THE FREEMAN

IDEAS ON LIBERTY

CONTENTS
MAY
1986
VOL. 36
NO. 5

164 Liberties Lost in the Balance
Joseph S. Fulda
Many controversies of the day can be traced to underlying government interventions.

166 Hostile Acquisitions and the Restructuring of Corporate America
Frank W. Bubb
The freedom to buy and sell corporate assets plays a crucial role in preserving shareholder rights, and tends to promote economic efficiency.

178 The Continuing Plight of Agriculture
Dennis Bechara
After more than fifty years of government intervention, Federal farm policies continue to prevent needed market adjustments.

186 Unemployment Compensation
Hans F. Sennholz
Paying people not to work hinders labor mobility and harms the very people it is supposed to help.

193 Teaching Economics
Ronald S. Hertz
An experienced teacher outlines his course in free market economics.

196 A Reviewer's Notebook
John Chamberlain
Robert H. Frank's "Choosing the Right Pond" argues for a "libertarian welfare state."

198 Other Books
"Takings: Private Property and the Power of Eminent Domain" by Richard A. Epstein.

THE FREEMAN
IDEAS ON LIBERTY

Published by
The Foundation for Economic Education
Irvington-on-Hudson, NY 10533

President of the Board: Robert D. Love
Vice-President of Operations: Robert G. Anderson
Senior Editors: Beth A. Hoffman
Brian Summers
Editorial Adviser: Paul L. Poirot
Book Review Editor: Edmund A. Opitz
Contributing Editors: Howard Baetjer Jr.
Bettina Bien Greaves
Gregory F. Rehmke
Joan Kennedy Taylor

The Freeman is the monthly publication of The Foundation for Economic Education, Inc., Irvington-on-Hudson, NY 10533 (914) 591-7230. FEE, founded in 1946 by Leonard E. Read, is a nonpolitical educational champion of private property, the free market, and limited government. FEE is classified as a 26 USC 501 (c) (3) tax-exempt organization.
Other officers of FEE's Board of Trustees are: Bruce M. Evans, chairman; Thomas C. Stevens, vice-chairman; Joseph E. Coberly, Jr., vice-president; Don L. Foote, secretary; Lovett C. Peters, treasurer.

The costs of Foundation projects and services are met through donations. Donations are invited in any amount. Subscriptions to *The Freeman* are available to any interested person in the United States for the asking. Single copies $1.00; 10 or more, 50 cents each. For foreign delivery, a donation of $10.00 a year is required to cover direct mailing costs.

Copyright © 1986 by The Foundation for Economic Education, Inc. Printed in U.S.A. Permission is granted to reprint any article in this issue, except "Unemployment Compensation," provided appropriate credit is given and two copies of the reprinted material are sent to The Foundation.

Bound volumes of *The Freeman* are available from the Foundation for calendar years 1969 to date. Earlier volumes as well as current issues are available on microfilm from University Microfilms, 300 North Zeeb Road, Ann Arbor, MI 48106.

The Freeman considers unsolicited editorial submissions, but they must be accompanied by a stamped, self-addressed envelope. Our author's guide is available on request.

New Cars, Used Buyers

For the sixth straight year, Japan has bowed to U.S. political pressure and imposed quotas on its auto exports. What will this mean for American consumers?

First, less competition. With fewer Japanese imports, consumers will have fewer cars from which to choose.

Second, higher prices. By restricting competition, the quotas have raised the prices of both Japanese imports and American-made cars. Estimates of these price increases run into the hundreds and thousands of dollars. By any estimate, the quotas have cost U.S. consumers billions of dollars.

Third, fewer U.S. exports. The fewer dollars we spend overseas, the fewer dollars foreigners will have to buy American goods. By restricting imports, we also restrict exports.

Fourth, no net saving in jobs. As Professor Hans F. Sennholz has demonstrated in his series of articles on the labor market (see page 186 for this month's article), unemployment is primarily a wage-rate phenomenon. To the extent that quotas enable U.S. auto workers to raise union wage-rates above market-clearing levels, unemployment actually rises.

No Peanuts

With the plight of American farmers so much in the news, we welcome this month's article from attorney Dennis Bechara, "The Continuing Plight of Agriculture." In seeking the causes of the farm crisis, Bechara found a maze of regulations which waste scarce resources, raise consumer prices, and harm the very farmers they are supposed to help. For example:

"In 1949, Congress granted the then existing peanut farmers an allotment,

or a license, to grow peanuts and thereby closed the doors to others. Thereafter, nobody without such a license could grow peanuts. At the present time, about half of all peanut growers rent their allotments from the owners of such licenses. The cost of such rental payments is then calculated into the price support system, which in turn, raises the subsidy to the peanut grower. In addition, since 1977 the amount of peanuts that may be marketed domestically has been artificially limited, so that the price of peanuts has increased. In 1981, the program was amended to allow anyone to harvest 'additional' peanuts so long as these are destined either for export or for oil or meal uses.

"The domestic price of peanuts is much higher than the world price. This, in turn, has led to import and export controls. For example, 'additional' peanuts may be exported, but peanut butter made from these additional peanuts cannot be exported. On the other hand, foreign manufacturers can use these additional peanuts to make peanut butter, and then export it back to the United States. The peanut program costs American consumers approximately $250 to $300 million a year in higher prices."

Mr. Bechara's article begins on page 178.

Thirty Years Ago

In the May 1956 *Freeman*, financial consultant Anthony M. Reinach provided a clear illustration of the costs of government intervention:

"There was once a time when the Czechoslovakians were the most efficient makers of shoes. They traded their shoes to Americans for automobiles, farm equipment, and other things which we produced more efficiently than they or our competitors. Our own shoe manufacturers were therefore faced with converting their production to something wherein they, too, would be competitively productive. But they feared change. So, cloaking their fear in a worthy cause, they sought government 'protection.' Aid was forthcoming in the form of a tariff on Czech shoes.

"Prices of shoes went up. A few wealthy citizens felt that they could no longer afford as many shoes as they once had, and the less wealthy were obliged to own fewer shoes or deprive themselves of something else they may have wanted. Some, who could afford to wear shoes at Czech prices, now chose to go shoeless rather than pay the new 'protected' prices.

"Although we are mainly concerned with the consumer, it can also be seen that government interference affects others. For example, some marginal retail shoe stores were now forced out of business, and more prosperous stores found themselves less prosperous through loss of trade. The same holds true for the shoe importers, wholesalers, jobbers, and others. The Czechs, of course, have had their shoe market curtailed. And the manufacturers of those items which had been used in trade for the Czech shoes were injured in proportion. This is only part of the picture, but it does serve to illustrate the endless harm generated when government enters the market place."

End Notes

- We're pleased to announce the winners and runners-up in FEE's first student essay contest. See page 177 for details.
- Limited space is still available in our week-long summer seminars (June 15-21, July 13-19, and August 3-9). Call Greg Rehmke here at FEE (914) 591-7230 □

Liberties Lost in the Balance

Government intervention leads to irreconcilable differences.

by Joseph S. Fulda

Joseph S. Fulda is Assistant Professor of Computer Science at Hofstra University and resides in Manhattan.

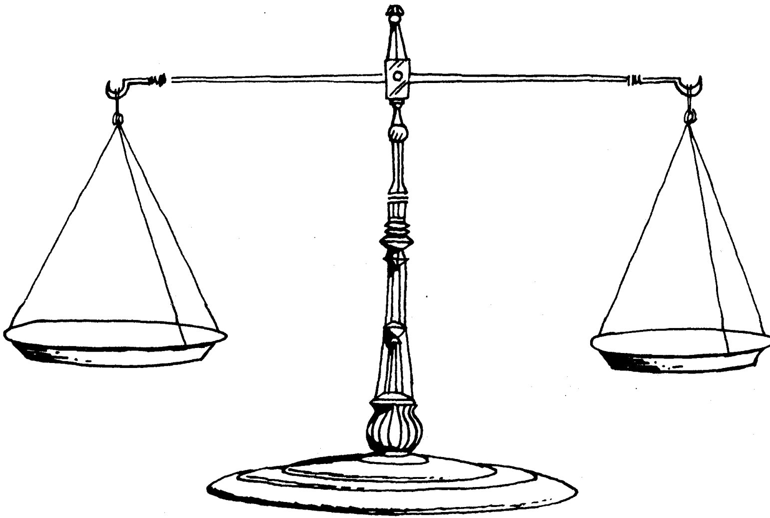
One of today's major functions of the Supreme Court is to decide between competing claims based on the rights of the parties to the dispute. In balancing the parties' rights at least one side and often both sides find their rights circumscribed.

As we shall show by means of several well-chosen examples, this function of the High Court (and for that matter, lower courts and legislators as well) would be rendered nugatory in a libertarian society. In each case there is some underlying government intervention which forces the conflict between the liberties of the parties and makes a choice between them inevitable.

Consider for example the issue of prayer in the public schools. Proponents say, correctly, that the founders of the Republic never meant to exclude God from the classroom, that prayer has never harmed a soul, that it remains voluntary. Opponents argue, correctly, that students who are "different" and don't pray with the group will be singled out for unpopularity and that a child under such undue pressure has no volition to speak of. They add, correctly, that parents, not schools, should minister to the religious needs and beliefs of children.

And so the issue is left to the Supreme Court to decide. An unending stream of cases: Moments of silence, student-led prayer groups, prayer after school hours but on school property, and the like, is the result. Whatever the court decides, however, and no matter how carefully or idiosyncratically it draws the line between the religious liberty and educational freedom of the various constituencies, someone must surrender a piece of his freedom.

When I am asked whether I favor prayer in the public schools, however, the answer is quite a bit simpler. No lines to be drawn, no careful circumscriptions of rights, and no balancing of one man's liberty against that of another man. "I do not favor public schools," I reply, "and therefore do not reach your question." The key to the controversy is not "prayer" but "public." It is the underlying government



intervention of compulsory schooling and tax-financed, government schools which forces the competing claims to a head. Were the schools to be all private, there would be no problem, as each parent selected the school which best meets the interests of his or her child as the parent defines it.

As another example, consider the demonstrations led by neo-Nazis in Jewish areas. Opponents say, correctly, that hatred has no place in a society of refugees, diverse ethnic groups, and freedom. They add, correctly, that such "speech" was never intended to be free by the Founders, who made a careful distinction between freedom and license. Proponents say, correctly, that the test of free speech in a free society is only met when that which is spoken is repugnant to the great majority of people. They add, correctly, that truth is best served by an unbridled freedom of expression and that hatred is unlikely to take root in today's benevolent America.

Again, however, someone must surrender his liberty, no matter how the question is decided. Were streets to be private property, as libertarians have proposed, the owners would determine what may or may not take place on their property and the government would not be called on to choose between its citizens. With public ownership of the streets and by-ways of America there is simply no way for the government to accommodate both the claims of those who wish a public forum and those who do not want their sensibilities lacerated by the promulgation of such vicious, vituperative, empty speech.

Most controversies of the day can be reduced to an underlying government intervention. Thus, similar to our first example, we have the furor over sex education, phonics and reading, values clarification, evolution and Creation, and the like. Likewise, public religious displays, smoking in the streets, and soliciting of funds by religious groups in public areas are all similar to our second example. In each case the controversy would disappear with privatization and the rights of *all* parties would be respected. ☐

Hostile Acquisitions and the Restructuring of Corporate America

A free market for corporate control tends to protect shareholders and promote economic health.

by Frank W. Bubb

Frank W. Bubb is a corporate securities lawyer residing in Swarthmore, Pennsylvania.

