

CAN THE CORPORATION SURVIVE? *

The corporate executive's power to make decisions affecting owners, employees, and consumers, is becoming more constrained every day. He must answer to various governmental authorities for his personnel policies — hiring, firing, promotion, wages, pensions and other compensation, unionization, etc. His financial reporting must meet the requirements of the Securities and Exchange Commission and the Federal Trade Commission. The Internal Revenue Service dictates how he must keep his accounts for their purposes. The Justice Department and Federal Trade Commission must be consulted on acquisitions and mergers. He must meet the requirements of the Occupational Safety and Health Act in his plants or places of business. His advertising and sales practices are scrutinized by the Federal Trade Commission. He must comply with an imposing array of environmental regulations (federal, state and local) dealing both with his products and his operations. He is restricted in his use of land. Sales of some products such as DDT, cyclamates and red number 2 food coloring have been banned, TV sets must have UHF tuners, automobiles must embody a long list of safety and anti-pollution devices, new drugs can be marketed only with permission of the FDA. The list of regulations confronted by a businessman today is almost endless.

Though it is only a tiny portion of the costs of regulation, the paper work required to meet the demands of the cognizant regulatory agencies is alone almost overwhelming. Some recent estimates¹ indicate that the twenty major oil companies spend approximately \$60 million per year just to meet government report requirements. Indiana Standard, for example, files 24,000 pages of reports per year with federal agencies, plus another 225,000 pages of supplementary computer output to FEA per year. Exxon last year submitted one required report of 445,000 pages to FEA.

"What else is new?" you say. The growth of government — as measured either by its expenditures or by its propensity to regulate, traces back almost to the ratification of the Constitution. During the last 200 years

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Long-time readers of our publications will find many similarities between the findings reported herein and our own research results.

¹James Carberry, "Red Tape Entangles Big Petroleum Firms in Complying With Federal Regulations," *Wall Street Journal*, September 3, 1975, p. 32.

we've managed to achieve the most spectacular growth in human welfare in history. Why can't we expect the same kind of economic growth in the future? Indeed, won't the pendulum swing back toward a reduction in the role of government? Aren't there signs of concern on the part of the public with government's size and the extent of its interventions in private affairs, which will turn things around in the future?

Our answers to those questions are all negative. We see no forces which are likely to curb the gradual encroachment of government. Moreover, we believe the era of dramatic economic growth is over; not because of new resource or technological constraints; not because we are running short of energy, we are not; not because we are confronted with environmental or ecological disaster, we are not; *but because government is destroying the individual incentives which are the well-springs of economic growth.* We see the large private corporation as one of the casualties of this process. The corporate form of organization is likely to disappear completely, but even if it survives in some form, the larger corporations as we know them are destined to be destroyed. Indeed, in a few industries we believe their demise is imminent!

Assets of these firms will not instantaneously disappear. Some firms will simply go out of business, selling off those assets which have value in other uses and abandoning those that don't. Other firms will take different organizational forms. Some will be nationalized, some will become labor managed, and many more companies (in the early stages at least) will be subjected to increased governmental control through the appointment of more "public representatives" on their boards of directors.

We raise the question of the survivability of the corporate form not because we are particularly concerned with the welfare of current stockholders, but because we believe the process which is endangering corporate survival will in the aggregate reduce human welfare and lead to a society in which the rights of individuals to decide their own fate is substantially reduced.

"Social Responsibility" and the Attack on Corporations

Large corporations today are being forced by law and by threat of law (euphemistically called social responsibility) to serve as a vehicle for effecting almost any social reform which happens to take someone's fancy — discrimination, poverty, training, safety, pollution, etc. These demands generally amount to nothing more than a requirement that the corporation bestow benefits on one group of individuals at the expense of another group.

People are often led to believe by the press, politicians, social activists, etc. that benefits or costs can be granted or imposed on "corporations". This is a brilliant fallacy, useful in championing many causes. A moment's thought, however, will convince almost anyone that since the corporation is not human (in fact, it is only a legal fiction which serves as a nexus for a very complex set of contracts between individuals), to speak of imposing costs or benefits on it is just as sensible as speaking about imposing costs or benefits on a rock or a machine. The costs and benefits which are often characterized as being imposed on the corporation are in fact imposed on the human parties to the contracts (explicit and implicit) effected through the corporation. These individuals are the owners of the corporation (stock and bond holders), consumers and labor.

In almost all cases, part of the wealth transfer implied by the various "socially responsible" actions demanded of corporations is from the owners of the corporation to the beneficiaries of the actions — women, Blacks, consumers of a clean environment, etc. Whether one judges these wealth transfers to be good or bad, desirable or undesirable, is a matter of personal value judgment which as economists and scientists, we can say nothing about. However, we can, as economists, analyze the impact such changes will have on individuals and on the corporation as an organizational form.

