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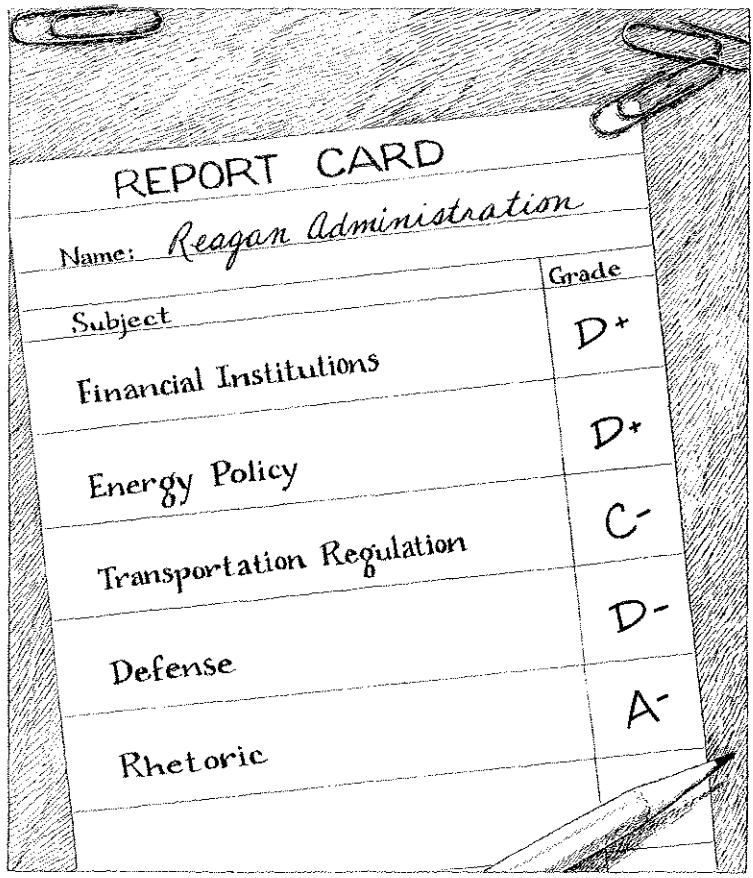
The Reagan Revolution:

Rhetoric is Not Enough



During his campaign and in his first economic message, President Reagan outlined a four-point program designed to alter fundamentally the federal government's role in American life, and lift us out of our current economic and social malaise. To date, public controversy has concentrated on the equity and workability of tax cuts, monetary stability, and reduced public sector spending. Unfortunately, the enhanced economic opportunities and increased consumer welfare that can be achieved through deregulation has been virtually crowded out of public scrutiny.

Nevertheless, deregulation is extremely important for our long-term economic health. But it is an elusive goal for modern political democracies, since it must confront powerful, entrenched pressure groups whose own perceived interests often conflict with the larger public interest. What is the Administration's progress to date? Must we postpone our promised rendezvous with destiny? The Manhattan Institute assembled a panel of sympathetic but independent economic analysts in New York to consider policy initiatives in transportation, financial markets, agriculture, energy, and defense. Led by George Hilton, Professor of Economics at UCLA and author of several definitive works on issues in transportation policy and economics, the participants at this Policy Forum all would agree that changing the political and economic habits of the last few generations will likely be an uphill struggle indeed.

The Reagan Revolution

George Hilton—Today's Policy Forum is entitled, "The Reagan Revolution: Rhetoric is not Enough." I commend the Manhattan Institute for sponsoring this critical inquiry into the economics of the Reagan Administration.

Our first speaker today is Marcus Alexis, Professor of Economics at Northwestern University. Professor Alexis was an anti-regulation Carter appointee to the Interstate Commerce Commission (ICC). That may sound like a contradiction, but he did, in fact, help to reduce the regulatory morass of the ICC while under the employ of the Carter Administration. As somewhat of an expert myself in the field of transportation, it is my pleasure to introduce Professor Marcus Alexis.

Marcus Alexis—Thank you, George. Most economists try to avoid government service because it can't do anything for your reputation. Almost no matter what you do, your colleagues will remember the difference between your philosophy and what you ended up doing. So I was delighted that I came out of the ICC, if not totally, at least relatively, unscathed, even though, as my colleague George Hilton once said, some economists believe the ICC should be abolished, its building razed and the ground salted so that nothing will rise in its place.

George Hilton—By the way, I don't agree with that idea myself; the salt would have undesirable ecological effects, and the building, which is a nice work of neoclassical architecture, should be preserved to house a new organization that would impose user charges on inland river transport.

Marcus Alexis—With that important point clarified, I'll continue. Recent changes in the ICC have made me wonder whether much of the good work that was done at the Commission in the two years that I was there has been lost. Let me tell you what I said before the Joint Economic Committee in my testimony on truck deregulation. I said that the Commission has embarked on a deliberate policy to reimpose restrictive, burdensome, inefficient, inflationary and wasteful regulations on the trucking industry. Now, why would the Reagan Administration do this? After all, there are good reasons why Reagan ought to be pro-competition and favor deregulation. Deregulation was supposed to be an important part of the triangle of the Reagan Revolution, along with lower taxes and reduced government expenditures. Moreover, during the campaign, candidate Reagan wrote a letter to the American Farm Bureau in which he supported competition in the transportation industry.

But there are also reasons why the Reagan Administration would be pro-regulation. First, candidate Reagan received support from both the Teamsters and the American Trucking Associations. Second, Senator Paul Laxalt, who is one of the President's closest advisers, had a former law partner who wanted to be in Washington. His name is Reece Taylor, now the Chairman of the ICC. Reece Taylor had other political assets: he was a financial chairman for Reagan in Nevada and California in 1976, and in 1980 he was the Republican National Committeeman in Nevada. In short, he was appointed because of his political connections; the President has a tendency to confuse being pro-business and being pro-market.

But Chairman Taylor is not the only problem the ICC has. Other Commission members have been appointed and while these people are better than those who were on the Commission last year still the Commission is not as pro-competitive as it was two years earlier. On balance, the Commission is less pro-competitive than it was when I served, but more pro-competitive than Taylor. The appointment strategy of the Administration has been to yield to the pressure

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"The President has a tendency to confuse being pro-business with being pro-market."
—Marcus Alexis

to appoint Taylor and then to surround him with people who are more pro-competitive than he is. This strategy worked out to some extent, but whether the Commission has the internal guidance to come up with the right decisions is a big question. For one of the things that the appointment of Reece Taylor did was drive out most of the good young people who joined the Commission during my time. I would say, as one of Carter's aides did after a big cabinet shake-up, "My god, they killed the giants and kept the pygmies." I wonder whether the pygmies can carry on the war. There has been such serious damage to the staff that good people don't want to work there.