"I think it is time for Congress to send a clear signal to corporate America that we will no longer tolerate unrestrained warfare between top managements for control of corporate assets," said Representative Peter Rodino (D-NJ). "They [hostile corporate takeovers] do not create jobs. They do not add to the national wealth. They merely rearrange ownership interests and shift risk from shareholders to creditors," according to Martin Lipton, a Wall Street attorney specializing in takeover defense.

As the wave of highly publicized mergers, acquisitions, buyouts, and divestitures soared to new records in 1984 and 1985, reactions like these became commonplace. Even *Forbes* magazine headlined a feature article on the subject with the following: "As the American economic environment changed, predators emerged from under rocks and began to prey on healthy businesses. Is there no stopping them? Will they devour us all?"[1]

In 1985, some 50 bills were introduced in Congress to regulate corporate acquisitions, primarily to protect target companies. Among other things, such bills would:

- impose additional requirements on tender offerers;
- give the independent (non-employee) directors of a target company the right to veto a tender offer or the acquisition of a controlling interest, subject to reversal by a shareholder vote;
- require tender offerers to file "community impact statements";
- prohibit open market purchases by one corporation of more than 20 per cent of another's stock;
- deny successful acquirers a tax deduction for interest on debt incurred to finance their acquisitions.

Although none of the 50 bills made it out of committee, legislative pressure to protect corporations from hostile takeovers will undoubtedly continue.

Important Principles at Stake

Through the sensationalism that has surrounded the wave of corporate deals, two important principles have received too little attention: (1) hostile corporate acquisitions play a crucial role in preserving the private property rights of shareholders, helping to maintain large corporations as private—rather than quasi-governmental—institutions, and (2) the ability freely to trade *businesses*, not just goods and services, is an integral part of the right to private property.

In addition, a free market for corporate control and a free market for ongoing businesses are both vital to a society's economic health. Both tend continually to reshuffle assets into the hands of those who can manage them more efficiently.

In their 1932 classic, *The Modern Corporation and Private Property*, Adolph Berle and Gardiner Means observed that control of large, widely owned corporations was becoming separated from their ownership. When a corporation's ownership is dispersed among a large number of shareholders, its current managers usually have effective control because they can use the corporate election process to perpetuate their position.

The dispersion of corporate ownership gives rise to a classic "free rider" problem. If a corporation's managers are not acting in the best interests of its owners, each shareholder has an interest in replacing them. Yet the costs to each shareholder of communicating with other shareholders, or of becoming adequately informed about issues presented by other shareholders, are substantial. In most cases, they are so high in comparison to a given shareholder's expected gain from acting that it is virtually impossible for shareholders to act in concert to oust incumbent managers.

There are solid economic reasons why the separation of ownership and control evolved during the first part of this century and continues to flourish. It permits a division of labor between investors and managers: a person can invest in an enterprise without bringing along the ability or desire to manage it, and a talented person can manage a large organization without being wealthy enough to own it. Unbundling investment capital from management skills also permits investors to reduce their risk by diversifying investments.

However, the separation of ownership and control creates two sorts of risks: (1) managers may act in their own interests as opposed to those of the firm's owners, and (2) incompetent managers may remain in charge, even though it would be in the interests of the owners to hire new ones. These problems are not insignificant. In the extreme case, if shareholders had no control over the firms they own, their property rights as shareowners would be expropriated, as it were, by self-perpetuating oligarchies.

Economically, giving hired managers unfettered control over assets they do not own would lead to some combination of two unpleasant alternatives: (1) the economy would be populated by lethargic behemoths akin to the "firms" of a socialist economy, run by well-paid insulated managements with little personal stake in the firms' performance or (2) people would simply refuse to invest in corporations, thereby eliminating the potentially huge economic benefits of letting investors not manage and letting managers not invest.

Politically, the prospect of huge blocs of productive assets in the

hands of self-perpetuating groups accountable to no one would lead inevitably to making such groups accountable to the "public," i.e., the government. Demands for this sort of solution were heard frequently as late as a few years ago, when Ralph Nader's "corporate accountability" movement sought to require Federal incorporation as a means of regulating the internal workings of large corporations. We know this system by another name: fascism. It has not been noted for its success.

The critical question is this: How can the rules be structured to capture the benefits of separating ownership from control without suffering its disadvantages? How can managers be given the incentive to act in the interests of shareholders?

This question underlies most of the development of corporate law, especially since the time of Berle and Means. The law and most legal scholars have given two answers: impose certain "fiduciary duties" on corporate managers, and implement "shareholder democracy" through rules governing the solicitation of proxies.

Unfortunately, while the imposition of fiduciary duties is able to prevent most overt conflicts of interest, it is almost totally unable to prevent management incompetence. And as Joseph Flom, a New York takeover attorney, said at a recent Corporate Counsel Institute meeting, the notion that proxy contests can discipline management is "off the wall." A proxy contest for control of a large corporation costs between $5 and $10 million. Without an enormous investment in stock, he reasoned, there is no motivation to mount a challenge to incumbent management. "It is an ineffective, costly way that is beyond the reach of most stockholders."[2] There is no better proof of the unworkability of shareholder democracy than the almost total absence of proxy contests in corporate America.

The "Market for Corporate Control"

While legal scholars and jurists were busy pursuing the blind alley of rules and regulations, a far more effective way of aligning management with shareholder interests evolved, unbidden, out of the marketplace. During the 1960s, the "market for corporate control" sprang on corporate America with the advent of the hostile takeover bid.

No planner sat down in advance and said, "let's make managers *bid* for the privilege of managing assets owned by others," but that is how the process works. If someone thinks he can manage a corporation better than its current managers, he can offer to buy out some or all of its shareholders at a premium over the current market price.

Note how this mechanism solves the free rider problem described above. Instead of attempting to mount an expensive, time consuming challenge on his own or wading through reams of boilerplate to ascertain which of two groups of proxy contestants is better qualified to run the corporation, each shareholder is now confronted with a much simpler choice: Am I better off with what I've got or with what the bidder is offering me? Just as market prices operate as "aids to the mind," to use Ludwig von Mises' phrase, by conveying huge quantities of information in a simple form, a bidder's offer is his most effective way of communicating with the target firm's shareholders.

How can incumbent management maintain control? By doing a good enough job that investors drive the corporation's stock price higher

than any potentially competing group of managers would pay. The price of the corporation's stock is management's ongoing bid for the privilege of continuing to run it.

In the last couple of years, the market has developed a second way for incumbent managers to bid: the leveraged buyout. If managers facing an actual or potential challenge think they can outperform the challengers, but if the market (as reflected by the price of the company's shares) doesn't agree, they are free to outbid the challengers for ownership of the company—if they can raise sufficient funds from lenders and other equity investors.

While potential challengers are not infallible, their actions tend to be economically rational because they face the same economic constraints as incumbent managers. Except for the handful of wealthy individuals who play the takeover game, challengers are also corporate managers. If they make an improvidently high offer for another company, the price of their own company's stock will tend to fall.

In sum, the prospect of having their corporations yanked out from under them provides incumbent managers with a powerful, direct incentive to maximize returns to shareholders. It has often been noted, even before the market for corporate control evolved, that managers are affected by the price of their corporation's stock. The lower a corporation's stock price, the more costly it is to raise equity capital. The less equity capital a corporation has raised, the less it can support a given level of debt. Therefore, poor management effectively limits a corporation's growth. In addition, management compensation is often tied to the price of the corporation's stock through the issuance of stock options. However, for managers willing to be big fish in a small pond and to compensate themselves other than through stock options (not a difficult task!), a low stock price, by itself, is not a strong incentive to act in the interests of shareholders.

A common objection to the recent wave of corporate takeover battles is that they divert management from running the business. "Rather than planning new products or considering new markets, many executives are spending their time looking around at whom they might take over or who may try to take them over."[3]

This objection is just one step more sophisticated than the old socialist slogan, "production for use, not profit." It is based on the implicit assumption that value is created only by activities directly related to the production and distribution of goods and services. It does not grasp the importance of activities which tend to allocate capital to higher-value uses. Since the market for corporate control tends to move assets into the hands of those who can manage them more efficiently, the "diversion" of management effort is no diversion at all, but an input for a highly productive process.

Another objection to corporate takeover battles is that they divert bank loans and other capital from productive activities. This objection seems to assume that money lent to finance a takeover is sucked into a black hole. In fact, the money is paid out to shareholders who use it to make other investments or to repay loans.

While this discussion shows the importance of a free market for corporate control, it is not meant to endorse all the specific tactics employed by hostile acquirers or to condemn the tactics employed by defending managements. Such tactics (invariably termed "abusive"

by opponents), which often relate to the treatment of non-tendering shareholders after a successful takeover, involve complicated legal and moral issues well beyond the scope of this article.

The Restructuring of Corporate America

Hostile takeovers to replace incompetent managers or to spur greater management efficiency are only part of a much larger picture. Even hostile takeovers of well-run enterprises perform other valuable functions to enhance shareholder returns and promote economic efficiency. It is possible that a corporation's incumbent managers are the most efficient managers of its particular bundle of assets and liabilities, but that such managers could be outbid for control of the corporation by people who realize that:

- the assets would be worth more if they were transferred to another corporation, perhaps because such a transfer would result in economies of scale;
- the assets would be worth more in total if some were split off, either to be merged into other firms or to be managed as smaller firms by people with more expertise in that "niche" and more incentive because they can be given a larger personal stake in a small firm;
- the assets would be worth more if some parts of the business were shut down, enabling management to concentrate on the rest;
- the assets include a disproportionate amount of cash, which could be used more efficiently if it were transferred to the shareholders through dividends or share repurchases;
- the corporation could reduce its tax bill by issuing tax deductible debt to retire shares.

In addition, hostile takeovers are a relatively small part of the total "corporate restructuring" picture. The vast majority of mergers, acquisitions, buyouts and divestitures occur in nominally "friendly" transactions, either because managements are acting on their own to maximize shareholder returns or because they fear that a hostile acquirer will implement an obviously sensible restructuring.

The restructuring of corporate America has two basic components, both of which are often part of the same transaction: (1) reshuffling assets into more efficient combinations, and (2) increasing the ratio of debt to equity on corporate balance sheets.

A record $180 billion of mergers, acquisitions, buyouts and divestitures occurred in 1985, easily topping the previous record of $122 billion set in 1984. Firms acquired in 1985 included such corporate giants as General Foods, Shell Oil, Hughes Aircraft, Signal, Nabisco Brands, American Hospital Supply, American Broadcasting, Carnation, G.D. Searle, American Natural Resources, Houston Natural Gas and Revlon. The trend has rolled on into 1986 with General Electric's acquisition of RCA.

The steady drumbeat of mega-deal announcements seems to have created the impression that all of corporate America is about to be swallowed up into a handful of super-conglomerates. This view, implied by scare stories in much of the popular press, is distressingly wide of the mark.