Corporations can, in the long run, behave in a "socially responsible" way only to a very limited extent. When it becomes clear that "socially responsible" behavior is abrogating the rights of the owners, the values of corporate ownership claims will fall (as they have) and corporations will be unable to raise new capital, or will be able to raise it only at very high costs. The costs imposed on the owners of corporations through the implementation of the notion of corporate responsibility (often accomplished through procedures which are only thinly disguised blackmail) is generally equivalent to the imposition of special taxes on those owners. At some point when the expected future cash flows to the owners are sufficiently small and sufficiently uncertain, those ownership claims will become worthless (like the value of many rent controlled apartment buildings in New York City which continue to be abandoned by their owners at record rates). In these circumstances, the corporation will be able to remain in business only to the extent that it can finance its operations out of internally generated cash flows or through financing or subsidies from the public sector. If such subsidies are forthcoming, of course they will be accompanied by additional constraints, controls and guidelines, and the end result will be either government takeover or destruction. The Penn Central Railroad is an example of the terminal stages of this process, and we discuss it in more detail below.

The Inconsistency Between Democracy and The Market System

The threat to the continued existence of the large corporation is only part of a much more pervasive issue which affects most aspects of every individual's life. This issue is the fundamental conflict between our form of political democracy and the market system. We are convinced that these two systems are incompatible with each other, and it seems only a matter of time before the political sector succeeds in eliminating much of the

private sector of the economy. We readily acknowledge that this incompatibility is inconsistent with the notion with which we have all been indoctrinated, that government is the agency which *protects* the rights of individuals, *enforces* contracts, etc.

In fact, of course, the government plays two very different roles. It does have responsibility for protecting rights, but it also has the power through legislation and through court decisions to alter individual rights. The use of this power by politicians, bureaucrats and various special interest groups to increase their own welfare at the expense of others is the basic source of the inconsistency between a political democracy as we know it, and the market system.

The Role of Contracting Rights and Rights in Property

While property rights and contracting rights play a crucial role in all our lives, we tend to take them for granted. Even economists in their analyses of the forces which determine the prices of various goods and services, often overlook the fact that what is really bought and sold in markets is not simply physical objects, but sets of rights in those objects — the right to take physical possession, the right to resell, the right to consume, the right to change the form of the object, the right to transport it, etc. It is not the price of a bushel of wheat as a physical object that is determined by the forces of supply and demand; it is the price of the set of rights which goes with "title" to wheat, i.e., the right to resell it, to grind it into flour, to take physical possession, to transport it, etc. If the bundle of rights which goes with owning wheat is changed, the value of the "wheat" changes. The same comments hold for land, (e.g., does it include mineral rights?, how is it zoned?), for buildings, for capital equipment, for radio frequencies, for money, even for the value of the services which we perform with our minds and muscle. The value of all goods is determined by the rights individuals possess in those goods.

By now, it should be clear what we mean by rights. We do not use that term in any moral or ethical sense, but simply to refer to actions which the law allows *specific* individuals (owners) to take, including writing contracts with others.

Consideration of the role of rights is particularly important in the case of financial instruments — stocks, bonds, notes, even money. Financial instruments are simply contracts. Their value depends on the rights which they confer on the owners. Generally, shares of stock give the owner a "residual" claim on the assets of the corporation — a claim on what remains after all other claimants are paid off. Bond and note holders hold claims on the assets of the corporation which are usually fixed in dollar amounts. One of the reasons the corporation is particularly vulnerable is that its very existence depends on the viability of this system of financial claims.

The Role of Government and the Revocation and Abrogation of Rights

Government plays two distinct roles in the operation of the property rights system. On the one hand it establishes the rules of the game; that is, it prescribes rules that determine which individuals have what rights. On the other hand, it acts as umpire or referee; it adjudicates disputes over which specific individuals have what rights,

and it has a responsibility to see that the rules are followed.

It is the first of these roles, the capacity of governments to change the rules, that lies at the heart of the problem which concerns us here. As the rule maker, government can and does frequently *revoke* rights, i.e., it decrees that henceforth it will not be legal for individuals to use their property, or to enter into contracts in ways which heretofore had been sanctioned. When the government decrees that new automobiles sold in the United States must meet certain safety, anti-pollution, and fuel consumption requirements, they are revoking certain rights to use assets held in the name of the owners of firms and the rights of consumers to purchase products without these devices. Price controls revoke rights in the use of money, and thereby reduce the value of money (ironically, under the guise of preventing devaluation of the money).

In addition to taking actions which revoke general classes of rights, however, the government also uses its powers to *abrogate* specific contracts between individuals. Abrogation occurs when governmental authority is used to deny without compensation the rights of individuals who are party to a contract which has been created as a consideration in an exchange. This is what the government did to the bondholders of the New York Port Authority, New York City, and the Penn Central Railroad.