I would like to back up a bit and talk about the Motor Carrier Act of 1980, which was the act that really set the trucking industry in a pro-competitive direction after forty-five years of strictly enforced regulation by the ICC. The act was not a true deregulatory measure, but it did make it easier for new companies to enter trucking. It also broadened grants of authority, so that people did not have to get grants to carry specific products but would be authorized to carry, say, foodstuffs in general rather than just tomatoes. The act also allowed more independent rate setting.

What were the effects of that act? Well, although there was a big bugaboo about what would happen to service to small communities, in the first year of the Motor Carrier Act small communities reported that they were receiving service at least as good as they had before deregulation. Another beneficial effect of the act was that many more small businessmen, minorities and women among them, entered the trucking business. Before I was on the ICC, there were less than twenty minority group members who held certificates out of 17,000 regulated truckers. When I left, there were close to 300, which was a fifteen-fold increase in a period of two years.

That is the policy history. Now, what has the Reagan Administration done about trucking deregulation? On the positive side are the Commission's legislative efforts, although the Department of Transportation is really more responsible for them. I'm thinking especially of the Commission's work to have Congress completely deregulate the busing industry, for which they deserve a high mark. But another of the Commission's legislative proposals is very bad; it would impose what is called a "fitness only" standard on truckers who want to obtain a certificate. Truckers would have to prove they have a certain amount of financial resources before they could be certified and that is actually a stricter requirement than the one now in effect.

Most of the Commission's other actions

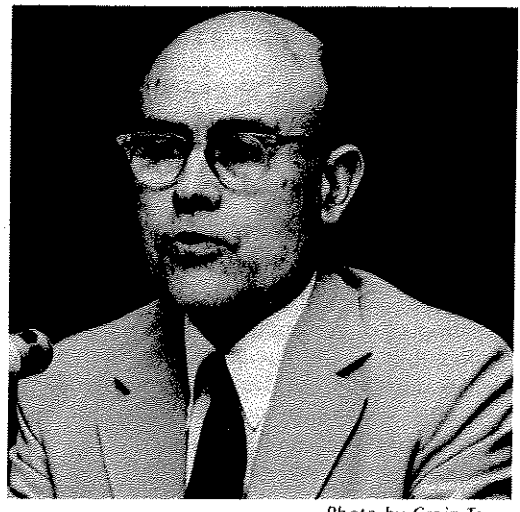

Photo by Craig Terry
George Hilton, *University of California, Los Angeles*

have also been bad. Since he has become Chairman, Reece Taylor has insisted on reviewing tariff filings absent complaints; that is, he has not waited until someone has complained about a tariff before investigating to make sure it is not predatory or discriminatory. An example of this was the Roadway case. Roadway had just entered the Pacific Northwest trucking market and introduced promotional discounts in order to get new business. In a split decision, the ICC allowed the discount, but Taylor wrote a strong dissent. He said that Roadway failed to prove the discount was not predatory or discriminatory, even though there was no burden on Roadway to so prove. But in fact, Roadway did provide substantial evidence that their rates were above their costs, and so, in that sense, were not predatory.

Why is all this happening? At the hearings before the Joint Economic Committee, I was struck by a statement Reece Taylor made. He said he never had any guidance from the Administration. I, therefore, will offer my guidance. It is quite clear to me that the substantial interest the Teamsters and American Trucking Association have in regulation will prevent any legislative attempt to gradually move towards a competitive trucking industry. Only a sudden break will work. Therefore, I have come to the conclusion that the ICC's regulation of trucks and other motor carriers should be scheduled to end December 31, 1983. I pick that date to avoid the 1984 election politics. At least half of the ICC's $70 million budget goes for regulating trucking, an industry that is inherently competitive and needs no government regulation. We can therefore save $35 million by deregulating trucking immediately. Reece Taylor has argued for grad-

ual deregulation, likening the industry to a deep sea diver who must ascend gradually to avoid the bends. I think the ICC is more like a drug addict. It has an insatiable appetite for regulation and the cure is cold turkey withdrawal.

George Hilton—I'd now like to introduce George Benston, Professor of Economics at the University of Rochester, who will speak about the Administration's record in the regulation of financial markets.

George Benston—I want to discuss the general situation of our financial institutions, and then the regulation of financial markets, particularly the Securities and Exchange Commission (SEC).

First, regarding our present condition, I think everyone knows that the thrift associations, the savings and loans institutions and the mutual savings banks are in great trouble. The commercial banks are also in trouble, but they are not quite aware of that yet, or if they are, they are willing to live with it. The thrifts are in trouble partly because of regulations imposed on them which, in fact, they willingly accepted. They receive subsidies for being specialists in mortgages and for having, in effect, long term assets and short term liabilities.

To get some perspective, let's go back to the 1960s, when the interest rate ceiling paid by thrift institutions on savings accounts was extended to savings banks and to savings and loan associations. This was supposed to be a temporary crutch, to get the thrifts over the crunch that they had at that moment. But of course, once you get someone a crutch to help him out because his leg hurts a bit, pretty soon he cannot walk at all. The savings and loan industry did accept that crutch—I rather think they wanted it—and it did get them over the immediate problem. They were able to take wealth from small savers who could not use large instruments to get the market rate of interest, from people who did not know about the alternatives, and from people for whom the costs of making adjustments were high. It was a very moral system, it took money from the poor, who of course would only have drunk it up and lived lasciviously, and gave it to the homeowners. In the long run, however, these regulations prevented savings institutions from serving consumers by readjusting to changing market conditions. What consumers really want, then and now, are alternatives. They want checking accounts, they want consumer loans, they want to get market rates in return for their investments, and they want a package of services that is effective for them. Commercial banks provide these services. Now that we have unexpectedly high nominal rates of interest, depositors are shifting their funds out of mortgage lending institutions, leaving them terribly vulnerable.