In fact, the past few years have witnessed an unprecedented phenomenon: a "riot of voluntary restructuring" and the creation of "a giant auction market in which almost every dollar of corporate assets seems to be on the block."[4] The most significant fact about this entire trend is that fully one-third of all inter-corporate transactions are divestitures.

Among the largest are General Electric's sale of Utah International; R.J. Reynolds' sale of Aminoil; RCA's sale of CIT Financial; Texaco's sale of Employers Reinsurance; Gulf & Western's sale of several businesses, including Simmons and Kayser-Roth; United Technologies' sale of Inmont; City Investing's divestiture of Uarco, Rheem Manufacturing, World Color Press and Motel 6; ITT's sale of numerous businesses, including Continental Baking; and Continental Group's sale of most of its containerboard and kraft paper operations. In 1984, U.S. corporations sold some 900 divisions and subsidiaries, up 40 per cent over 1980.

Divestitures and acquisitions are not two unrelated phenomena, one to be applauded and the other condemned. One company's divestiture is often another's acquisition. In addition, divestitures play an integral role in the acquisition process as acquirers sort through what they need and what would have more value in the hands of others. "Asset stripping," as it is pejoratively termed, is frequently used by acquirers to pay down debt incurred to finance their acquisitions, as in the case of Allied's takeover of Bendix or Avco's acquisition of Textron.

Legal Causes

The substantial removal of three legal roadblocks in the early 1980s set the stage for this "riot of voluntary restructuring":

(1) The Justice Department significantly relaxed antitrust restrictions based on size. In the 1960s, for example, the Justice Department blocked the merger of two Los Angeles grocery chains because they had a combined total of 5 per cent of the market. Today, acquisitions that result in 20 per cent market shares routinely go unchallenged.

(2) State antitakeover statutes, once a mainstay of corporate defense strategies, have fallen by the score on the grounds that they conflict with the tender offer provisions of the Securities Exchange Act of 1934.

(3) The phased decontrol of crude oil, as well as the partial deregulation of banking, finance, insurance, transportation and brokerage created opportunities for economies of scale through mergers and acquisitions.

The relaxation of antitrust enforcement has permitted a merger wave that is economically more sound than the conglomerate wave of the late 1960s and early 1970s. With the Justice Department blocking most horizontal and vertical mergers during that period, the only way for aggressive corporations to expand was by taking on unrelated businesses. The *ex post* theory that was used to justify the conglomerate trend was that good managers could run any combination of businesses, and that conglomerates perform a valuable function for investors by diversifying.

Now, however, corporations are being permitted to grow through acquisitions more closely related to their core businesses. To finance these acquisitions, many—especially conglomerates—are unloading

It is hardly an exaggeration to say that without a Stock Exchange there can be no market economy. What really distinguishes the latter from a socialist economy is not the size of the "private sector" of the economy, but the ability of the individual freely to buy and sell shares in the material resources of production.

—LUDWIG LACHMANN

businesses that are healthy but extraneous. Divesting such businesses has in turn become more attractive because the companies to which they are most valuable—those in the divested units' industries—are now permitted to bid for them. "As the game rolls on, the business landscape of the U.S. ends up with more and more 'pure' companies concentrating on just one or two fields they know best."[5]

Economic Causes

The three legal factors mentioned above caused this massive reshuffling of assets only in the sense that they reduced governmental barriers to the free interplay of a number of economic forces:

(1) Mergers in the same or closely related fields often yield significant economies of scale, whether in production, distribution, technological development, or management. This is especially true for firms in recently deregulated industries where regulations either directly prohibited mergers or kept profits artificially high so that management's incentive to search for savings was dulled.

(2) Management skill is not unlimited. Just as central planners cannot manage an entire economy, a corporate management team cannot efficiently handle two dozen disparate businesses. The only way out of this dilemma is to expand the management team by creating new layers of management—a sure recipe for burying valuable assets in a bureaucratic maze. As economist Frederick M. Scherer concluded from his extensive study of the conglomerate merger movement, "We typically found management failure. The acquirers didn't know how to manage their acquisitions."[6]

(3) Contrary to the diversification rationale for conglomerates, investors may prefer a different mix of investments than that assembled by corporate managers. While small investors managing their own portfolios may have some desire for management-assembled packages, the rise of mutual funds and pension funds has tilted the balance in the other direction. "Increasingly, professional portfolio managers prefer to trust their own skill at picking industries to invest in, rather than letting corporate managers offer them a packaged smorgasbord."[7]

(4) Information in securities markets is not costless. Investors and investment analysts find it easier to understand companies that are in a handful of businesses than those with scores of extraneous assets.

(5) The inflation of the 1970s increased the market value of certain assets held by corporations, but accounting rules prevented corporate

balance sheets from reflecting this appreciation. It became increasingly difficult for investors to understand the value of assets held by corporations, especially complex ones with diverse and far-flung assets.

For all but the first of these reasons, corporate managers are finding that, contrary to the received wisdom of the past, the parts may be worth more than the whole and that a simplified, slimmed-down business may result in a higher stock price. Unearthing a business buried deep in a complex corporate structure may allow both that business and the remainder of the corporation to be managed more effectively, and may allow the market to better evaluate both businesses. But—and this is a critical point—unearthing such businesses would be substantially less profitable if the antitrust laws blocked their acquisition by other corporations in the same line.

Hostile Acquisitions Accelerate the Asset Reshuffling

While the relaxation of antitrust enforcement and the partial deregulation of certain industries were necessary for consenting managements to undertake this massive restructuring, the process was greatly accelerated by the hostile takeovers unleashed by all three of the legal changes described above. A process that might have been undertaken in a leisurely fashion by many managements assumed new urgency when they felt the hot breath of corporate raiders on their necks. "With each attack by corporate raiders, 'people are becoming aware' of hidden value, says [raider Irwin L.] Jacobs. So, lest they fall prey to the raiders, managers are digging up and cashing in on the buried assets themselves."[8]

"Earnings—what most investors react to—were worth less [after the inflation of the 1970s], while the underlying assets were worth more. The situation was ready-made for raiders and liquidators who knew how to buy on the basis of earnings and how to sell on the basis of assets."[9] If their corporations did not sell assets, there was no way for shareholders to capture their value in the form of higher stock prices. Asset sales by successful acquirers—and then by incumbent managers seeking to deter acquisitions—provided the vehicle by which shareholders could capture this hidden value. Raiders forced an earnings-oriented marketplace to take asset values into account.

The most prominent example of the power of hostile acquisitions to accelerate an economically desirable restructuring is T. Boone Pickens, whose Mesa Petroleum tried and failed to take over several major oil companies. His raids forced target companies to merge into "white knights," divest extraneous assets, reduce their top-heavy management bureaucracies and pay cash to shareholders through share buybacks. According to economists Harold Demsetz and Michael Jensen, speaking at a Securities and Exchange Commission forum, the oil market has undergone massive changes in the past decade, making it inevitable that there would be fewer oil companies.[10] Realizing this fact before most oil company executives, Pickens acted as an arbitrageur, forcing them to adjust to a reality they had not yet grasped.

Objections to the Asset Reshuffling

We have already seen that a good deal of the popular fear of corporations gobbling each other up until only a few are left is unfounded. A similar but more subtle objection to the restructuring of American corporations is that, as firms concentrate their resources in one or two core businesses, there will be fewer

competitors left in each market, thus increasing their monopoly power.

The weak link in this argument is the jump from the fact of fewer competitors to the conclusion that monopoly power is increased. This argument is reminiscent of the era when the United States was virtually a self-contained economic unit, when all the relevant firms in an industry were American. In the last two decades, foreign trade has expanded from roughly one-twentieth of America's economic activity to roughly one-sixth. Most major American firms face significant competition from abroad. The best way to ensure that the restructuring of American corporations does not increase their monopoly power is to lower trade barriers.

This argument also underestimates the role of potential competition in deterring large companies from charging "monopolistic" prices. Such potential competition is enhanced by a robust market for businesses. A potential competitor, which may lack expertise in a given industry, can short-circuit an arduous learning process by acquiring a small firm in the target industry. Thus, the same wide-open process that often reduces the number of competitors in a field also enhances the ability of others to enter it.

Another frequently voiced objection to hostile acquisitions is that they "cause" plant shutdowns and layoffs, disrupting people's lives. This objection confuses the messenger with the message. Acquirers do not shut down plants or pare staff out of spite, but to increase their economic returns. In most cases, such actions should have been undertaken by prior managements to adjust to a changing economic reality.

In any event, the highly visible plant closings following on the heels of takeovers do not appear to be more frequent than plant closings generally. At the SEC forum mentioned above, economist Michael Jensen "said there is no evidence that takeovers are associated with a higher than average number of plant closings. What tends to get closed down, he said, are redundant corporate headquarters, suggesting that the pleas for protection are coming from top executives who fear for their jobs."[11]

Leveraging Corporate Balance Sheets

So far, we have focused on the reshuffling of assets among corporations, or the left-hand side of corporate balance sheets. However, virtually every transaction has also involved the right-hand side of corporate balance sheets, invariably by increasing the ratio of debt to equity.

A major question facing every potential acquirer is how to finance its acquisition. Since most acquirers do not have sufficient cash sitting in their corporate treasuries, they must either issue additional stock or borrow. For reasons explained below, they almost always borrow, either from bank syndicates or by issuing bonds directly to the public. Until recently, it was difficult for acquirers to borrow from the public because the level of debt required for many acquisitions was so high that rating agencies refused to give it an "investment grade" rating.

Enter the "junk bond," an unrated, high-risk, high-yield bond. A couple of years ago, enterprising investment bankers discovered that there is a substantial market for such securities, especially among investors large enough to reduce their risk by diversifying. Junk bonds

have become a powerful tool in the hands of potential acquirers by permitting them to issue large quantities of debt backed by the assets of the acquired company.

While the quantity of junk bonds issued in hostile acquisitions has been relatively small, the availability of junk bond financing has made it possible for small raiders to threaten much larger target companies. Even though Mesa Petroleum failed to take over a single major oil company, its access to such financing made its raids more credible.

MESA PETROLEUM

T. Boone Pickens of Mesa Petroleum

The lesson of junk bonds has not been lost on managements of potential targets. Now that takeover defenses based on the antitrust laws or state antitakeover statutes have become largely ineffective, such managements have discovered the "financial defense." If raiders believe that the target has sufficient cash flow to support a much higher level of debt, target managements can pre-empt this cash flow by issuing debt, using the proceeds to raise their stock prices by repurchasing shares.

In the last couple of years, a trickle of share repurchases has turned into a torrent, as such major firms as Unocal, Phillips Petroleum, Atlantic Richfield, Exxon, Union Carbide, Ford, CBS, Litton Industries, and Revlon instituted major buyback programs, often financed with debt. Debt is often used to finance selective share buybacks from raiders, a process pejoratively termed "greenmail."

In addition, debt is the *sine qua non* of another recently perfected defensive technique, the leveraged buyout, in which the managers of a target company outbid or pre-empt a raider by borrowing enough to buy out the company's existing shareholders.

In sum, just as hostile acquisitions have served as a powerful lever to force the reshuffling of assets among corporations, they have also directly or indirectly caused a great many corporations to increase their ratio of debt to equity. New debt issuances less repayments totaled $164 billion in 1984, while shares retired in buybacks, mergers and leveraged buyouts exceeded new issuances by $72 billion in 1984 and $65 billion in 1985.