Recent History of Revocation of Rights

In recent times we seem to have witnessed a major upsurge in the revocation of rights. Examples abound and we mention only a few to illustrate the form and scope of the problem.

1. The first peacetime imposition of wage and price controls in the United States in August of 1971.

2. Environmental Protection Programs:

a) Section 110A of the 1970 Clean Air Act limits the rights of landowners to develop such projects as major new shopping centers. The Act requires that such projects must file environmental impact statements and meet the requirements of regional planning boards before implementation.

b) EPA standards which banned the use of high sulfur coal in many areas, and forced many utilities to convert from coal to oil, followed by Federal Energy Agency rulings which forced many of these same utilities to reconvert from oil to coal.

3. Land use planning and control:

a) The outright prohibition of further development of the California Seashore for several years, and the current stringent limitations on building which has replaced that ban.

b) Stringent new restrictions limiting the use of lakes and land owned by individuals in the Adirondack State Park in New York.

c) The enactment of a law in Minnesota in 1973 placing all contained water in the State (lakes, potholes, marshes and even puddles) under public ownership and control.

4. The spread of rent control in metropolitan areas such as Washington, D.C., and Boston.

5. The provisions of the Occupational Safety and Health Act (OSHA) which limit the freedom of individuals to contract with employers to work under more hazardous conditions in return for higher pay.

6. Various Affirmative Action Programs of the Department of Health, Education and Welfare, which limit the employment policies of organization.

7. The recent Federal pension reform act (ERISA)

which limits the type of pension programs which firms may offer to their employees.

8. The regulation of the oil industry by the Federal Energy Administration which fixes the prices of output, and imposes production controls.

9. Finally, we have the Woodcock-Leontief National Planning Proposal which is a clever first step on the road to even more widespread governmental control of the production and purchasing decisions of individual businesses and consumers. We can be sure that the proposed "advisory plans" will not long remain advisory when business and individuals refuse to conform.

All of these rights have been revoked without compensation to any of the parties who are forced to bear the costs, whether they be owners of the land, utilities, water, rental property, etc.; employees in the industries involved; or consumers of the product. Revocation has not been treated as an eminent domain proceeding under which the state is required to compensate the property owners.

Abrogations of Contracts in the Financial Sector

Abrogation of rights like revocation is becoming more and more common, and the Penn Central Railroad provides one of the more prominent examples. The story of bankruptcy of the Penn Central Railroad is interesting for two reasons: 1) because of the role which government regulatory policies have played in bringing about the bankruptcy, and 2) because of the abrogation of the creditors' rights which occurred following the bankruptcy.

Government policies, especially those that limited the rights of the management to hire, fire and fix the compensation and terms of service of labor, to abandon uneconomic lines and services, and to establish an economic tariff structure, are the major reasons for the difficulties faced by the rail system. Despite competition from other forms of transportation, there is no doubt that there exists some set of rail lines and services which the owners could provide at prices which would cover costs. Regulation, however, has prevented the rail companies, and Penn Central in particular, from adopting this structure.

Having forced the Penn Central into bankruptcy, the government then simply abrogated the contractual rights of bondholders and other claimants. The creditors of the Penn Central were prevented by the federal government from seizing the assets of the firm; a right which they clearly had under the provisions of the indenture agreements and bankruptcy law. Meanwhile, during the period the assets were withheld from the creditors, the firm was operated by court appointed trustees who significantly eroded the value of the assets — some argue to the extent of a billion dollars or more.

Furthermore, under the plan proposed and implemented by the U.S. Railway Association (established by Congress in 1973 to develop a "rescue plan" for the Penn Central and other Eastern railroads) those assets have been transferred to Conrail in return for Conrail common and junior preferred stock, and USRA "certificates of value" (and not a cent in cash). It is unlikely that the Conrail common and junior preferred stock will ever have value (imagine the value of residual claims on the Post Office). The USRA "certificates of value" which are similar to debentures maturing in 12 years (or earlier, at the option of USRA) carry an 8% interest rate, but the base value of the certificates was set at approximately \$450 million. The final payment on the certificates will be reduced from \$450 million by the actual value of the Conrail common and junior preferred stock at the time of

the certificates' redemption. This is the total compensation offered Penn Central's creditors whose claims amounted to \$3.5 billion.

The trustees for the creditors assert that the assets of the Penn Central are worth \$7.5 billion. The approximate valuation of \$450 million placed on those assets in the government's takeover was arrived at by a procedure which can only be described as ludicrous. First, the assets were valued at their dismantled scrap value, (\$3.6 billion). It was then assumed that conversion to scrap would take place over 25 years. 50% of the estimated scrap value was deducted for the cost of the liquidation. Another \$1 billion was subtracted for the time delay in the receipt of such proceeds, and another deduction was made for payment for the Northeastern corridor, which will go to Amtrak. The \$450 million figure was what was left.