What can be done? Well, first I must discuss the prohibition of interest payments on checking accounts by the Banking Act of 1933. The public rationale was that banks were paying high amounts out and were therefore likely to fail. In fact, that never happened. Banks that paid interest on checking accounts in those days had a lower rate of failure than others because they cut back more quickly when the crisis hit. The Banking Act of 1933 was actually the result of a political horse trade between big and small banks. Big banks did not want to pay interest on checking accounts, particularly those of other banks. Small banks did not want branch banking because they feared losing local monopolies. The small banks also wanted the FDIC but did not want to pay for it, so the cost was imposed on the big banks in return for prohibition of interest on checking accounts. It was all beneficial for everyone at that moment; the only people hurt were the public, which is normally the case. The problem now, however, is that the world has changed while the regulations have not. Like interest rate ceilings, the prohibition of interest on demand deposits is killing the people it was designed to save.

Restrictions on branch banking should also be lifted. Branch restrictions were enacted to protect the monopoly of smaller banks. There are no such monopolies anymore, except in very

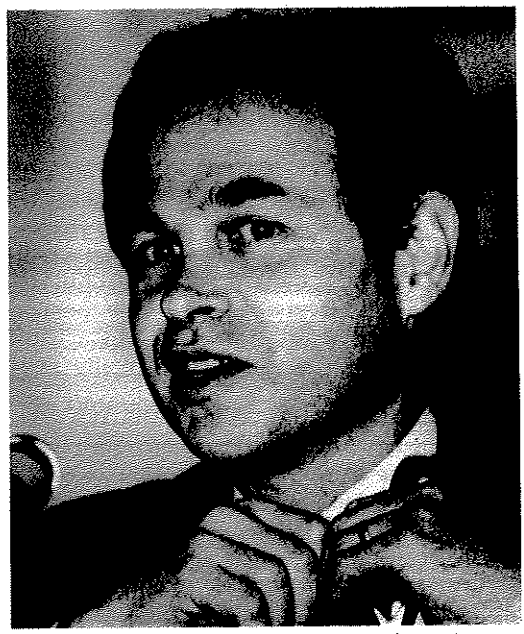

Photo by Craig Terry

George Benston, *University of Rochester*

"The prohibition of interest on demand deposits is killing the people it was designed to save."
— George Benston

small communities. Most of the major banks, in fact, have large numbers of employees in every major city in the United States, so we do have nationwide branch banking; we just do not have it as efficiently as we might. Another change that should be made concerns the Glass-Steagall Banking Act (1933) which keeps the banks from providing investment service to their customers. It was thought at the time the law was passed that a bank might make a bad loan on its own account and then advise its customers to invest in that company to help pay off the bank's loan. Whether those practices did or did not occur — I might say that in reading the hearings before the New Deal banking and securities laws were passed, I found no evidence they had occurred — the rigid separation of investment and commercial banking makes no sense. Would banks in a competitive environment risk their reputation in this way?

The SEC is also imposing disclosure regulations that all research indicates are at best useless. They prevent new companies from coming into the market, and prevent people from starting new enterprises that might be beneficial to the public. The SEC does keep a lot of lawyers in business and I suppose they could be doing worse things. The new Administration presumably is dedicated to making changes in this regulatory structure but no changes are being made.

We must recognize that the Depression laws never were needed, are not needed now, and in fact are very destructive. We can certainly eliminate the prohibition of interest on demand deposits, remove interest rate ceilings on savings institution deposits, and probably permit savings and loans to merge with commercial banks. We can allow banks to offer the services to the public that the public wants and so encourage competition in the industry.

George Hilton — Very good, George. We continue with Clifton Luttrell, Vice President for the Federal Reserve Bank of St. Louis, who will speak on agricultural policy.

Clifton Luttrell — Thank you, George. The Reagan Administration originally planned for some dismantling of the U.S. Department of Agriculture (USDA) bureaucracy and to move toward a free market in agriculture. Federal budget outlays for agriculture were expected to decline. Outlays for price support and related programs, which totaled $4.2 billion in 1981, were estimated to total $7.1 billion in 1982, then to decline to $3.8 billion in 1983 and to $1.9 billion by 1985. The department's budget estimate for fiscal 1983 of full-time equivalent employees is 117,300 for 1981, a figure that was supposed to decline to 117,000 in 1982 and to 108,900 by 1984.

These well-conceived plans have already gone awry. Total budget outlays for agriculture rose from $5.6 billion in 1981 to an estimated $8.6 billion in 1982, and instead of declining as planned, the 1983 budget is estimated at $9.4 billion, having been increased in recent weeks by $4.9 billion for farm commodity price support operations. In addition, on January 29, Secretary Block announced a return to "voluntary" acreage reduction provisions — a euphemism for production controls — for wheat, feed grains, upland cotton and rice. Farmers must participate in the acreage reduction program to be eligible for acreage diversion payments, loans, target price supports and the reserve loan program. Government loan rates have been set at relatively high levels for those producers who divert 15 percent of their wheat, upland cotton or rice acreage to conservation uses and for feed grain producers who divert 10 percent of their acreage to conservation uses. These price supports triggered the higher budget estimates. In addition to diversion payments, farmers who cooperate with the government have access to relatively high target prices and reserve loans, all at the taxpayers' and consumers' expense.

At first glance, it would appear that the Reagan economic program for agriculture represents a retreat from the farm policies of the Nixon and Carter administrations and a return to the economic chaos of the 1930s, the late 1950s and the 1960s when carryover stocks of crops held by the government often exceeded annual production. A closer look, however, indicates that no basic changes in farm policies occurred during the Nixon and Carter administrations. In fact, there has been little change in basic farm policies or farm programs since the 1930s, when the first major effort was made to raise farm commodity prices and farm incomes above their market-determined levels. I base this argument on three points. First, the bureaucratic machinery necessary for farm production control and price support purposes was never dismantled; second, the controls on production were removed only after farm commodity prices rose sharply relative to other prices; and third, production controls and price supports along with major increases in USDA budgets have accompanied each movement of farm prices towards their lower long-run equilibrium levels.

To support this view, I draw your attention to the fact that the Agricultural Stabilization and Conservation Service (ASCS), the production control arm of the USDA, remained in place in every farming county in the United States even

during and immediately following World War II when U.S. farm commodity prices rose rapidly and much of Western Europe was nearly starving. In 1978, when most of the control programs were inactive, the ASCS had 3,000 federal employees and an additional 14,00 work years of employees at the county level. The number of USDA employees averaged 115,000 per year during 1970-73 when the control programs were in effect and 123,000 during 1974-77 following the termination of the programs.