What has made this stampede into debt work? Why can raiders make a profit acquiring much larger companies entirely with debt? Why do share repurchase programs raise stock prices instead of causing shareholders to flee from corporations with more fragile financial structures? Why does everyone seem to win from a leveraged buyout?

The answer is that the tax law discriminates against equity financing and artificially encourages debt. Interest on debt is fully tax deductible, while dividends are not. Dividends are taxed twice, first when the corporation is taxed on its net income, and again at the shareholder level.

Given the huge tax advantage conferred on debt, why do corporations issue any equity securities (above a nominal level) at all? Debt is risky for a corporation because interest payments are fixed legal obligations independent of its changing financial fortunes. By participating in the company's risk, equity investors give it more flexibility and resilience. Corporate managers usually seek a debt to equity ratio which they consider optimal, in light of the corporation's tax status, the riskiness of its business, and the extent to which they are averse to risk.

Since the tax bias against equity financing has existed for years, why

has such a massive move from equity to debt occurred only in the past few years? It appears that two factors contributed to this change.

First, the removal of legal barriers to hostile acquisitions allowed risk-oriented raiders to impose their risk preferences on more conservative incumbent managements, either by replacing them or causing them to "leverage up" as a defensive tactic.

Second, the Economic Recovery Tax Act of 1981 increased corporate cash flows by permitting accelerated depreciation, but did not increase the book earnings which tend to be the focus of investor attention. Raiders were among the first to understand that the larger cash flows enhanced the ability of corporations to repay debt. By bidding for companies on the basis of cash flow, raiders forced the market to take it into account in valuing companies.

Conclusion

The partial removal of key legal restraints in the early 1980s has permitted the flowering of the market for corporate control, helping to align corporate managements with the interests of shareholders and creating a giant auction market which tends to reshuffle assets into more efficient combinations. Interwoven with this process has been a dramatic increase in corporate debt, largely brought on by the tax bias against equity financing, making many American corporations more vulnerable to an economic downturn.

The latter trend has evoked a great deal of adverse commentary and numerous legislative attempts to curb hostile acquisitions. While halting takeovers would undoubtedly slow any further erosion of corporate balance sheets, it would also deny us the benefits of the market for corporate control. The artificial expansion of corporate debt is best remedied by ending the tax bias against equity financing. □

1. "Why Is No One Safe?" *Forbes*, March 11, 1985, pp. 134–140.
2. "Takeover Turmoil Represents Law's 'Golden Age,' Corporate Counsel Told," *Securities Regulations & Law Report*, October 18, 1985, pp. 1830–1832.
3. "Let's Make a Deal," *Time*, December 23, 1985, pp. 42–47.
4. "Splitting Up—The Other Side of Merger Mania," *Business Week*, July 1, 1985, pp. 50–55.
5. *Ibid.*
6. "Bigger Yes, But Better?" *Time*, August 12, 1985, pp. 34–35.
7. *Business Week*, July 1, 1985.
8. *Ibid.*
9. *Forbes*, March 11, 1985.
10. "Economists Urge SEC to Resist Pleas for Curbs on Hostile Takeovers," *Securities Regulations & Law Report*, February 22, 1985, pp. 329–332.
11. *Ibid.*

Winners of the 1985–1986 Freedom Essay Contest "The Foundations of a Free Society"

College Division

First Prize: Peter S. Heinecke, Princeton University
"The Fallacy of Comparable Worth"

Second Prize: John Majewski, University of Texas at Austin
"The Industrial Revolution: Working Class Poverty or Prosperity?"

Runners-up: Terence B. Byrne, McNeese State University
"An Old Hostage Crisis: America's 'Free' Farm Markets"

Jay Habegger, University of Colorado at Boulder
"Inflation, Money, and Freedom"

Brent M. Johnstone, University of Texas at Austin
"Information and the Economic Problem"

High School Division

First Prize: Sarah H. Lindsey, Yardley, Pennsylvania
"Educational Freedom"

Second Prize: Mary Jane Massey, Daytona Beach, Florida
"George Mason: Framer of Liberty"

Runners-up: Tim Lawrie, Fairfax Station, Virginia
"'Liberation' Theology: A Policy of Slavery"

Gavin Marshall, Oakville, Ontario, Canada
"Majority Rule vs. Individual Rights"

Bobby Taylor, Kingsport, Tennessee
"A Proposal for Educational Reform"

Look for the winning essays in forthcoming issues of *The Freeman*.

The Continuing Plight of Agriculture

Why Federal farm policy fails.

by Dennis Bechara

Mr. Bechara, an attorney, is a frequent contributor to *The Freeman*. This article is based on a lecture which he delivered in November, 1985, during a FEE seminar held in the Washington, D.C. area.

On December 23, 1985, President Reagan signed into law the Food Security Act of 1985, commonly known as the "farm bill." This statute will affect the state of American agriculture for the next five years. During the past year, the precarious condition of the agricultural sector has been a hotly debated issue. Although the enactment of the 1985 farm bill is designed to confront and resolve the crisis, the unfortunate fact remains that the same failed tools which were utilized in the past will continue to be used in the future. It should not surprise us if more surpluses and low farm prices continue to plague the farm sector in the immediate future.

Why is our agricultural sector in such a precarious state? Is more government intervention the answer to the problem? Before analyzing our current crisis, it will be instructive to review our past agricultural policies, for our present attitudes toward the farm sector may be explained by our historical development as a country. Only if we fully understand the root of our policies will we be in a position to improve the lot of agriculture.

One of the fundamental differences between the development of the United States and the evolution of Europe is the abundance of land in this country. As the government acquired more land rights in the West, it became the national policy to settle the West and actually to give land to those who were willing to carve a family farm out of the wilderness. The Homestead Act of 1862 is perhaps the watershed of this era of open lands. It has been estimated that over one billion acres of land were thus given to farmers during the settlement of the West.

Although most of the family-size farms essentially provided sustenance to the families that operated them, farmers were able to grow enough crops out of which they hoped to acquire other goods that they needed. The problem, however, was that as a result of the Federal farm policies, which encouraged anyone who wanted to enter farming to do so, a perennial surplus of production always loomed on the horizon.

As the newly settled farmers attempted to set up their operations, they faced innumerable obstacles. A significant one was the need for capital to finance their operations. Consequently, farmers, in general, became a debtor class. Politically, this meant that traditionally they

favored a policy of easy credit and easy money. Perhaps because of the dispersed land ownership pattern that evolved as the West was settled, farmers also tended to regard any concentration of economic power with suspicion. They therefore generally favored both the regulation of railroads and the dismantling of large corporate utilities. Granges were partly responsible for the regulation of railroads on a state-by-state basis. These state laws, in turn, prompted Congress to enact the Interstate Commerce Act in 1887 which regulated railroads on a national scale.

Prior to the First World War, there was a farm surplus problem. However, as a result of the outbreak of the war, and the subsequent American participation in it, the federal government encouraged further agricultural production. Easy credit policies were enacted, and the justification for the overproduction was epitomized in the slogan "Food Will Win the War." Predictably, at the end of the war, farm prices fell, reflecting the government-encouraged surplus production. As protection to the farmers, Congress proceeded to enact higher tariffs on farm commodities through the McCumber Act of 1922. But farm prices remained low. Farming was perhaps the one bleak point in the economic boom of the 1920s. No matter what the government did, farm prices remained low.

The Birth of "Parity"

The year 1922 saw the birth of the concept of "parity." This concept first appeared in a booklet written that year by George N. Peek and Hugh S. Johnson entitled "Equality for Agriculture." The thesis of this booklet was that farmers were entitled to receive a "fair" price for their commodities. The fairness of the price was connected to the level of prices received during the golden era of agriculture, which were the ten years that preceded the First World War.

Congress, reflecting the thinking of the farm sector, enacted a proposal which embodied these ideas. The proposals were known as the McNary-Haugen bills. These bills would have restructured domestic distribution of farm commodities, so as to raise the prices to the much-heralded "parity" level. The excess which could not be marketed domestically, however, would have, in effect, been dumped on the international market while the U.S. consumer would have paid for this subsidy. These bills did not become law, and in 1927, when President Coolidge vetoed the latest version of these bills, he justified his veto utilizing rather prophetic language. In his veto message, the President said:

> Government price-fixing, once started, has alike no justice and no end. It is an economic folly from which this country has every right to be spared . . . There is no reason why other industries —copper, coal, lumber, textiles, and others—in every occasional difficulty should not receive the same treatment by the government. Such action would establish bureaucracy on such a scale as to dominate not only the economic life but the moral, social, and political future of our people. The main policy of this bill runs counter to the well-considered principle, that a healthy economic condition is best maintained through a free play of competition, by undertaking to permit a legalized restraint of trade

Current attitudes toward the farm sector may be explained by our historical development as a country.

AMERICAN FARM BUREAU FEDERATION

> in these commodities and establish a species of monopoly under government protection, supported by the unlimited power of the farm board to levy fees and enter into contracts. For many generations such practices have been denounced by law as repugnant to the public welfare. It cannot be that they would now be found to be beneficial to agriculture.

Agriculture in the 1920s experienced an unsurpassed productive capacity as the result of both technological advances and governmental policies. Naturally, farm prices fell due to this surge in productivity, and the signals that the low prices communicated to society were that there were too many resources invested in agriculture. The adjustment process has proven painful to many farmers. In 1790, 96 per cent of the population was engaged in farming. By 1927, the farming sector had decreased to 27 per cent. The farming sector is now one-tenth of what it was 50 years ago—2.5 per cent. Low farm prices were a symptom that indicated to society that its resources were misallocated and that a migration away from agriculture was the desired goal. In spite of all the government policies enacted to halt this migration, the trend has continued.

During Herbert Hoover's administration, prices received by farmers fell to historically depressed proportions. Farm income fell by more than half between 1929 and 1932. As a palliative, a new government agency was organized to take care of falling prices. This was the Federal Farm Board which was organized as a result of the Agricultural Marketing Act of 1929. Endowed with a revolving fund of $500 mil-

lion, the Federal Farm Board set about to stabilize the prices of wheat and cotton. The price of a bushel of wheat was $1.04 in 1929, but in spite of the purchasing activities of this agency, the price of wheat fell to 39 cents per bushel by 1931. The Board accumulated such large stocks of wheat, that at one point it controlled 80 per cent of the country's supply. Cotton fared no better. After having incurred heavy losses, Congress refused the agency any further funds and it ceased operations. Protectionism, however, seemed to be the course of action to follow, and the Smoot-Hawley Tariff of 1930 only succeeded in engendering further retaliatory tariffs that impeded world trade.

With the advent of the Roosevelt administration, a host of new statutes were enacted which were designed to treat the economic emergency caused by the Great Depression. Each sector of the economy provided its own explanation for the cause of the crisis. Agriculture too had an explanation for its problems: there was just too much production. So the Agricultural Adjustment Act of 1933 was enacted. This is the prototype of the legislation that in many ways is still in effect today.

Raising Income by Reducing Production

The cornerstone of the Agricultural Adjustment Act of 1933 was to raise farm income by reducing production. Farmers were paid to reduce the acreage under cultivation and were guaranteed a minimum price on certain commodities. The crops that were to be controlled by this statute were the so-called "basic" commodities: wheat, corn, cotton, peanuts, rice, and tobacco. Although these commodities generated about one-fifth of farm income, they earned the lion's share of government funds spent in order to support prices.

