ruth Bader Ginsburg? Could people like them work together without one or the other being financially or emotionally damaged? Perhaps a person like her would feel unnerved and offended by a person as rude and crude as him. Perhaps he would feel unbearably tense and claustrophobic in the presence of someone as prim and dignified as she. In the past, we have always negotiated such interactions as free wheeling adults without the suffocating threats of the personal injury attorney breathing down our necks. We have now become a nation of eggshell walkers.

And what about women and blacks who are the primary intended beneficiaries of anti-harassment laws—what effect do these laws have on them? Former president of the National Organization For Women, Karen DeCrow, said in a recent essay in *USA Today*: "I have begun to worry about this younger generation of feminists. The New Puritanism is frightening. What we had in mind 25 years ago was not a New Puritanism, but freeing women from being eternal children."

The image and legal status of women as perpetual victims who need special protection from offensive speech will be a hindrance to women's hiring and advancement. Men who have never before had a reason to discriminate against women now have one—the fear of being fired, falsely accused, or sued. For every woman who wins a personal injury jackpot, there will be

thousands who will not be hired or promoted due to employers who are paranoid about lawsuits or accusations.

How many employers will quietly decide against hiring a woman to send on the road with the company's best and most aggressive salesman? How many bar owners or construction managers, faced with a female applicant, will feel secure that their work environment can be guaranteed free of sexually offensive speech? Those who may have previously been motivated to hire women may look at current punitive damage penalties and quietly decide that hiring a woman is not worth the risk.

Women would become stronger and less segregated from the male club if they would develop the assertiveness skills to outwit, outcharm, outmaneuver, and outwisecrack workplace harassers. Ideally, a sexist boss or coworker can be circumvented or conquered like any other workplace obstacle, increasing a woman's self-esteem and empowerment.

If such is not the case, and a hostile workplace environment has become insurmountable, workers should have access to outside counselors where the involved parties could be required to go to resolve their conflicts. The company could be required to pay for counseling or mediation, but such payments would be far less threatening to the employer and more productive than punitive damage awards. It is always preferable to educate and change attitudes rather than to punish and change only language. The lottery-sized incentives to sue a boss would disappear if complaints did not result in huge payoffs.

There is faulty logic and basic unfairness in laws that protect only particular groups with hostile environment and speech crime laws. A society that makes Polish and dumb blond jokes an actionable offense should not fall off its chair when lawyers, exercising flawless logic, claim that hatred and prejudice have grown against them to the degree that they, too, now are vic-

tims. Harvey Saferstein, president of the California Bar, and the greatest living example of chutzpah run amok, has proposed that lawyer-bashing be designated a hate crime. All of the theatergoers who cheered wildly when the *Jurassic Park* dinosaur ate the lawyer could be charged with hate speech. Shakespeare could be purged from the schools for presenting a character advocating that we kill all the lawyers.

It is dismaying to see the Supreme Court treat the nation's employers with (to borrow a legal phrase) such callous disregard. As Justice Antonin Scalia writes, "As a practical matter, today's holding (on the sexual harassment case of Forklift Systems) lets virtually unguided juries decide whether sex-related conduct engaged in by (or permitted by) an employer is egregious enough to warrant an award of damages."

Leaving such complex issues in the hands of unguided juries is only alarming to those who must pick up the tab. Juries will not receive a definition of what constitutes a hostile environment because the Justices have not devised one. The Supreme Court refuses to be responsible for defining the crime for which they are so cavalierly allowing the nation's employers to be punished. Congress, too, has limited its responsibility, exempting itself from the punitive damage penalties it has legislated for the private sector. If a congressman "permits a hostile environment" to exist, no one will confiscate his house.

Allowing for the first time punitive damages for permitting a hostile work environment is too vague and open-ended, too ambiguous, too fluid, and too punitive. It will have a chilling effect on creativity, free speech, and the advancement of women in the workplace. It will benefit no one except personal injury attorneys and a few jackpot winners.

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