Meanwhile, the Department of Transportation stopped the trustees from paying debt service due on equipment obligations despite the special exemption provision in Section 77j of the Bankruptcy Act passed by Congress which provides that these obligations shall be enforced despite bankruptcy proceedings.² The important point in all of this is that these changes in the contractual rights have been made by the Congress and the courts without consent of the Penn Central creditors, and in violation of the agreement which they had effected with the Penn Central when the loans were made.

We predict that the implications of these actions taken by the government in the Penn Central case will be the nationalization of much of the rest of the transportation industry (including the airlines). The public utility and oil industries will not be far behind.

Why do we make these predictions? Given what is happening to financial contracts, we believe that a mortgage on a Commonwealth Edison plant is not worth much more than the paper it is printed on. In the event of bankruptcy, the political authorities will never allow the creditors to take over those assets. Furthermore, utilities are facing a serious cost-price squeeze. The costs of fuel, of dealing with regulators, of meeting environmental standards are all rising while at the same time, political resistance to price increases is becoming more intense. The combination of these forces has substantially increased the probability of bankruptcy for many of these firms.

The increased likelihood that the bond indenture agreements will not be enforced in the event of bankruptcy and the increased probability of that event, has crippled the utilities' efforts to raise capital in the private capital market, and what little they have been able to raise has been very costly. The combination of these forces will eventually produce a decline in the quality and quantity of service offered by the utilities. When blackouts and other service failures become common, consumers will be irate. The politicians and the news media will seize on this opportunity to manufacture another of their crises — this time over the failure of privately owned regulated utilities to "properly serve" the public. The result will be public financing of some form coupled eventually with a public takeover of the assets and operations of the utilities.

The New York City "Crisis" and the Abrogation of Contracts

Abrogation of contracts has been a major factor in the so-called New York City crisis. In June of 1975 the New York State Legislature enacted a law establishing the

²Richard Dicker, "U.S. Officials Blunder in Treating Creditors of Rails Adversely," *Money Manager*, February 9, 1976.

Municipal Assistance Corporation ("Big MAC"). This act arbitrarily, after the fact, and without compensation, abrogated the bond indenture covenants providing that the bond and note holders of New York City had first claim on the tax revenues of the City in the event of default. As reported in the Annual Report of the Controller of the City of New York 1974-75, Section 25.00 of the Local Finance Law specifies that revenue anticipation notes "... are issued in anticipation of the receipt of such revenues as State aid for education, local non-property taxes, etc. When these revenues are received, they must be used only for the payment of these notes as they become due." Under the law establishing "Big MAC", these revenues are now to be used first to pay for "essential services" and not as specified by the Local Finance Law.

The "moratorium" on the payment of interest on \$1.6 billion of City notes maturing from December 1975 through March 1976 is another example of abrogation of New York City contracts. Note holders were offered 8% "Big MAC" bonds maturing in July 1986 in exchange. In evaluating this offer, it is interesting to note that the formal 66 page Exchange Offer says:³

"The (MAC) Corporation has no taxing power. The bonds do not constitute an enforceable obligation, or a debt, of either the State or the City, and neither the State nor the City is liable thereon. Neither the faith and credit nor the taxing power of the City is pledged to the payment of the principal or of interest on the bonds." It is unclear to us just what the noteholders of New York City were offered which might conceivably have value.

President Ford and the Congress, however, have no trouble understanding this problem of priorities from their standpoint. Their "bailout" plan provides that first claim on city revenues goes to the Federal government. This provision was also enacted without permission of the creditors of New York City.

On a more general scale, the proposed revision of the bankruptcy laws now in Congress, which, if enacted will apply to all municipalities, involves similar abrogations of the contracts of municipal bondholders throughout the entire country. The effect of the Ford bankruptcy plan will be:

- a. give the court trustee the right to issue prior claim bonds without approval of the current bondholders;
- b. give the court trustee the right to decide municipal expenditures without bondholder approval;
- c. finally, it will reduce the position of bondholders to one of "equity holders" in the bankrupt city with no rights to control the city's management or spending or taxing policies. They are allowed to hope that there will be something left over to pay their claims.

Contrary to the hysterical predictions by city, state, and federal political authorities and echoed by most of the news media, the mere default of New York City on its bonds would not have caused much difficulty in other cities across the country. However, if the proposed revisions to the bankruptcy law are enacted, all municipalities will face a much more hostile capital market. New York State's casual treatment of its contractual obligations will not go unnoticed in the capital markets. We cannot expect investors to be willing to hold municipal securities in the future at the same interest rates as in the past.