One of the oddities of the price support system has been that it is designed to subsidize the volume of production, not the farmers' needs. Thus, small farmers have consistently received very few benefits from the price support system, whereas large farmers have benefited proportionally more. At the present time, one-third of all farms in the United States produce approximately 85 per cent of all farm sales. Therefore, two-thirds of all farmers receive insignificant government assistance from the price support system.

The implementation of the farm policy of the New Deal was mainly based on acreage reductions rather than on price supports, since these supports were set at a low level. However, with time, the support prices began to be increased to reach levels above the market-clearing point, so that stocks of surplus commodities began to appear. Land which produced subsidized crops was cultivated more intensely to increase the yield per acre. Other land that would have produced subsidized crops had it not been for the acre reduction requirement was cultivated for various additional crops. This, in turn, created surpluses in other areas.

The mechanics of the price support system have not changed very much since their inception in 1933. The Department of Agriculture, through an agency called the Commodity Credit Corporation (CCC), issues nonrecourse loans to farmers who produce the subsidized commodities. If the price of the commodity rises above the loan rate, the farmer is free to sell the commodity and is obligated to repay the loan. Therefore, the loan rate becomes a minimum price. If, on the other

hand, the price of the commodity falls below the loan rate, the farmer simply relinquishes the commodity over to the CCC and the loan is considered paid in full. Thus, whenever the loan rate is set above market-clearing levels, the CCC ends up holding the surplus production.

The Agriculture and Consumer Protection Act of 1973 introduced the concept of "deficiency payments," which consists of an additional subsidy representing the difference between the lower loan rate and the higher price support or price target. Farmers are entitled to a deficiency payment whenever the selling price of the regulated commodity falls below the price support point. Although designed to avert the chronic overproduction of agricultural commodities, this mechanism has proven ineffective in reaching its goals.

The 1985 farm bill has continued the use of both nonrecourse loans and deficiency payments. The only change is that the loan rate has been lowered in an attempt to control chronic overproduction. The purpose of the lower loan rate is to encourage farmers to sell their products in the marketplace, rather than forfeiting them to the CCC. The anticipated lower farm income is supposed to be offset, however, by the deficiency payment. Therefore, since the farmer will still receive a subsidy, regardless of the market price of the commodity, it is doubtful that surpluses will be eliminated.

The export boom of the 1970s once more temporarily eliminated the perennial surplus problem. The government relaxed all production controls, and 55 million acres of cropland were added to production in order to meet this demand. Financial institutions, in turn, issued credit based on the assumption that land prices, which were increasing, provided sufficient collateral. Farm debt, which stood at $50 billion in 1970, increased to $214 billion by 1985. But after 1981 several factors radically altered the picture. Interest rates increased, a world recession reduced exports and other countries began to increase their productive capacity. In addition to this, the value of the dollar increased, making farm products even more expensive in world markets.

The Present Crisis

Notwithstanding the massive subsidies farmers receive from the federal government, the farm economy is presently facing a severe crisis. Farm income has decreased by about a third during the past four years. In spite of this, the costs of the price support and market subsidies that form part of our national farm policy have ballooned to unprecedented levels. When the 1981 farm bill was enacted, it was expected to cost the taxpayers no more than $12 billion. Instead, the actual costs incurred amounted to over $60 billion. Similarly, in 1981, farm exports reached the unprecedented height of $44 billion, which represented approximately 60 per cent of the world's agricultural market. Our share of the market has subsequently declined to approximately 50 per cent and our exports were $32 billion in 1984.

The 1981 price support legislation enacted rigid and high price supports which only encouraged other countries to further increase their production. Therefore, land values began to decline. Since the value of the collateral no longer supported more credit, financial institutions have reduced lending. Since 1981, around 200,000 farmers have gone out of business.

Because Federal price supports have been above market clearing

levels, the government has acquired large stocks of surplus production. As a temporary solution, in 1983 the "Payment in Kind" (PIK) program was designed. Farmers who participated in the scheme were given comparable amounts of crops. Eighty-three million acres of cropland were idled, and the government surplus disappeared. But sales of fertilizer, machinery, feed and other products necessary for farming were reduced. Experts at Georgia State University estimated that the PIK program cost 200,000 jobs. This estimate does not include the actual amount of crops given away, worth approximately $10 billion.

The 1985 farm bill continues substantially the policies of the past. The outcome of these past policies has consistently been overproduction. In response to the surplus problem, Congress has established four mechanisms to combat surpluses. These are the acreage reduction programs, marketing agreements, voluntary land retirement, and import quotas. The 1985 bill continues this trend.

The acreage reduction program goes hand-in-hand with the price support mechanism. Essentially, if a farmer wishes to participate in the subsidy program, he or she is required to limit the acreage apportioned to the cultivation of the subsidized commodities.

Marketing Orders

Marketing orders represent another mechanism for dealing with the recurrent surplus problem. The marketing order scheme has its origins in the Capper-Volstead Act of 1922 which allowed the formation of agricultural cooperatives. This statute exempted agricultural cooperatives from the coverage of antitrust legislation. Even though the cooperatives were free to cartelize production, they were never able to effectively influence prices because not all producers agreed to join them. In other words, the forces of the market prevented the formation of monopolies. Therefore, further statutory intervention was required, which culminated in the Agricultural Marketing Agreement Act of 1937.

This statute authorized the Secretary of Agriculture to set up marketing orders for milk, vegetables, fruits and other minor products. Presently, there are 47 marketing orders in effect, covering a variety of crops worth around $5 billion a year. After a marketing order is adopted by the Secretary of Agriculture, a referendum of producers is held. If the order is ratified, it then comes into effect. The order may be amended from time to time by the Secretary, who usually follows the recommendation of producer administrative committees. Some of the marketing orders are not particularly important. For example, the market-support variety requires producers to contribute to an advertising fund. However, most of the marketing orders are designed to restrict supply in various ways. Some are concerned with setting quality standards. Others restrict the amount of products the farmer may bring to market, or determine how much fresh produce handlers may ship, or require producers to put part of their crop in storage until market conditions improve so as not to lower the market price. Any excess must be diverted for other uses, or simply left to waste.

Predictably, the effect of marketing orders is to increase prices. In addition, resources are misallocated since supply-control orders, by raising prices, encourage more production of the commodity. This, in turn, produces more waste, since more commodities are then diverted

to other uses or left to rot. It has been estimated, for example, that up to 30 per cent fewer acres would be needed to produce the amount of California and Arizona oranges which ultimately are marketed. Innovation is also reduced, since there is no incentive to reduce costs of production because a producer's sales are limited by the orders. An example of an innovation that has been frustrated is the development of a special shrink wrap that would allow lemons to be wrapped fresh for periods of about six months. It has also been estimated that 25 per cent of the lemon crop is wasted.

Voluntary land retirement has been a traditional method whose purpose has been to reduce agricultural production. In many instances, the additional purpose of fostering soil conservation has also been utilized as a means of limiting farm acreage. By the 1960s, 60 million acres had been removed from production. Ironically, the price support system and the disaster payment programs have encouraged farming in areas that have been subject to unusual environmental risks. For example, in the semi-arid climate of the Great Plains, ranchers may be tempted to cultivate some of the subsidized crops. After the prairie grasses are eliminated and a crop cultivated, the rancher may be required to set aside part of his land in order to receive the subsidies. This only exposes that soil to the dangers of erosion. The 1985 farm bill has recognized the deleterious effect of the price support system to certain erodible lands, and the eligibility of those lands in the subsidy program has been restricted.

Import Quotas

Import quotas are the fourth method which has traditionally been used to combat surpluses. Sugar is one of the products that has consistently been protected from foreign competition. The domestic price of sugar is approximately four times the world price. Foreign-grown sugar may only be imported in limited quantities and from certain countries. The sugar quota allowed from foreign countries has decreased significantly over the past four years. In 1981 we imported 5 million tons of sugar, whereas by 1985 the amount was decreased to 1 million. This has foreign policy repercussions, since most sugar-producing countries are less-developed countries that urgently need foreign exchange to support their economies.

In spite of these four methods of reducing surplus production, high price supports have consistently provided the incentive to engage in overproduction. If the price supports did not exist, farmers would guide production based upon market prices. When market prices are low, the signal communicated to producers is that production should be reduced, and farmers will act accordingly. With the present system, however, farmers can disregard the market signals and overproduce, confident that the government will guarantee a support price. The surplus production only succeeds in lowering market prices, which, in turn, becomes the political justification for keeping the price support system in effect.

One of the justifications for price supports and marketing orders is that agriculture is a different type of industry. There are many aspects of the agricultural cycle that are beyond the control of farmers. Natural disasters, insect infestations and droughts are examples of the difficulties with which farmers have to contend. But there is a large segment of agriculture, over half of the sector, which operates without

the benefit of price supports. Livestock, as well as many fruits and vegetables, have successfully operated without these supports.

The free market has the capability of protecting farmers against unforeseen price fluctuations through the trading of agricultural options. This system enables farmers to sell a commodity sometime in the future at a predetermined price. Since 1936, however, this system had not been allowed to operate in most of the major domestic commodities. But as a result of the enactment of the Futures Trading Act in 1982, the trading of agricultural options in the regulated commodities has been allowed. The first trading of these contracts began in October of 1984. It should be pointed out, however, that with the price support system in place, the prospects of these contracts are limited.

The current agricultural programs have inconsistent and conflicting effects. Some of the programs—like easy credit to buy and operate a farm, or research activities or irrigation projects—lower the costs of production. Other programs—some of the ones discussed in this article—tend to increase prices. Our legislated programs are encouraging overproduction, which has the unwanted effect of decreasing prices and reducing farm income. The surplus production which the federal government normally holds has been partially sold in the international markets. Foreign countries have increased their productive capacity, and this alternative no longer is viable in the long run. Our farm policy should not be based on sheer hope that some future event will take care of overproduction.

Circumstances have changed over the past fifty years. Farm income, as a percentage of the income generated in urban areas, has increased. The farm sector, on the average, earns about four-fifths of the earnings in the non-rural sector. Politics should be eliminated from our farm policy. It is not unknown for politicians to encourage the raising of price supports at strategically convenient times in order to gain votes. It is time we stop the present contradictory and negative farm programs. The longer we hesitate in embracing the free market, the worse it will be for all. □

In Future Issues . . .

June

- "Deregulation of the Natural Gas Industry" by J. D. Steelman, Jr.
- "Inflation and Unemployment" by Hans F. Sennholz
- "Privatization Further Down the Road" by Daniel Klein

July

- "Toward Free Banking" by Donald R. Wells and L.S. Scruggs
- "The Political Economy of Education Vouchers" by Dwight R. Lee

Unemployment Compensation

Unemployment compensation harms everyone—including those it is supposed to help.

by Hans F. Sennholz

Dr. Sennholz heads the department of economics at Grove City College in Pennsylvania. He is a noted writer and lecturer on economic, political, and monetary affairs. His latest book is *Money and Freedom*.

To compensate workers for wages lost during periods of unemployment, most countries have systems of unemployment insurance. They are compulsory, in the sense that government enforces coverage and uses the taxing power to finance the expenditures. Previous contributions by or on behalf of the workers largely determine benefit eligibility and amounts according to formulas stipulated by law.