My second point is that production controls were removed and price supports became relatively ineffective only when farm commodity prices rose to above long-run equilibrium levels. For example, from 1939 to 1944 (when farm production controls were finally removed during World War II) farm commodity prices almost doubled (rising from an index of 40.0 to 75.5) while prices of all consumer items rose only 26 percent. But, when farm prices declined 5 percent from 1950 to 1954 as prices of all consumer items rose 10 percent, production controls and price supports were reapplied. They remained generally in effect until the early 1970s. In 1972 a large increase in export demand for farm products resulted in another sharp increase in farm product prices. Such prices remained well above other price indices until 1977; hence, the production control programs were largely removed. The controls were reinstated to some extent in 1978 and 1979 despite relatively favorable farm prices and have been reinstalled in full force this year as farm commodity prices have declined somewhat further, relative to the rate of inflation.

The USDA budget has moved inversely with relative farm commodity prices since 1970. Then, farm prices were relatively low and the USDA budget relatively high — $5.2 billion. By 1974 farm prices had risen 75 percent while all consumer items had risen only 27 percent. Consequently, the USDA budget declined to $2.2 billion. With less favorable farm commodity prices in 1977 and 1978, the USDA budget rose to $5.5 billion and $7.7 billion, respectively. It declined somewhat in 1979 and 1980 with relatively favorable farm prices, but began to rise sharply in 1981 and 1982 as farm product prices declined relative to inflation.

My point is that despite the free market rhetoric of the Reagan Administration with respect to agriculture, there has been no real change in farm policy. Farm policy has essentially remained the same since the decision to lift agriculture out of the market system in the 1930s. Politicians — including Reagan — have continued to respond to relatively high farm product prices by reducing price support and production controls and as soon as farm product prices drop to more normal levels, they reinstall production controls and price supports. The bureaucratic machinery has been maintained intact since the thirties.

These programs callously ignore the well-being of the majority of the nation's people. Food and fiber costs have often been maintained at artificially high levels. The direct cost of the programs to taxpayers has also been large; in one year (1940) such costs totaled 17 percent of the national budget. The programs have led to the inefficient use of resources both on and off the farm. The removal of acres from production has disrupted the efficient use of land, machinery and farm labor. In addition, a large percent of the more than 100,000 USDA employees would have been employed in more productive occupations if these programs did not exist. This does not imply that these people are laggards; it simply means that their alternative product is of higher value than the services provided by the USDA.

Finally, farm programs are of little, if any, help in alleviating poverty in agriculture. Farm resources, like other resources, are bid up to the point where marginal costs equal marginal revenue. There will always be marginal farms in a competitive society, and the relatively poorer farmer will get only a minute portion of the benefits from the programs.

Thus, while the Reagan Administration has spoken in favor of a free and competitive agricultural economy and has actually moved in this direction in some areas of the economy, I see no change in farm policy.

George Hilton—We will now continue with James B. Ramsey, Professor of Economics at New York University, who will examine the Administration's energy policy.

James B. Ramsey—I am not the least bit surprised by what Reagan has done or failed to do in energy policy. In fact, Reagan has performed pretty much as I expected. What he has done is what I would expect a politician to do.

There are four issues I'd like to tackle; actually, there are three issues and one nonissue so I'll get rid of the nonissue first. I mean the business of alternative fuels — solar, synthetic and so on. These are fuels for which we have no real use, but which do make for very interesting talk, sometimes very emotional talk. I attended an energy conference awhile back and I noticed that most of the supporters of solar energy and geothermal energy approached their topic very emotionally. It was God, motherhood and apple

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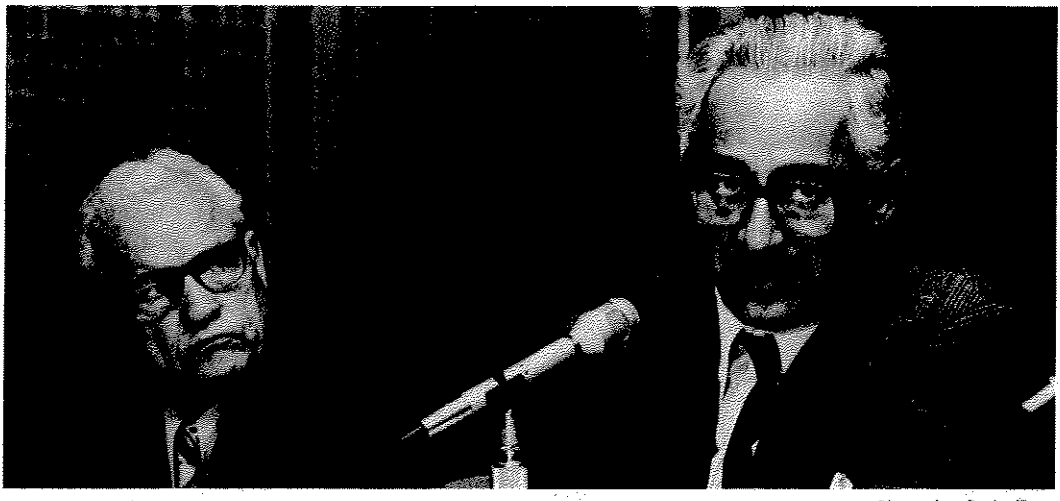

Photo by Craig Terry

Clifton Luttrell, *Federal Reserve Bank of St. Louis (l)* and **Pierre Sprey,** *Pierre Sprey, Inc.*

pie to them. In fact, one of the chief proponents of these energy supplies was an organization named The Mother Earth Society or something like that. Anyway, I regard the maintenance of the synfuels program at any funding level as a complete waste of money. It distresses me that we are wasting so much money to absolutely no point, but there is no sense crying over spilt milk, and so I will move on.

The other three issues are first, the Department of Energy (DOE); second, the question of whether the deregulation of oil was a success or failure; and third, the prospects for deregulation of natural gas.

With respect to the DOE, it is with us to stay, notwithstanding any comments by Secretary Edwards. I remember when the DOE, or rather, an earlier version of it, was first established. We were told that it was a temporary expedient and that it would last perhaps six months. Soon after, that six-month expedient had become the Federal Energy Administration (FEA) and then the full-fledged department it is today. Indeed, I am told it is now one of the best paying departments in the entire Washington bureaucracy. The ability of bureaucracies to maintain themselves long after their reason for being has vanished is extraordinary.