Unfortunately, these are not isolated instances of government abrogation of contracts. On June 15, 1975, the New York and New Jersey State Legislatures repealed

³As quoted by Thornton L. O'Glove and Robert A. Olstein, "Out of the Frying Pan," *Barron's*, December 15, 1975, p.11.

the Port Authority Covenant passed by both State Legislatures in 1962 and included in all Port Authority bonds since then. This covenant forbade the Port Authority from ever financing deficit ridden mass transit systems, and it was abrogated by the two State Legislatures even though the bonds were still outstanding. Furthermore, there was no compensation made to these bondholders, and (as could be expected) the market prices of the bonds fell significantly upon repeal of the covenant.

On the purely private contracting side, we have the case of Westinghouse Electric Corporation, which has over the years made a practice of contracting with the purchasers of its nuclear plants to supply nuclear fuel. Though those contracts contained price escalator clauses, they did not allow for increases large enough to offset the dramatic increase in the cost of nuclear fuel that has occurred in the last few years. The reaction of Westinghouse was to announce that fulfilling the contracts was "commercially impracticable," and that "it is therefore legally excused from a portion of its obligations to deliver uranium."⁴ It remains to be seen whether the courts will permit Westinghouse to abrogate these contracts without awarding damages to the firms which purchased reactors.

The Impact of Revocation and Abrogation on the Value of Rights and Productive Activity

Individuals have displayed surprising ingenuity in adjusting to changes in the rules of the game in the past. Indeed, individual ingenuity lies behind the resiliency which the market place has exhibited in achieving the incredible economic progress mentioned earlier in the face of the disincentives and constraints thrown up by the political sector. But it is that same ingenuity which we believe will in the end be the undoing of the corporation. Individuals in deciding both how much wealth they will hold and the form in which they will hold it, will take into account potential returns and risk, and the same is true for trustees of pension funds, endowments, insurance funds, banks, etc. Neither individuals nor agents responsible for investment on behalf of individuals will voluntarily hold wealth in forms which promise highly uncertain and yet modest rates of return.

The value of a right to an individual depends on how transitory (or alternatively, how permanent) that right is believed to be. Tenuous rights, rights which are likely to be revoked on short notice, or abrogated when the owner attempts to enforce them, will be of little value. When potential investors become convinced that the rights of managers to use the assets of corporations in the interest of stockholders and creditors is very tenuous, or when they become convinced that the contractual rights represented by their shares, bonds, or other financial instruments are likely to be abrogated, they will simply stop investing in corporations. Mr. Richard Dicker, Vice President and General Counsel of the Equitable Life Assurance Society of the United States, put the problem very well.⁵ Referring to the abrogation of creditors' rights under Section 77j of the Bankruptcy Law that the Department of Transportation had perpetrated in the Penn Central case, he said:

"This is another example of why I have found it necessary to advise our investment people that in considering new capital investments in equipment obligations they can no longer rely on the Bankruptcy Act exemption provided for such obligations, so long as the

⁴"Sanctity of Contract?", *Barrons*, September 15, 1975, p. 7.

⁵In *Money Manager*, Vol. 5, No. 6 (February 9, 1976).

Federal Government and specifically the DOT is asserting its present proposition on this matter.

"Not only does this deter knowledgeable investors from making new investments in railroad rolling stock, but it also has the same effect upon the similar Bankruptcy Act exemption for aviation equipment. If a Federal court can be importuned by the DOT to restrain enforcement in one case, it can be done in another."

The "rule of law" or common law devotion to precedent which introduced substantial stability into the structure of rights is being abandoned by the courts and overridden by legislative action in the passing of statutory law. We are much less certain that any contract we enter into now, or investment we might make, or property we might buy, will be subject to the same rules and regulations in the future.

Uncertainty in the structure of rights or in the "rules of the game" substantially changes both peoples' behavior and the use of resources. In particular, it significantly reduces private investment in the kind of long term projects which have played such an important role in determining our standard of living. It is very difficult to observe these effects because they primarily involve actions not taken, that is projects not undertaken, buildings not built, etc., and are not the stuff of which newspaper headlines are made. Nevertheless we believe their impact is substantial. The low standard of living in South America and other underdeveloped countries is due we believe in large part to the uncertainties in contract and property rights induced by the tremendous instabilities of the political system — uncertainties and instabilities brought on by revolutions, nationalizations, imposition of exchange controls, wage and price controls, etc.

We believe that the remarkably poor performance of the stock market over the past decade is due in substantial part to the fact that the concentration of wealth in large publicly held corporations is particularly susceptible to expropriation through changes in the legal, political and regulatory climate. The total real return on the S & P 500 (adjusted for inflation) over the period 1965-1975 was -20%. For the decade 1964-1974 it was -31%. Since 1926, no other 10-year period has shown such low returns as these two, even including those of the great depression and market crash in the 1930's. The real rate of return on all common stocks on the NYSE from 1926 to 1965 was about 7.2% per year. If stocks had risen in price enough in the period 1965-1975 to provide investors with this same average inflation adjusted return, the Dow Jones Index would have ended 1975 at a level of about 2,400 instead of 900. A. F. Ehrbar reported recently⁶ that the inflation adjusted total market value of publicly held companies in the U.S. fell by \$388 billion over the 10-year period 1965-1975 or almost 50% of its value. These facts are difficult to explain, because unlike the 1930's we did not experience a major collapse in the economy during this period.