The primary purpose of the system is economic assistance and compensation of employees for wage loss during periods of economic decline and depression. The economic effects of such periods are compounded by sociological effects that are reflected in physical and mental ill health, rising crime rates, divorce rates, and even suicide rates. Unemployment compensation seeks to alleviate the ill effects.

The American system is a federal-state system that was forced upon the states by the Social Security Act of 1935. The Act levied an unemployment tax on employers, but offered a 90 per cent offset (1) for employer payments of state payroll taxes for unemployment benefits or (2) for reductions in such state taxation under a program of experience ratings. The law left the states free to determine their own benefit levels and duration of benefits. Consequently, benefit provisions and tax rates differ widely among the states.

The system is a form of public charity that springs from a new conception of social welfare. The public now accepts the concept that government must bear the ultimate responsibility for public relief, including unemployment assistance. This new attitude brought forth extensive social legislation and led the way to the "welfare" or "social service" state. The American system followed in the footsteps of earlier systems in Scandinavian countries, some Commonwealth countries and Great Britain, which in turn were influenced by the labor legislation of Bismarck Germany in the 1870s.[1]

The social service state has few genuine critics. Its countless supporters are guided by a great number of motives that continue to lend intellectual support to the system. Their first and foremost motive, we are led to believe, is *charity* toward their fellow men. They wax eloquent about their feelings of benevolence, good will and affection,

indulgence and forbearance. In the name of charity they call upon government to cater to the needs of the people. Government is to assure a system of social assistance, to grant every citizen the right to extensive welfare benefits, unemployment compensation being just one of them, so that everyone may achieve maximum cultural and even spiritual well-being.

A few critics are highly suspicious of this attitude that makes government the guardian of charity and welfare. Some are guided by Judeo-Christian principles that make charity a responsibility of each and every individual. To them, private initiative and charity are the keys to American progress and prosperity, having led to unprecedented improvements in working and living conditions. They look upon private charity as an important bulwark against complete state control and the political command system, which they abhor for many reasons.

The welfare state as a transfer state is an early form of the command system, appealing to envy and covetousness and, by creating classes of beneficiaries and victims, continuously breeds social conflict and strife. It is driven by government coercion and guided by majority vote. It is never fair, but always political. It is cumbersome and slow, unable to act promptly and efficiently.

An Automatic Economic Stabilizer

The Judeo-Christian command of charity is no call for politics. Unemployment compensation is the product of politics. Its supporters may concede the point, but they hasten to defend the system on grounds that it is a desirable economic stabilizer that moderates the business cycle. They applaud it as an important countercyclical force that injects purchasing power when unemployment rises and absorbs it when unemployment falls again. It is said to stabilize the propensity to consume and thereby acts in a countercyclical, stabilizing way.[2]

In his popular textbook, *Economics*, Paul A. Samuelson applauds unemployment insurance and other welfare transfers as "a first line of defense" that goes into action automatically to counteract a recession. "Unemployment insurance pumps funds into or out of the economy in a countercyclical, stabilizing way. Similar features are seen in many income support programs. Food stamps, aid to families with dependent children, and early retirement on Social Security are examples of public transfer payments that help to shave the highs and lows from the business cycle."[3]

It is difficult to fathom the operation of the Samuelson pump that moves funds into and out of the economy. Unemployment tax revenues do not move in and out of the economy. They are levies imposed by politicians and collected by internal revenue agents, exacted from employers who in turn obtain them from the productive labors of their employees. Civil servants then disburse the funds to some unemployed workers. If there should be a temporary surplus, the U.S. Treasury spends it, issuing IOU's in the form of U.S. Treasury bills and notes. If there should be a shortfall, the taxes are likely to be raised to the level of expenditures. One searches in vain for the pumping action that causes the funds to exit from the economy, remain hidden for a while and then to return to active duty.

The only pump at work is a transfer pump that reduces the paychecks of working employees while it yields benefits to unemployed

workers and salaries to civil servants who operate the pump. Contrary to popular belief, payroll taxes do not seize employer income. They do not reduce entrepreneurial profits or capital interest or managerial remuneration. Every penny exacted on behalf of employees is taken from employees through lower take-home pay. Lower take-home pay offsets the unemployment tax. The levy does not cause unemployment, but it continues to prevent saving and investing, which would raise labor productivity, bolster the demand for labor, and reduce unemployment.

No pump on earth can prevent the business cycle or moderate its effects. No food stamps, no aid to dependent children, no early retirement on Social Security can prevent the cycle once it has been set into motion through inflation or credit expansion. No matter what else government may contrive or attempt, easy-money policies bring about economic booms that cause business misjudgments and maladjustments. Once a boom has run its course it necessitates and brings forth a depression which is a period of readjustment. There are no miracle cures for business cycles, no recipes for full employment. Government cannot "fight" depressions through more easy money and more transfer payments. It can, however, prevent them by abstaining from the policy that causes them: inflation and credit expansion.

To embark upon pumping action at any stage of the cycle is to make matters worse. During the boom it may add to the maladjustment, during the recession it may delay the readjustment. Unemployment taxation, like any other taxation and government intervention, does not counteract the business cycle. It aggravates the disorder.

New unemployment levies are forced exactions to which the labor market has not yet adjusted. They boost labor costs and temporarily reduce employer income. Governments usually impose new levies either through higher rates or higher bases, or both, at the very moment of business difficulties, during the depth of depression. The exactions compound the situation by lowering the productivity of labor even further, thus reducing the demand for labor and boosting unemployment. They continue to have a painfully contracting effect until the take-home pay has fallen by the amount of the new tax exactions. Unfortunately, organized labor tends to resist the reduction, which aggravates the unemployment. Workers are led to lay the blame for rising unemployment on employer greed and the private property order rather than on the tax boosts and their own reluctance to adjust to the boosts.

Skills and Training

Unemployment taxation and compensation may not encourage capital formation, but they are said to promote the preservation of skills and training. With their eyes glued on the output of the transfer pump, and completely ignoring the pump input, as well as the energy it takes to operate the pump, the popular champions of unemployment compensation view it as an auspicious outpouring that preserves given skills and training and thereby safeguards labor productivity. They favor generous compensation because it reduces the financial pressures on the unemployed to accept different or lower-level jobs.[4]

Surely, it is a grievous fallacy to contend that unemployment is more conducive to maintaining skills and training than work on any level;

that it is more beneficial to finance idleness than to encourage the unemployed to accept lower-level jobs; that society is better served by mass unemployment than lower-level production. Work on any level usually broadens skill and ability and adds valuable experience that improves individual productivity. It is presumptuous to contend that there is no learning except on one's own level of skill and expertise.

The skill- and-training argument completely ignores a fundamental characteristic of the private property order, which is continuous change and readjustment of production to the wishes of consumers and to the ever-changing state of technological knowledge. Capital and labor must adjust continuously; failure to adjust inflicts losses and causes unemployment. The chronic unemployment of some eight million Americans, which most observers are quick to place on the doorsteps of the business cycle, must be charged primarily to the very policies that prevent and discourage change and readjustment, from minimum wage legislation to the legal privileges of labor unions. Unemployment compensation that encourages preservation of old skills and discourages new learning and new skills aggravates and prolongs the chronic unemployment.

The reluctance to adjust to changes and acquire new skills may rest on individual apathy, sloth or just fatigue. But it may also spring from the notion that many unemployed workers have great skills and training that need to be preserved with the help of generous unemployment compensation. This is a popular error. The pains of unemployment are felt most frequently by the least productive members of society; they suffer a common fate because government or labor unions, endeavoring to raise their pay and benefits, manage to price them out of their jobs. Surely, the unemployment rate among minimum wage workers, steel workers and automotive workers, most of whom have minimal skills, training and education, is measurably higher than in any other vocation.

Employee Disincentives

In the United States the existence of separate state systems makes for competition that reveals some startling contrasts. The high-benefit states are the high-unemployment states. The low-benefit states are the low-unemployment states. Low benefits, severe conditions and disqualifications, and the resulting low tax rates, seem to attract new industry and promote economic expansion, which provide new opportunities for employment. High benefits call for high taxation which, going higher and higher, may hamper business and breed unemployment.

The trends of unemployment are predictable, being subject to various influences and controls. Monetary, fiscal and foreign-trade policies affect the productivity of labor and consequently the demand for labor. The level of unemployment benefits has a significant impact on worker incentives and the supply of labor. Recent growth of the benefit provisions of the unemployment compensation system as well as public assistance benefits has significantly reduced the supply of labor. It subsidizes unemployment and thereby breeds more unemployment.

Acting man always faces a choice in allocating his resources among alternative uses. In this case he must allocate his time among alternative uses. He may use it in production (work) or in consumption (leisure). The mode of allocation generally depends on the relative

prices of both: a rise in the price of one relative to the price of the other tends to lead to a decrease in its consumption; a falling price tends to increase consumption.

Unemployment benefits reduce the cost of leisure and encourage the withdrawal of some labor from the labor market. New benefits and extensions of old benefits reinforce the withdrawal, which is hidden in the thicket of rules and regulations that seek to deny workers the freedom to choose between work and leisure. Withdrawal from the labor market obviously assumes freedom of action and voluntary reaction to changes in the relative prices of labor and leisure. Unfortunately, institutional restriction and prohibition often deny individuals the freedom to choose. Many individuals are barred from participation in production and exchange by such barriers as minimum wage legislation and license and permit requirements, which causes some workers to seek refuge in the underground economy. But most workers still have the choice between labor, which is regulated and taxed severely, and leisure, which is subsidized generously with unemployment compensation and other benefits of the transfer system. It cannot be surprising that many workers prefer the joys of leisure over the disutilities of labor.

Over the long run, aggregate unemployment rates have been rising in the United States. They have been increasing almost exclusively among unskilled or semiskilled laborers for whom the difference between the market wage of labor and the unemployment compensation and other benefits is minimal. A worker who earns $200 net per week for his labor exertion and $200 in the form of unemployment compensation and many other subsidies from food-stamps to Medicaid, lacks any pecuniary incentive to labor. He lacks the incentive to accept employment at a market rate of wage that may be lower than his compensation rate. He may prefer to remain unemployed until the benefits run out.

According to Department of Labor statistics, some seven to eight million Americans are unemployed. More than thirty million live in retirement and receive Social Security benefits. More than nine million depend on survivor benefits. Over six million live on public assistance or supplemental income. Altogether more than fifty million non-working Americans depend on transfer payments for their support. Surely, their number significantly reduces the supply of labor throughout the American labor market and renders the remaining labor more expensive. Not only does it deprive working people of the transfer income that is forcibly taken from them, but it also denies them the productive contribution many transfer beneficiaries could be making.

Society is substantially poorer because millions of able people no longer contribute to economic production. In recent decades American society has grown visibly poorer in the services which unskilled and semiskilled workers usually render. Many are idle, living on unemployment compensation and public assistance.

An Invitation to Deceit and Fraud

To limit the demand for its offerings, the system imposes benefit conditions that are designed to deny the leisure option. To be entitled to benefits, a person must be ready, willing and able to work. He must be unemployed through no fault of his own. Benefits are denied if he quits his job without a valid

reason, is discharged for willful misconduct, refuses to apply for or accept any suitable work within a reasonable distance of his home, or attends a school or training course. The amount of benefits may be reduced if he is self-employed or has any type of earning.[5] Unfortunately, the conditions are rather ineffective, and breed deceit and fraud on a massive scale.