Regarding the decontrol of oil, which took place on January 28th, 1981, it was clearly a success. We have ceased at long last to subsidize OPEC, we have managed to encourage to some small extent exploration and development and we have shifted resources back towards worthwhile, but risky, exploration. The screams we heard about how decontrol would cause a minimum twenty cents increase in the price of a gallon of gasoline and a 1 percent rise in the Consumer Price Index (CPI) have been well stifled. The CPI has actually gone down a small amount since decontrol. There has been a tremendous improvement in our balance of trade and our society in general operates more efficiently because of oil decontrol.

What about decontrol of natural gas? My feeling is that it is unlikely we will deregulate natural gas as scheduled. Indeed, I doubt this Administration will ever do it, despite the success of oil deregulation and despite the fact that natural gas development would reduce our dependence on fuel imports and so put pressure on OPEC. Given all the rhetoric that we have heard from this Administration, one would have thought that natural gas deregulation would have been pushed forward vigorously. But no, at best we have had a cautious testing of the waters.

Why this lack of progress? For the simple reason that natural gas deregulation is a different kettle of fish politically than the deregulation of oil. Because of the nature of the contracts that are used in natural gas sales, and the nature of the gas distribution system, the type of consumers who use gas is far different than the type that uses oil. Natural gas users are mostly households. There has been tremendous political pressure to insure that household users have an uninterruptible supply of gas during the winter. Consequently, firms using gas are all on an "if-and-when" basis, that is, their gas can be cut off if households need it. During the past half dozen years, the extent to which industry has been put on an "if-and-when" basis has increased dramatically. Further, natural gas is

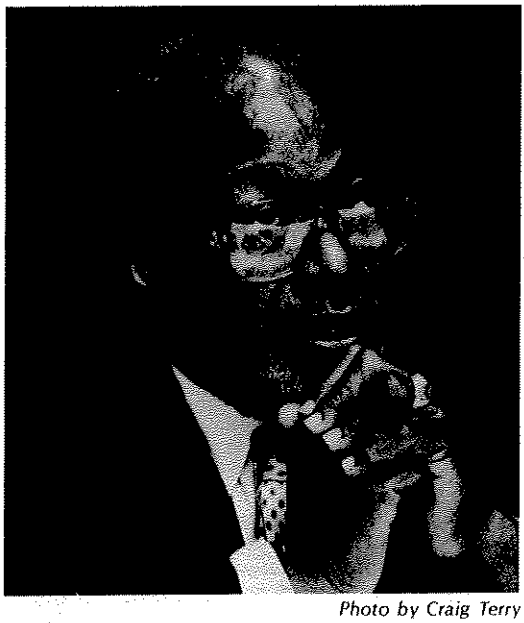

Photo by Craig Terry

Marcus Alexis, *Northwestern University*

difficult to resell. Consumers can't transfer it among themselves unless they are hooked up to each other by pipelines, which means that industries can't circumvent the current unfair distribution system by buying from other consumers. The result is, it is very easy to organize a discriminatory price system for natural gas. Households are now subsidized at the expense of other users. The current system transfers income from industrial users to household users. Nonhousehold users are therefore forced to use higher-priced oil instead of gas.

What would happen if the price ceilings for gas were removed? First of all, household prices, at least for those who are currently hooked up to gas, would rise approximately 50 percent. But for those not hooked up and for those using other fuels, the price of energy, mainly oil in this case, would fall more than 60 percent. As a matter of fact, the total amount of money that would be saved by people who would get lower energy prices would be much greater than the amount lost by those who would face higher prices. It is sometimes said that the deregulation of natural gas would be inflationary. Of course, it was also said that oil decontrol would be inflationary, and that turned out to be nonsense. Neither will natural gas deregulation cause inflation, and I'm leaving aside entirely right now the fact that inflation is a monetary phenomenon. Under price controls, there is a large group of people who can't use gas and so use more expensive alternatives. Under deregulation, they will be able to switch to gas, which will still be cheaper than what they are now using. But those people who are more important for votes, namely householders, would face an immediate and obvious price increase. Those who are going to benefit from deregulation do not have a lot of votes and would benefit only indirectly. Therefore, the political pressure to maintain a price ceiling, notwithstanding the fact that its effects are mostly bad, will continue. Politicians have to be reelected long before the general benefits of decontrol are obvious.

I will end by saying that politicians will be politicians, so don't expect economic sense.

George Hilton—We now come to Pierre Sprey, who is a defense consultant and weapons analyst and one of the originators of such weapons as the A-10 antitank aircraft, the F-16 fighter and the M-45 tank.

Pierre Sprey—Let me start by saying that if we are going to review the performance of this Administration, or any administration, in defense, it is only fair to use a relative standard; that is, to judge Reagan by how well he has done relative to previous administrations. Were we to use a standard relative to what the country really needs in defense, I'm afraid the judgments would be too depressing for a luncheon audience.

First of all, I must admit that there is very little that any one four-year administration can do in defense. Defense is a very large, very fast-moving field, and defense projects have a tremendous amount of inertia. Most multi-billion dollar defense projects have at least a ten-year lead time—that need not be so, but that is the way things work today. Moreover, since we have been talking today about how bomb-proof bureaucracies are, I'll say that the most bomb-proof bureaucracy of all is the defense bureaucracy.

Nonetheless, judgments have to be made and therefore I will quickly outline seven areas that I think are central in determining how well this Administration is doing. I will focus on spending programs, even though from a military point of view many other areas—for example, the kind of people you attract into the services and the Defense Department—are far more important.

First of all, you have to look at how well the Administration has done in acquiring weapons that work, and more of them. Is it continuing the trend fostered by the services and the defense industry to acquire ever more complex, ever less effective weapons in smaller and smaller quantities? The programs to look at in this respect are the ones we have usually been bad with, tanks, anti-tank weapons for the infantry, close support

"The most bomb-proof bureaucracy of all is the defense bureaucracy."
— Pierre Sprey

aircraft and submarines. We have to do better with these because they are far more important than most other weapons in our arsenal.

The second question to ask is, what has the Administration done about testing? Testing—independent, objective testing—is absolutely central in acquiring weapons that work. The key question to ask here is whether testing ever results in a program being canceled. If testing never cancels a program, obviously there is not much point in running the tests.