We expect the effect of the erosion of private rights to show up first as a reduction in the capitalized values of the claims on assets of firms. The decline in capital values reflects investors' anticipations of reduced cash flows and increased risk. What has happened to equity values in the last decade is thus consistent with the hypothesis that private rights are deteriorating at an increasing rate. The fact that the prices of assets which are far less susceptible to "theft" by the political sector (such as gold, silver, other precious metals and art) have increased substantially over the same period provides additional evidence consistent with our hypothesis.

⁶*Fortune Magazine* (February, 1976), p. 59.

Human Rights vs. Property Rights and Why Government Authorities Attack the Private Rights System

Understanding the nature of private rights and the role of government in the system of rights is crucial to understanding why private rights are being gradually whittled away, and why we see no stabilization or reversal of that trend. In this connection, it is worth pointing out another brilliant fallacy, namely, the false distinction between so-called "human rights" and "property rights." *All rights* are, of course, human rights; there can be no other kind. Those who use this distinction are simply resorting to a clever semantic ploy. They are fabricating a conflict between one kind of rights ("human") which are "good" and another kind of rights ("property") which are "bad". Since all rights are human rights, the only possible conflict is between individuals, i.e., conflict over which individual will have what rights.

Moreover, participants in the government sector, politicians, and bureaucrats, are as individuals no different from the rest of us. They prefer more rights to less; and they have the same incentive as the rest of us to expand the set of rights from which they benefit. It is the latter fact that lies at the bottom of the conflict between political democracy and the market system.

As individuals, of course, government authorities cannot literally acquire title to assets like those of the Penn Central, even if the government takes over the assets. But it is not necessary for them to have full title to assets in order to capture for themselves some of the benefits derived from the use of those assets. The more readily they can control the use of the assets, the more opportunity they have to ensure that they get some benefits, and the benefits need not come to them directly. Bureaucrats and politicians can and do use their positions in government to bestow benefits on others, but they do so in exchange for votes, for campaign funds, for favors, for job offers, etc., all of which yield benefits indirectly.

Individuals who have rights benefit from stability in those rights. The more confident owners are that they will be able to retain rights, the more valuable those rights will be. If it is easy for government officials to alter rights, or if the government structure itself is very unstable, as it has been in many countries, rights will have little value.

If one looks at the other side of that coin, however, stability in private rights is by its very nature a constraint on what government (i.e., bureaucrats and politicians) can do! The more difficult it is to enact laws, issue administrative rules and regulations, or make court decisions which revoke or abrogate individual rights, the more restricted is the domain of the bureaucrat and politician. To the extent that government's power to revoke or abrogate rights is limited, the market for the services of individuals in government is limited.

Revocation and abrogation of rights is the currency in which politicians and bureaucrats deal. Like all of us, they are constantly searching for ways to expand the market for their services. To do so, they must effectively break down the system of private rights because it limits their market. Our individual interest in having rights which are immutable, is in direct conflict with the interest of bureaucrats and politicians who want to be able to alter rights at will.

Why the Political Sector Will Be the Ultimate Victor

There are two sorts of constraints that potentially could limit the efforts of government authorities to

dismember the private rights system. One of these is simply the Constitution. The original framers of the Constitution clearly understood the temptation which always confronts those who exercise the power to change the rules of the game. They tried very hard to limit what government authorities could do to private rights. In Section 10 of Article I, for example, they provided that, "No State shall make any law impairing the obligation of contracts," and in Article V they provided that, "No person shall be deprived of life, liberty or property without due process of law, nor shall private property be taken for public use, without just compensation."

Whatever the Constitution says, however, the evidence suggests it is useless to rely on the courts to check either the abrogation or revocation erosion process. While a final judgement cannot be rendered yet, the courts have done nothing to deter any of the abrogations discussed above. The mere fact that the legislatures of New York and New Jersey have openly enacted laws which clearly violate the provisions of Section 10, Article I of the Constitution says something about what the legislatures think the courts will do, and therefore what we can expect from the courts on this front.

The picture is, if anything, much worse when it comes to revocation of rights. The courts have consistently upheld the power of Congress, the Administration, and regulatory authorities to promulgate almost any regulation they happen to fancy, no matter what the consequences in terms of revocation of private rights. Indeed, the courts have in recent years often taken the lead in making new laws which consistently have *revoked* previously extant private rights, especially, in the so-called "Civil Rights" arena (another semantic ploy). The truth is there is little, if any, remaining Constitutional protection of private rights against governmental attack.