For example, it is difficult to estimate the number of beneficiaries who labor in the underground economy and who blithely forget to report their earnings. But failure to report is tantamount to fraud, which is deception practiced deliberately in order to secure unlawful gain. The unemployment compensation laws call for prosecution of anyone making false statements or knowingly withholding information to obtain benefits illegally. But few such cases appear in court and even fewer judges are prepared to impose the penalties.

Beneficiaries are expected to apply for and accept any suitable work within a reasonable distance of their homes. But many who prefer leisure over work use imagination and ingenuity, resorting to clever tricks and artful dodges that meet the requirements of application but avoid being offered a job.

Similarly, to quit a job without valid reason or to be dismissed for willful misconduct means forfeiture of benefits—at least, the law so stipulates. In reality, unemployed workers may cite a great many reasons that may be true, imagined, or even manufactured. The system officials passing judgment on the valid reason or willful misconduct usually concur with the workers and dispense the benefits. Employer efforts to protest and appeal the decision are so costly it is often easier to accept the decision, right or wrong.

Some states deny unemployment compensation to strikers on the assumption that strikers voluntarily leave their jobs and are unavailable for work. However, other states, especially in the Northeast where the labor union ideology is dominant, manage to pay strikers on grounds that they do not leave voluntarily, but are driven out or locked out. When the United Steelworkers struck Wheeling-Pittsburgh Steel Corporation, operating under Chapter 11 of the Federal Bankruptcy Code in an effort to reorganize $514 million in debt, Ohio's Bureau of Employment Services ruled that Ohio strikers were locked out and, therefore, entitled to benefits.[6]

The effects of this policy are clear. Workers throughout the state suffer reductions in take-home pay so that the United Steelworkers of America, who earn nearly twice the rate of the average worker, can exact more income and wealth from company creditors and stockholders. The subsidy aggravates the strike and magnifies the company losses, which consume business capital, reduce the demand for labor and cause more unemployment.

Moreover, the benefits may necessitate boosts in unemployment taxation, which raise labor costs and reduce the demand for labor throughout the state. Unemployment is bound to go higher throughout the Buckeye State. The payment of benefits to strikers makes a farce of the provision that workers must be unemployed through no fault of their own. If strikers who are noisily manning picket lines and forcibly barring other workers from going to work, are said to be unemployed "through no fault of their own," then worker fault has practically been eliminated and all fault been placed either on the doorsteps of employers or the economic system itself.

Conclusion

The high unemployment that is persisting in the United States has given rise to a vigorous debate as to its causes and potential cures. On the one hand are those observers who argue that the high level of unemployment reflects primarily a deficiency of aggregate demand. In the footsteps of John Maynard Keynes, they contend that higher and more rapidly rising levels of spending, including unemployment compensation and public assistance, supported by appropriate monetary and fiscal policies, can bring unemployment down to a satisfactory rate of four per cent or less.

Opposing this orthodox view is the economic argument that there is no lack of jobs in an unhampered labor market. Unemployment springs from extraneous force, in particular, by government and labor unions raising the cost of labor above its productivity. Numerous laws and regulations seek to bestow popular benefits, reduce effort and output, and erect obstacles to labor adjustments to changing costs and opportunities. Government and labor unions make the labor market a long obstacle course for unskilled and semiskilled workers. Unemployment compensation is one such obstacle. □

1. Ludwig von Mises, *Omnipotent Government* (Spring Mills, Pa.: Libertarian Press, 1985), p. 158 *et seq.*
2. *Unemployment Compensation in Pennsylvania*, Commonwealth of Pennsylvania, Department of Labor and Industry, UCP-19, REV 6-84.
3. Paul A. Samuelson and William D. Nordhaus, *Economics*, 12th edition (New York: McGraw-Hill Book Co., 1983), p. 175.
4. William Haber and Merrill G. Murray, *Unemployment Insurance in the American Economy: An Historical Review and Analysis* (Homewood, Ill.: Irwin, 1966).
5. *Pennsylvania Unemployment Compensation Handbook*, Commonwealth of Pennsylvania, Department of Labor and Industry, Office of Employment Security, UCP-1, REV 11-80. p. 2.
6. *The Wall Street Journal*, September 3, 1985, p. 14; 4.

New!

Money and Freedom

by Hans F. Sennholz

Money and Freedom is a remarkable study of money and some fateful errors of popular monetary doctrines. It explodes the widespread notion that money cannot be left to "vagaries" of the market order and therefore must be controlled by government. Professor Sennholz argues forcefully and convincingly that such control, which amounts to a money monopoly, causes monetary destruction. Money is inflated, depreciated, and ultimately destroyed whenever politicians and officials hold monopolistic power over it.

Money and Freedom is published by Libertarian Press and is also available from The Foundation for Economic Education.

102 pages, paperback **$6.00**

Order from: The Foundation for Economic Education
Irvington-on-Hudson, New York 10533

Teaching Economics

How best to present economic principles.

by Ronald S. Hertz

Mr. Hertz was a CPA and a partner in a leading accounting firm. For many years he taught a course in economic theory at the New York Institute of Credit. Shortly before his death in 1985, he set down these thoughts.

Progress toward a free society and a free economy cannot be made until a substantial part of the population understands the operations of the market. What constitutes a "substantial portion" is not a scientific matter. Perhaps only 15 or 20 per cent is enough to make the difference when votes are counted. One of the problems, however, is the very fundamental deficiency in the notion that "votes" are a satisfactory method of determining the future of a society.

Without belaboring the question of how depth and breadth of education can be achieved, it certainly can be concluded that almost as important as the basic concepts themselves, for the achievement of these ultimate goals, is the effectiveness of the teaching. After teaching students who have not previously been exposed to economics, I have gradually come to some conclusions as to what fascinates young people and what approach draws them to economics and might hopefully convince them to maintain a lifetime interest in the subject.

First, students must be persuaded that they will never understand the world around them, including occurrences in their daily lives, without understanding economics. Students are fascinated when their attention is called to the "spontaneous order" of the market. Easily found examples in the environment are the similarity of prices asked for the same commodities uptown and downtown, in-state and out-of-state, and at even greater distances if we ignore transportation time and costs. Another simple example is the remarkable phenomenon that the retail outlets we patronize tend to have just the right amount of goods for the people who come in to buy. All this happens without a central planning system. On further thought, it could not, does not, happen with a central planning system.

The equity of the spontaneous order of the market is further underscored when the students consider the varied tastes, goals, attitudes, means, and values of their acquaintances. Given the heterogeneity of human beings, the accomplishments of the market appear quite remarkable. In economics as I teach it, the students learn that the spontaneous order is achieved as trades take place among individuals with differing interests and wants. When transactions take place

Ronald S. Hertz (1926–1985)

at the margin, heterogeneous individuals become compatible and mutually satisfactory transactions are consummated.

Economic theory may then be put into the context of the "invisible hand" or "spontaneous order." My course then concentrates on the processes or "forces" of the market. To appreciate their importance, the students must gain some understanding of what might be called the philosophical context of economic theory. They must realize, for example, that economics deals with *human actions* in the face of a *scarce environment*. They must come to understand how *deductive reasoning*, on the basis of fundamental axioms, leads to conclusions, economic laws or principles, which are incontrovertible unless the original premises are repudiated or the reasoning is unsound. Regardless of what appears to the senses in the environment, therefore, the laws of economics are not reversed or refuted, but merely obscured from the casual observer by the infinite number of forces working at all times in the real world.

I also introduce the thesis that economics is a science of means. Economics is described as "value-free." Personal tastes and other factors entering into an individual's goals, are *givens* and not the subject matter of economics per se. Economics is non- judgmental, in the sense that it scrupulously avoids making value judgments about the ends or goals of human action. Rather it focuses on the means for achieving those ends.

Hopefully, at the end of a brief introduction of this sort, the student's appetite has been whetted. By that time, he or she will understand the basic, self-evident axioms and can reason with the teacher from then on—from these axioms to the laws of economics, from the elementary to the more complicated, and then on to the "sponta-

"After teaching students who have not previously been exposed to economics, I have gradually come to some conclusions as to what fascinates young people and what approach draws them to economics and convinces them to maintain a lifetime interest in the subject."

neous" introduction of money, which makes complex transactions possible.

The market then, overall, is seen as the structure of voluntary, purposeful human actions, based on private property, governed only by principles of peace and social cooperation. Private property is the necessary concomitant of a voluntary society. Explained in this manner, the economy is shown to evolve solely from the actions of individuals, only voluntarily collectivized, and the forces of nature.

Our present system is riddled with government intervention of various sorts, the effects of which are disruptive. However, the system is still primarily the outcome of individual actions, not of overall coercion. All systems, whether theoretically "pure" market or "pure" socialist, are subject to the kind of analysis which only an understanding of market theory enables one to make.

Non-Market Forces

The next step in teaching economics is to introduce non-market forces, as they are superimposed step by step upon the market. Such non- market forces always turn out to be forms of coercion, political superimpositions, either direct or indirect. Key examples are explored in detail—government control over money leading to inflation, artificially stimulated bank credit expansion and its inevitable consequences, the effects of price and wage controls, regulation of business, and so forth. International trade is shown to become an economic problem only as a result of the political establishment of national borders and the institution of various government interventions within those national boundaries. Finally, totalitarian socialism is described in depth as the consequence of government interventionism carried to its extreme. Reference is made to the Soviet Union and other socialist countries, as well as to the "ideal" socialist state, if such can be conceived. The fundamental flaws of socialism are addressed and the students examine and compare both ends of the spectrum of economic systems—the market and socialism.

In this way, in accordance with my profound conviction, I try to project the urgent need for people to understand economic theory and the market. Only with an understanding of market theory can anyone recognize "order" in a world in which heterogeneous individuals conduct their daily affairs without supervision superimposed by government or a higher authority. Only with an understanding of theory, can one expect to pierce the mysteries which the economy presents to uninformed laymen. □

Choosing the Right Pond

by John Chamberlain

Robert H. Frank's *Choosing the Right Pond* (Oxford, 306 pp., $22.95) is, paragraph by paragraph, often a delight to read, but in addressing one-thousand-and-one topics in no particular sequential order it leaves one with the impression of a most confusing eclecticism.

Frank believes in what he calls a "libertarian welfare state," which in itself is a contradiction in any meaningful terms. He thinks we have an adaptive society and can have most anything. "Ours," he says, "for the taking is a society that is not only more efficient, but also more equitable and less restrictive than the one we have today." He hints that we could get it by taxing consumption instead of income.

Frank believes, very roughly, in marginal utility economics, but he has an incurable itch to qualify all statements. It is quickly apparent that he thinks people can be paid in many other things than money. People work for cash incomes, yes. But they also work for status, which can take many forms. The mixture plays hob with any theory of collective or individual bargaining.

The question of whether a worker is paid the economic value of his contribution might, says Frank, "have been settled long ago if there existed simple, unequivocal measures of the economic value of what people produce." Unfortunately, most modern production is done by teams. This makes it difficult to define, much less measure, what one worker contributes to what the team as a whole produces.