The third area you want to look at is very important: what is the Administration doing to introduce competition into procurement? If you stop and think about it, you'll realize that our Defense Department buys weapons by almost the same system the Soviets do. That is, we have a very large state bureaucracy that buys weapons from another state bureaucracy; for in most respects, Lockheed, Raytheon, Westinghouse, Boeing and Northrop are extensions of the state.

Fourth: has the administration reduced corporate welfare to defense industries? To what extent has it made effective moves to cut the very damaging ties between senior defense officials and senior officers in the industry?

Fifth: has the administration improved military readiness, the readiness to carry out combat operations? Has it increased no-notice exercises, cut logistic overhead, gotten adequate inventories of supplies?

Sixth: to what extent has this administration enhanced real civilian control of the Defense Department by forcing its sub-bureaucracies to compete, which is the only lever that an administration can have over such a huge bureaucracy?

Lastly, the bottom line for the defense performance of any administration is the extent to which it is able to reduce defense expenditures, or at least keep them reasonable, while increasing our military forces.

How does the Reagan Administration shape up in these areas? As to procuring weapons that work and procuring more of them, the Reagan Administration is slightly worse than the Carter Administration. Neither of them has done anything except yield to the normal pressures from the military services for getting weapons that don't work. This administration has started no new weapons projects at all. The only things it has done is to cut back on one turkey inherited from the Carter Administration, the M-X, and revive and stuff two old turkeys, the B-1 and C-5. Under the Carter Administration the B-1 was relatively cheap and we were supposed to buy about 240 of them. Now the B-1 has picked up 80,000 pounds, and probably another 50 percent in costs, and we are supposed to buy only about 100 of them.

With regard to testing, the current administration has performed exactly like the Carter Administration. Not one program in either administration was ever canceled on the basis of test evidence, yet I would say at least three out of four programs initiated under either administration has shown clear evidence that they would fail in combat.

I think that as far as competition in procurement goes, we still have an essentially socialist defense establishment. This administration is very much like the Carter Administration; both of them have gone along with the services, which prefer to deal with monopoly suppliers. That is always much more comfortable for bureaucracy.

As to reducing the corporate welfare or pork barrel aspects of the defense budget, here I would have to rate the Reagan Administration as a little worse than Carter's. Perhaps the most egregious example of corporate welfare payments is the revival of the C-5, which is a thoroughly ineffective, extraordinarily expensive transport airplane that probably has the worst record in actual service of any transport aircraft built in this country. It has been revived simply to continue the long-standing Lockheed bailout because Lockheed's investments in the civilian airliner business have turned out to be bad.

With regard to cutting the ties between industry and Defense Department officials, I again think the Reagan Administration has done slightly worse than the previous one. In both cases, chief procurement officials have viewed their role principally as representing the interests of the arms industry and the aerospace industry. The administration has taken no action to limit the advertising of weapons, or the use of taxpayer's money to pay for lobbying, or the unlimited selling of weapons abroad regardless of American foreign policy interests. Nor has there been any move to interfere with the huge political contributions of the aerospace industry, the effect of which has shown up very clearly in the '83 budget as an enormous increase in procurement expenses. Procurement is by far the largest area of increase despite all the talk about improving readiness and improving pay. The defense budget altogether has increased 13 percent, but the procurement slice has increased by over 28 percent over that. That is a classic example of the pork barrel component of defense spending.

Reagan's performance in improving readiness is slightly worse than Carter's. The numbers in the budget speak for themselves. During the Carter Administration, general operations and

"Reagan deserves credit for unobtrusively cutting the budgets of some obviously counterproductive programs."
— George Hilton

maintenance funds increased in rough proportion to procurement funds. In the '83 budget, procurement increases are four times as large as operations and maintenance increases. That means we are going to buy a lot of weapons that we can't maintain. Given that the weapons we are procuring are extraordinarily more complex than what we bought before, that is a remarkable decline in readiness.

In the area of improving bureaucratic competition, the Reagan Administration has done exactly as well as the Carter Administration; neither recognized competition as a valid management tool. Both the Carter and Reagan Administrations have taken the classic Harvard Business School approach — eliminate overlap and duplication — not realizing that they thus create bureaucratic monopolies. The services are now carefully cartelizing their turf, that is, dividing up their missions to make sure that they do not compete. One classic example is that the Air Force and the Army no longer compete over the provision of close air support to troops. That has been neatly divided up so that the Air Force has its war plans, which have nothing to do with the Army's war plans, and the Army buys its own helicopters and provides its own close support.

Now for the bottom line: to what extent has the administration been able to reduce the budget, or at least keep it at reasonable levels? The answer is obvious. If you take a long term view of defense expenditures, you see they have been remarkably constant since the Korean War. If you look at a chart of expenditures in constant dollars, you will see that in constant 1983 dollars, defense budget has hovered at around $180 billion a year for all years since the Korean War, with the exception of two years during Vietnam. That level was broken by the first Carter budget, and of course the increases since then have been remarkable. We are now about $70 billion over our traditional post-Korea level of defense spending. However, let me say that a lot of that increase will probably never come to pass. There is something like an inherent equilibrium in the defense budget. Whenever an administration goes overboard one year, within two or three years an equilibrium is reestablished. I suspect we will see nothing like a 70 billion dollar increase, but that will not be for lack of trying by this administration.

Moreover, Reagan is presiding over a tremendous shrinkage of military forces, which began even before the Carter Administration. For instance, we now want to produce about 600 or 700 tanks a year for the Army, when in the early fifties we produced as many as 6,500, and mind you, we are still spending exactly the same amount in constant dollars for a tank. Also it is clear that Secretary Schlesinger's attempt to increase the size of the Air Force by buying many low-cost planes is going to be unsuccessful. The Air Force has rejected buying low-cost airplanes, and so the 20 percent increase in force structure that was planned will never come to pass. Even more remarkable is the fact that the services, in their enthusiasm for expensive electronics, have actually managed to kill the prospect of developing any new airframes. It appears that for the forseeable future we are going to do nothing but modify old airplanes with new and extraordinarily expensive electronics. We have heard a lot about a 600-ship Navy from Secretary Lehman, but if you look at the details of the choices that the Navy is making, I think simple arithmetic will show you that we will be lucky to maintain a 300-ship Navy. Therefore, I think the Reagan Administration has taken further steps towards smaller but more expensive forces.