In the absence of Constitutional constraints, Congress, the Administration, regulatory bodies, the bureaucracy, state legislatures, etc., are constrained only by the electorate itself. We are left with the question of whether it is possible to elect a set of public officials who will not succumb to the temptation to enlarge the market for their services at the expense of private rights. We believe that this is impossible.

The basic problem is that as individuals we can all make ourselves better off in two major ways:

1. By expending time and other resources operating in the private sector to produce goods and services (be they art, automobiles, film or education) which other people wish to buy, and
2. By expending time and other resources operating in the political sector to get the rulemaker (i.e., the government) to change the rules of the game to reallocate wealth from others in society to ourselves.

In our production activities, we generally make other people better off (otherwise they wouldn't engage in voluntary exchange with us). In our political or rule changing activities, we generally make other people worse off and for two reasons:

1. The direct effects of the wealth transfers, and
2. The indirect effects caused by the reduced incentive to produce; income taxes, production restrictions such as are common in agriculture, licensing restrictions which prevent entry into various professions and markets, and the attenuation of property rights caused by significantly increased uncertainty over what the future rules of the game will be are some examples. These latter effects, the effects on production, are by far the most important source of reductions in our welfare

and in the long run they amount to killing the goose that laid the golden egg.

Even if we all recognize that we are in the long run making ourselves worse off as a society by appealing to the political system for individual largess, we cannot stop the process. The reason is, we cannot as an electorate, effectively agree among ourselves not to appeal to government for individual favors. It always pays some of us to form special interest groups in order to get favorable consideration. This in turn plays directly into the hands of public officials anxious to enhance their roles in society. Once some special interest groups succeed in their efforts, other groups inevitably are formed to press the cause of their members.

Politicians as Entrepreneurs

It is important to understand that politicians do not act as passive bystanders in all of this. Successful politicians are entrepreneurs, just like successful businessmen, and successful academics. They are constantly at work marketing their product. One of the most effective tactics they can use is to manufacture and promote various crises and then magnanimously come to our rescue. This is why they engage in the rhetoric of crisis —the energy crisis, the environmental crisis, the food crisis, the New York City crisis, the population crisis, the consumerism crisis, the multi-national corporation crisis, the unemployment crisis, etc., etc.

The creation of crises is, of course, an old political strategem. 180 years ago, James Madison described it as:

“The old trick of turning every contingency into a resource for accumulating force in the government.” In their marketing campaigns designed to create crises, politicians and bureaucrats have an enormous advantage because of their access to the press and the media. Furthermore, the fact that crises sell newspapers and attract TV viewers results in a natural alliance between the political sector and the mass media which does not exist for the corporate sector.

Corporations are a particularly vulnerable target for the marketing campaigns of politicians, and this is not simply a matter of identifying the behavior of corporate executives with self-interest and exploitation in contrast to the asserted “public interest” motivation of politicians. Corporations represent large visible blocks of wealth. Corporate stockholders and creditors are a widely dispersed and incohesive group. The financial claims on the assets of corporations are often intermediaries — banks, insurance companies, pension funds, college endowments, etc. — so that many of the beneficiaries (depositors, insured individuals, students, etc.) are not even aware that they are the beneficiaries. Moreover, the market for these claims is both volatile and complex, so that even if the “owners” are aware of their ownership, they cannot easily identify any decline in the value of their claims with the actions of government. Only a naive view of the behavior of politicians would lead anyone to believe that they would pass up this obvious opportunity to use the corporation as a pawn in expanding their own power.

In the early 1930's the famous economist Henry Simons correctly foresaw the trend toward organized interest groups and its implications for the future. The trade union movement of the 1930's provided the motivating force for his concerns. Speaking about this trend he said:

“The petty warfare of competition within groups can be kept on such a level that it protects and actually

promotes the general welfare. The warfare among organized economic groups, on the other hand, is unlikely to be more controllable or less destructive than warfare among nations. Indeed, democratic governments would have hardly so good a chance of arbitrating these conflicts tolerably as have the League of Nations and the World Court in their field.

“Suppression of the competitive struggle within economic groups, and their organization into collective fighting units, will create conditions such that only ruthless dictatorship can maintain the degree of order necessary to survival of the population in an economy of intricate division of labor. Under these circumstances the distribution of power among nations is likely, by the way, to be altered drastically in favor of those people best disciplined to submission and least contaminated with dangerous notions about the rights of man. . . .

“It seems nowise fantastic, indeed, to suggest that present developments point toward a historic era which will bear close resemblance at many points to the early Middle Ages. . . . With the disappearance of free trade within national areas will come endless, destructive conflict among organized economic groups — which should suffice, without assistance from international wars, for the destruction of Western civilization and its institutional heritage.”⁷

The Pitfalls of Evaluation of Individual Programs

By now it will surely have occurred to the critical reader that we have not addressed the question of whether some of these government regulatory activities or programs are on balance desirable. Don't any of them do more good than harm? Our neglect of that issue is not accidental. We believe that focusing on costs and benefits of government in the small is a pitfall. It prevents us from seeing the forest for the trees.