The fact that the output of the team as a whole can be measured, where the individual contribution cannot, means that guesswork will tend to equalize individual wage rates. The quest for status muddies all the waters. Individuals may actually prefer working for less productive teams as a means of escaping what they regard as a demeaning treadmill.

The anti-rat-race proclivities of individual workers have a general effect on all wages. "There occurs," says Frank, "a reduction in the reward workers receive for making extra contributions to their group's output." There is thus a "flattening" of the "slopes" of incentive pay schedules, which may account for much of the American productivity decline of recent years.

The quest for status means that many individuals will be content with titles. Being vice president of a company used to mean being next in line for the presidency. But Frank knows

about a large advertising agency in New York City that has 150 vice presidents and, above these, eleven executive vice presidents. Firms with multiple vice presidents will pay these executives less, and their lower staffs more.

Within the framework of traditional marginal productivity wage theory Frank finds lots of things that are "completely incoherent." There is a large literature that "discusses the widespread practice, in both union and non-union firms, by which workers impose strong sanctions against their co-workers who exceed informal production quotas. Instances are even reported in which firms themselves take steps to limit the amount workers produce. McKersie, for example, reports the case of a General Electric plant that abandoned an incentive pay experiment despite its strong effect on productivity, because it caused some production workers to earn more than their superiors."

In the oil business a good geologist may be able to indicate fields and methods of extraction that pay huge dividends to the lucky company for which he works. The problem here is that the geologist may be worth more to the company than its chief executive officer. The only way to handle such a situation is to pay the geologist fees outside the company. In many industries the practice of paying high consultant fees enables companies to avoid embarrassing comparisons.

The disconcerting thing about Frank's book is his tendency to take things back. He likes Milton Friedman's voucher plan for education. Vouchers offer greater possibilities for diversification than is now possible under state-provided education. The incentives for schools to recruit and retain the best possible teachers would be stronger under a voucher system. But Frank suggests that "an educational rat race of unprecedented proportions might be unleashed if we were to switch to the voucher method of financing education." The current system, says Frank, "provides substantial insulation from . . . pressures for most middle- and low-income parents." After reading five pages of Frank's seesaw discussion of the Friedman voucher proposal I am at a loss to know just where we come out.

I have the same sort of trouble with Frank's supposedly clinching chapter of the "Libertarian Welfare State." After reading Frank's fascinating analyses on how the quest for status modifies the quest for contract, with "flattened" incentive pay slopes resulting, what is one to make of the Frank statement that "firms do in fact compete vigorously with one another, both in product and in labor markets"? Is Frank taking his whole book back? No, for Frank has a final reiterative switch to make. "The wage structure we see within private firms," he says, "is not one in which workers are paid the value of their marginal products. Nor are the goods and services we buy in open markets the ones that best service the needs of our communities."

Frank reconciles the disparity between his statements about competition by saying that the "products we buy and the terms under which we work are at least in rough harmony with the demands we express as individuals." The "rough harmony" he speaks of goes with his theory of tensions. The Libertarian welfare state, he says, is "riddled with tension and trade-offs" that "come with the territory." He expects that the "haves" will naturally be for lower taxes while the "have-nots" will struggle for greater benefits. Some will want "greater standardization of the labor contract, while others will push for greater latitude to negotiate on an individual basis."

So it's a matter of pushing and hauling. Does this mean that Frank is willing to settle for the status quo? Not

quite. "The great trade-offs between liberty, efficiency, and equality will again confront us in the future," he says, "but for now we can have more of *all* of these things." I don't know what he means by italicizing the word "*all.*" Does he mean there is no need for trade-offs in the present?

Frank illustrates his book with cartoons, many of which are taken from *The New Yorker*. The cartoons play up anomalies and are a lot of fun. They are quite in spirit with the Frank text. But the fun does not make for coherence. A book that sees there are three sides to every question is no book at all. □

Takings: Private Property and the Power of Eminent Domain
by Richard A. Epstein

Harvard University Press, Cambridge, Massachusetts and London, England • 362 pages, $25.00 cloth

---

Reviewed by Joan Kennedy Taylor

Eminent domain is generally regarded as a power of government, not as a limitation on government. But this brilliant new book has the intriguing thesis that the eminent domain or ("takings") clause of the United States Constitution, properly understood, provides clear limits to government power, protects private property, and forbids any legislation that has the effect of redistributing wealth.

In English common law, according to Blackstone's *Commentaries* (1765), every Englishman had an "absolute right . . . of property, which consists in the free use, enjoyment, and disposal of all his acquisitions." Richard Epstein, an eminent law professor whose main interest is the common law, proposes that this legal definition, when incorporated into the eminent domain clause ("nor shall private property be taken for public use, without just compensation"), forms the vital link between the individual's bundle of rights and a government that is limited by those rights.

Although he is himself a Lockean, Professor Epstein disputes John Locke's concept that by living in a civil society men give "tacit consent" to its laws and are therefore contractually obligated to obey them. This concept has been the thin edge of the wedge of escalating government power. "In its place belongs an explicit and rigorous theory of forced exchanges between the sovereign and the individual that can account both for the monopoly of force and for the preservation of liberty and property. The bulwark of the individual is no longer the absolute protection of his property. Now it is that whenever any portion of it is taken from him, he must receive from the state (that is, from the persons who take it) some equivalent or greater benefit as part of the same transaction. The categorical command that property shall not be taken without tacit consent must therefore be rewritten to provide that property may be taken upon provision of just compensation."

And so it was, in the eminent domain clause that was put in the Bill of Rights and also appears in some version in all state constitutions. It is this clause that, because it presupposes the Lockean theory of the relationship of the individual to government, brings that theory into the Constitution.

In evaluating any government action, then, there are four questions that must be asked: 1. Is there a taking? 2. Is there justification? 3. Is it for public use? and 4. Is there compensation? These questions appear at the end of Part I, and are explored throughout the rest of the book.

Part II lays out the argument that if any of the common law conditions for private taking are present, then the plaintiff is entitled to some recovery, and the partial nature of the taking only effects the amount and nature of

the compensation, and not whether compensation is due. In constitutional law, this would mean that partial takings are takings, that destruction of property is a taking, that interfering with the "use and enjoyment" of property is a taking (one case allowed compensation because smoke driven out of a tunnel by an exhaust fan went across the plaintiff's property), and that consequential damages (like the loss of goodwill when a business is forced to move) are also takings. In other words, since under both common and civil law ownership is a *set* of rights—"possession, use, and disposition"—infringement on any of these rights diminishes property value and is a taking. Further, the analysis of takings has equal force whether when the taking is from many people at once, or from a single owner at a time. "The modern effort to distance the taking clause from general laws cannot be maintained. *All* regulations, *all* taxes, and *all* modifications of liability rules are takings of private property prima facie compensable by the state." (Emphasis in original.)

Having established the range of takings, what justifications make takings legitimate actions of government? Essentially there are three categories: the police power, consent, and compensation. The police power allows the state to take without compensation in response to a private taking. (The present day Supreme Court, says Epstein, impermissibly confuses the police power, which can act only to right a wrong, with public use, which allows actions to confer a public benefit upon payment of compensation.) The category of consent is a narrow one; an instance would be the ending by government of grazing rights on federal lands, when it was clearly understood that the government had the right to terminate at any time: no compensation is due for the termination.

Once it has been established that partial takings from the many are still takings for which compensation must be paid, the question of compensation becomes much more complex than is currently viewed. Much explicit compensation can be found to be inadequate or defective. Large-number takings are usually in the form of regulations, taxation, and modification of liability rules. These are not explicitly compensated for because it is assumed that the affected parties are both "benefited and burdened" by the same rule, and that therefore the affected parties receive implicit in-kind compensation.

An example of such a rule would be bankruptcy laws that assure that all creditors get something because any single creditor is barred from seizing the debtor's assets. Such a rule can pass the three tests that Epstein applies in order to detect a mismatch of benefits and burdens—the economic theory of property rights, the lack of partisan motive, and the lack of disproportionate impact. Much legislation and regulation that now passes judicial scrutiny, Epstein argues, would not pass if subjected to these tests. He applies the tests to show that most contemporary economic legislation—price controls, minimum wage laws, windfall profit taxes, state severance taxes, estate and gift taxation, even the progressive income tax—are unconstitutional.

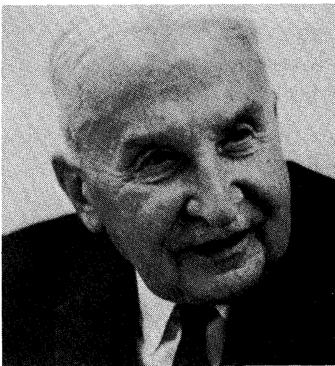
Sweeping as this conclusion is, Epstein goes further. He finds that the entire concept of transfer payments underlying welfare checks, social security legislation, unemployment benefits, food stamps, farm subsidies, indeed, most of our contemporary budget, is unconstitutional by this analysis. But being a real-world thinker, he then questions whether it is possible to undo such programs now that people have been led to rely on them, and ends by proposing a practical sequence of reforms that would start to reverse the damage. Overhaul the tax system, invalidate the mini-

mum wage, strike down the National Labor Relations Board (NLRB), lift price controls on oil and gas, revise and rollback much zoning. As a result, "Production will rise; taxes will in general fall; the tradeoff between welfare and productive labor will shift in a favorable direction so that even if benefit levels remain the same, fewer people will demand them. That result in turn will reduce the taxes needed to fund them, which implies greater levels of productivity." He warns that we do not yet have the will as a people to make these reforms, because the intellectual climate is so hostile to them. But a proper legal theory, if widely accepted, will lead to changes in the proper direction.

It would be hard to overestimate the importance of this book. Not the least of that importance is the stature of the man who has written it. Richard Epstein is a professor at the University of Chicago Law School who has already been offered a federal judgeship and has even been mentioned by legal reporters as a possible Reagan nominee to the Supreme Court. The power of his interpretation lies in the fact that, although no one before him mounted his specific argument about the eminent domain linkage between private property and public law, "[t]he received judicial wisdom about the linkage recognizes all the important parts of the picture." In other words, he has taken theories that the legal community accepts separately but combines in other ways, and shown how much better his theory fits them together. It's as if he found the pieces of a complicated jigsaw puzzle that no one else had completed, and was able to put them together into a coherent whole. The instant recognizability of the picture that emerges, together with the identification of the pieces that everyone has been playing with, offers a strong presumption that Epstein has indeed found the solution to the puzzle. □

(Joan Kennedy Taylor is the editor of FEE's latest anthology, *Free Trade: The Necessary Foundation for World Peace*.)

LIBERALISM:
IN THE CLASSICAL TRADITION



Ludwig von Mises

LIBERALISM: In The Classical Tradition by Ludwig von Mises is a book-length essay that sums up the ideas and principles of classical liberalism as they apply to the twentieth century. First published in Germany in 1927, it was published in the United States under the title *The Free and Prosperous Commonwealth* in 1962 and reissued in the mid-seventies by The Institute for Humane Studies. It has just been republished by The Foundation for Economic Education in association with the Cobden Press.

230 pages • $9.95 paperback

FEE pays all postage on prepaid orders.

Order from:

**The Foundation for Economic Education, Inc.
Irvington-on-Hudson, New York 10533**