Perhaps the worst aspect of all this is its effect on real defense capabilities. The shenanigans Reagan is playing with the defense budget have a tremendous negative impact on the staff of the Department of Defense, particularly on the uniformed people, who see this politicking with the defense budget. The people who remain in the services are the technicians and the bureaucrats, and those are exactly the kind of people that will let us down if we ever do have a war.

George Hilton—Thank you, Pierre. I confess I found that particularly illuminating because I knew virtually nothing about this.

If I may make a couple of concluding remarks — I was surprised at the extent to which we have heard adverse comments about the administration from various points of view. In going back to weapons like the B-1 bomber, which has been shown to be ineffective, it seems to me that this administration is in a literal sense a reactionary one. That is a word I never liked because it is used in a very imprecise fashion, but it seems to me apt in this case. The Reagan Administration is reacting to the lack of adequate defense spending in the past by going overboard on all kinds of procurements, no matter what the success rates of those weapons procured. This is a rather blind reactionism.

We will now take questions from the audience.

Howard Dickman, *Manhattan Institute*—Mr. Sprey, do you think you could explain a little more clearly the advantages of interservice rivalry? We are usually led to believe it is not a good thing.

Mr. Pierre Sprey—Interservice rivalry, along

"There are few Soviet weapons that work well, for in the USSR, as everywhere else, bureaucracy rarely does things well."
— Pierre Sprey

with overlap and duplication, are all excellent things. The Defense Department is so large that there are no savings to be had by centralizing most functions. Moreover, it is an organization that can fix on disastrously wrong ideas; buzzwords sweep through the Department of Defense like prairie fires. Therefore, it is better not to centralize a mission. For example, there are, fortunately, at least three different approaches to infantry in the military today; there is the Army's, the Marine Corps' and the National Guard's. All three are quite different, thank goodness, because right now the Army insists on mounting its infantry in rolling forts, which is an absolutely disastrous idea. But because we have two other approaches to infantry, not all of the U.S. infantry will be overcome by this disease.

If the Administration understood the benefits of bureaucratic competition it could use this rivalry in constructive ways. The Administration should openly say, "We have three approaches to infantry. We want to see which is best and we will reallocate funds appropriately." You can not imagine how much liveliness and innovation that kind of approach would create.

Peter Brimelow, *Barron's:*—I would like to know how all of the panelists grade this Administration relative to the Carter Administration?

George Benston—In the area of financial institutions, I would give this administration a D+ and Carter's a D−. In regard to the SEC, the rhetoric of the current Administration is good, but then again, Carter's Administration had the benefit of Dick Zecker's advice in economics, so I would rate them both D. Things could be worse, so I won't give anyone an F.

James Ramsey—The very highest I would give the current Administration in energy policy is D+ to C−, and the Carter Administration would probably get C−.

Marcus Alexis—As far as transportation regulation goes, the Carter Administration was entitled to a B+, the Reagan Administration would get a C− or a D. However Jim Miller, who is now at the Federal Trade Commission, is doing a good job.

So far I've only talked about land transportation, but regulation of water transportation is much worse. The Federal Maritime Administration under Carter deserved a D, and under Reagan, an F. Federal maritime policy is so bad that compared to what goes on there, Reece Taylor looks like a crusader for free trade.

Pierre Sprey—I think it takes a real connoisseur to see the differences between the Carter Administration and the Reagan Administration in regard to maintaining a sensible defense establishment. I do not pretend to have especially fine vision, but I would give the Carter Administration a D and the Reagan Administration a D− in defense.

Clifton Luttrell —The Reagan Administration is going to spend a lot more money on price supports and other such foolishness in agriculture than did the Carter Administration, but when you adjust for the fact that farm prices have dropped since Carter, the two administrations come out about even. I do not see any great difference between the two.

George Hilton—There are some bright spots, however, that we have not mentioned. I think something can be said for the Administration in the antitrust policy. It has accepted the overwhelming body of academic evidence that antitrust actions are counterproductive. The effort to structure industry according to an *a priori* idea instead of letting the market work is highly inefficient and the Administration has recognized that quite well. The appointment of William Baxter, who has done very good academic studies of antitrust policy, as head of the Antitrust Division of the Justice Department is a very good sign. There has been very substantial academic approbation of the handling of the AT&T and IBM cases, which have already begun to encourage more competition in intercity telecommunications and in the computer industry.

I also think Reagan deserves credit for

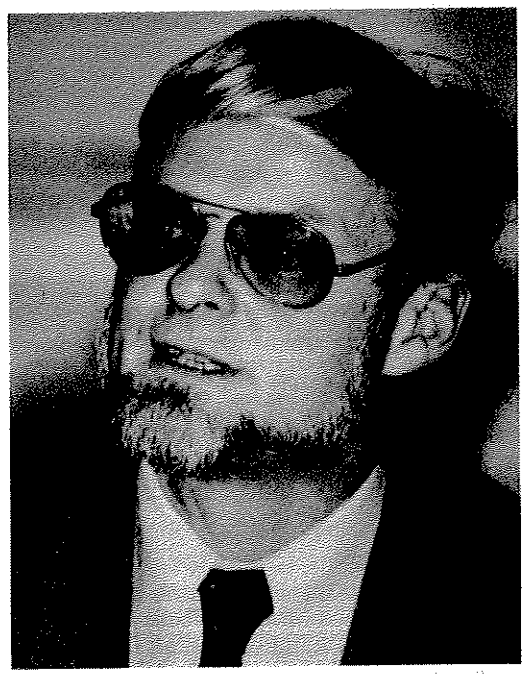

Photo by Craig Terry

James B. Ramsey, *New York University*

unobtrusively cutting the budgets of some obviously counterproductive programs. The mass-transportation programs are examples. Here in New York we are habituated to using mass transportation, but in most parts of the country it just isn't needed. The federal government has been granting operating assistance funds to the Los Angeles transit system, funds that are being used to increase the frequency buses run at off hours, to spread the system out to thinly populated areas, and similarly wasteful expenses. The Reagan Administration is cutting back in this area and I think it deserves some credit on that account.

Rudolf Hauser, *Oppenheimer & Co.*—Given the long lead times in developing new weapons and the gap that exists between us and the Soviets, what is your alternative to the inefficient weapons systems the Administration is advocating?