Government officials neither advocate nor use the net benefits criterion as a basis for their decisions. There is no survival test in the political arena which induces politicians and bureaucrats to enact only those programs or take only those actions for which the benefits exceed the cost. It is in their interest to expand the demand for their services through expanding their power in any way they can, and we cannot expect them to limit that expansion only to acts which yield net benefits to society.

To assess the consequences of government one must look at the total picture in the context of how the political system actually functions, rather than at individual programs in the context of some hypothetical or wishful notion about how the political system might operate. It is our judgment that regulatory programs which confer benefits in excess of costs are few and far between; indeed, we know of no major program for which a strong case could be made. Furthermore, when we look at the total of such activity, the case appears to us to be overwhelmingly negative. If the total effect is negative, and if that result is inherent in our political system, it is not much consolation to know that sometimes individual programs may on balance yield benefits.

One cost which gets neglected when we focus on individual decisions or individual regulatory programs rather than on the total impact of all such programs is the cost of the threat to property rights and contract rights induced by

⁷Henry Simons, “A Positive Program for Laissez Faire: Some Positive Proposals for a Liberal Economic Society,” in *Economic Policy for a Free Society* (University of Chicago Press: Chicago, Illinois, 1948).

the revocations and abrogations which accompany every governmental program. Individuals, in deciding how they will invest their wealth, and how they will allocate their labor will form expectations about the likelihood of expropriation based on what they observe happening to others throughout the system. As revocation and abrogation becomes more common, individuals will forego socially desirable investment opportunities because of the threat to their property rights. These foregone opportunities are difficult to perceive because they take the form of buildings not built, new machines not procured, new products delayed, etc., and therefore they are generally not even considered in evaluating the consequences of government actions.

In this same vein, implementation of the programs mentioned above tends to have a special bias in the wealth transfers it brings about. When new regulatory programs are implemented, it is generally assumed that present right holders should not be compensated for the costs they will incur as a result of the loss of their rights. That is, it is generally assumed that the establishment of the desirability of a particular program (by whatever criterion) is sufficient to justify the expropriation of the wealth of the current right holders. The extreme case is the environmental programs where those who want a pristine California shoreline, untouched wilderness areas, reduced use of pesticides, airports moved elsewhere, etc. are never required to bear the costs of their choices, even if, in fact, they would be willing to pay enough to reimburse those who lose. The bulk of the costs in these cases is usually imposed on property owners who have their rights in land constrained.

The mere fact that individual programs might yield net benefits is not a justification for imposing the costs of such programs on present owners of rights in the effected resources. Indeed, much could be said for the reverse. We are much more likely to restrict government officials to actions which do yield net benefits if the beneficiaries are required to compensate the losers. Such compensation would also eliminate the costs imposed on society at large emanating from the misallocation of resources induced by the revocation and abrogation of rights.

The Future

Given the incentives which government officials have to undermine the private rights system, and given the way

representative government functions, we see little reason to believe that the trend toward more and more government will be arrested. In particular, the process cannot be checked by electing the "right" people to office. Only a radical change of some sort in the basic structure of our political institutions could at this point alter the course of events, and it is hard to imagine how such a radical change could ever be brought about.

The private corporation has been an enormously productive social invention, but it is on the way to being destroyed. Large corporations will become more like Conrail, Amtrak and the Post Office. One scenario seems clear. It begins with the creation of a crisis by the politicians and the media. In some cases the crisis will be blamed on the "bad" things corporations do or might do, e.g., the multinationals. In any case, the remedy will be more and more controls on the corporations (something like what has been happening in the transportation and oil industries). When the controls endanger the financial structure of the corporations they will be subsidized by the public sector at the cost of more controls. When the controls bring the industry to the brink of collapse the government will take over. The details of the scenario will no doubt vary. Moreover, some firms will simply be driven out of business because of regulatory costs and the inability to raise capital.

There will be more "public" directors on the board of large corporations.

There will be increasing involvement of labor in the control and management of corporations. In West Germany corporations are now required to have labor union representatives on their boards of directors.

Although we believe the probability that our forecasts will be realized is high, it is not one. Indeed, we hope that bringing the problem to the attention of the public will generate a solution. Moreover, even if our predictions are realized, it won't happen tomorrow, and it won't mean the end of humanity. It will only mean that we will be much poorer and much less free.

Humanity has survived in various states of tyranny for thousands of years — one might even say this is the natural state of affairs for man. Future historians may look back and see the period from 1776 to 1976 as a brief 200-year accident in the history of man in which real freedoms existed for all.

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