Mr. Sprey—You have really asked two questions. One is how to reduce lead times. The way to reduce lead times is simply to develop and procure weapons competitively. There is nothing immutable about ten-year gestation periods for weapons, but that is what it takes when you make a weapon three or five times more expensive than it needs to be and ten or twenty times more complex than it needs to be. Competitive procurement really does work and it is amazingly fast. One example is the flyoff between the A-9 and A-10 airplanes. There was only a year and a half between the signing of the contracts and the flyoff. There was another flyoff between the F-16 and F-17 airplanes, which allowed us to produce an entirely new high-performance jet fighter in two years.

Secondly, as to the alleged gap between us and the Soviets, I'd say it is rather exaggerated. I mentioned that the Soviets buy weapons the same way we do. As a result, the large majority of Soviet weapons, like the large majority of ours, are absurd. For example, the much feared T-72 tank, which is advertised as a great Soviet advance, is a disaster. After it fires a round, the gun has to be raised clear of the turret before the next round can be loaded, then the gun automatically lowers back into position. In the meantime, of course, the gunner has lost sight of his target and so has to reaim. This whole long process goes on while people are shooting at him. Moreover, the T-72 uses an automatic loader rather than a manual one, which luckily we have decided to keep in our new tanks. The automatic loader has an unfortunate tendency to feed a certain part of the gunner into the breach. An American Army officer had been quoted as saying that we believe this is how the Soviet army chorus gets its sopranos. There are very few Soviet weapons that work well, for in the USSR, as everywhere else, bureaucracy rarely does things well.

George Hilton—That concludes our discussion. My thanks to the Manhattan Institute for organizing this forum, and to all of you.

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Economic diary/Mar. 22-Mar. 26

Edited by Jane S. Shaw

March 22

On the way: Good news on producer prices

The Reagan Administration, and the American public for that matter, will be getting some more good news on inflation come Apr. 9. According to Donald Ratajczak of Georgia State University, the March producer price index, scheduled to be released then, will show only a slight 0.2% gain. Ratajczak, who has made a science out of forecasting the PPI well before the official Labor Dept. estimates are made public, notes that the only reason the index will not decline, as it did in February by 0.1%, is the absence of further price discounts for automobiles and light trucks.

So strong is the disinflation trend right now that Ratajczak is actually hedging his bet. He notes that the numbers used in his survey of petroleum prices are East Coast prices. These do not show the same kind of steep declines as those recorded in numbers the government uses, which also include the Gulf and West Coasts. Those declines may well push the index into negative territory. Ratajczak expects that the PPI for finished goods for all of 1982 will rise only 4.5%, the smallest increase in six years.

March 23

Ominous implications in a hidden deficit

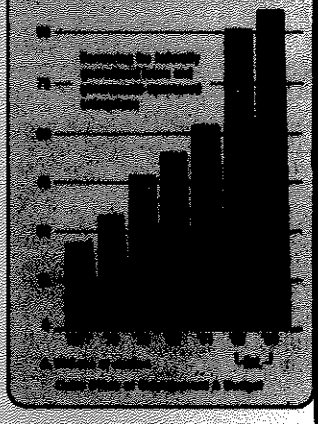
As if Wall Street and the financial markets didn't have enough to worry about with projections of a $120 billion deficit in fiscal 1983, Lawrence A. Kudlow, associate director of the Office of Management & Budget, reminded them today of an equally serious problem: the off-budget deficit. At a meeting of the New York Financial Writers' Assn., Kudlow, the OMB's chief economist, outlined the implications of indirect federal borrowing, which will rise by $[illegible] billion this year to total $90.6 billion and will reach $96.7 billion in 1983 (chart).

Off-budget financing consists of federal borrowing for government-sponsored corporations, such as the Postal Service, and for off-budget agencies, such as the Farmers' Home Administration, plus private borrowing guaranteed by the federal government, such as loans backed by the Government National Mortgage Assn. These funds, not totaled in the public budget, have been growing because they enable Congress to satisfy special interests without attracting public attention.

But Kudlow said that all this borrowing has virtually the same effect on the capital markets as does the Treasury Dept.'s borrowing to finance the budget deficit. To Kudlow, there is a causal link between the nation's gradually weakening economy and the steady rise in the government's role in the capital markets. During the 1960s, he said, the federal government absorbed a mere 15% of funds coming into the markets each year; last year it absorbed 35%.

Although Kudlow maintained that the Administration is making progress in capping that growth over the long term,

The surge in off-budget financing



he said that federal borrowing will exceed 40% of new debt this year and next. Such a forecast does not bode well for lower interest rates or a vigor-

March 24

Poor marks for Reagan in five policy areas

As federal deficits balloon, the Reagan Administration's macroeconomic policies are frequently under fire. But earlier this week the President's microeconomic policies also came under attack, and not by liberals but by conservative economists who support his goal of getting the government out of the marketplace. A panel sponsored by the free-market-oriented Manhattan Institute for Policy Research gave the Administration poor marks in five policy areas.

Marcus Alexis of Northwestern University criticized the Administration for protecting the trucking industry; Clifton B. Luttrell of the St. Louis Federal Reserve faulted it for maintaining farm production controls and price supports; James B. Ramsey of New York University deplored its failure to push for natural gas deregulation; and George Benston of the University of Rochester blamed it for stifling bank competition and for tightening securities regulation.

Perhaps the unkindest cut was dealt by Pierre Sprey, an arms consultant and proponent of stronger defense. He charged the Administration with propping up weapons companies and with maintaining cozy ties between those companies and Defense Dept. procurement officials. Political contributions from the aerospace industry, he said, "have shown up very clearly in the '83 budget as an enormous increase in procurement expenses."

March 25

From a Japanese plan, hopes for the U.S.

The persistence of high interest rates is raising doubts about the effectiveness of the Reagan Administration's current mix of big deficits and moderate money growth. But a new analysis of Japan's experience after the 1973 oil shock offers hope that this policy mix will work.

In a study by Hang-Sheng Cheng, the Federal Reserve Bank of San Francisco reports that, after prices skyrocketed, Japan managed to wring inflation out of its economy while maintaining economic growth. And this occurred despite a growing government deficit. At its height in 1978, that deficit, including both on- and off-budget items, accounted for 10% of the nation's output. In contrast, the U. S. deficit will not reach 5% of GNP this year.

The key to Japan's success, Cheng says, was monetary growth that stayed relatively steady during both the nation's 1974 recession and the recovery

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