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William E. Simon

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REBUTTAL: CREDIT ALLOCATION: PANACEA OR PROBLEM?†

*William E. Simon**

I. Introduction

In the December 1975 issue of this journal, Professor Lewis D. Solomon and Mr. Irv Belzer presented a well-documented survey article dealing with the huge capital needs in the United States over the next decade or so.[1] In the course of their article, the authors recommended that the government allocate credit to meet these needs citing as precedent such activities as the RFC in the 1930's and the experience with planning and credit allocation in other countries.[2] Their sole caveat was that political influences in the allocating process must be minimized. This policy prescription not only is lacking in economic substance but is also naïve regarding the political processes in our country. The recommendation assumes that the market credit allocating mechanism cannot do the job and, more importantly, that allocating scarce credit by a government board or agency can meet the task. I disagree with both propositions. Government interference in the marketplace, no matter how well-intentioned, leads to inefficiencies and higher costs. To justify such a scheme the resulting benefits must be greater than the costs; a contention I hope to prove fallacious.

II. The Problem and Some Ways to Deal With It

A variety of economic studies have pointed to the need to devote more of our country's output to the capital sector of our economy—so that we can meet the needs of a growing labor force, raise real standards of living for the American people, help preserve the integrity of our environment, provide for safer working conditions and achieve a greater degree of energy self-sufficiency.[3] All of these cost money, and the consensus forecast implies a rise in the business fixed investment share of Gross National Product (GNP), from the historic rate of about 10½% to around 11½% or possibly even 12% depending on the study cited.

† The *Notre Dame Lawyer* always welcomes the opportunity to publish pieces *responding* to articles or commentaries previously presented to our readers. Publication of this rebuttal, however, does not represent an endorsement by the *Lawyer* of Secretary Simon's views. Indeed, the ideas expressed in both commentaries are those of the authors and not necessarily those of the *Lawyer* or of the Editorial Board.—*Ed.*

* The Secretary of the Treasury for the United States of America.

1 Solomon & Belzer, *Looking Ahead: Capital Shortages, Tax Policy, and Economic Planning*, 51 NOTRE DAME LAWYER 251 (1975).

2 *Id.* at 278-85.

3 B. BOSWORTH, J. S. DUESENBERRY, & A. S. CARRON, CAPITAL NEEDS IN THE SEVENTIES (1975); CHASE ECONOMETRICS, THE NEXT TEN YEARS: INFLATION, RECESSION AND CAPITAL SHORTAGE (1975); G. FORD, ECONOMIC REPORT OF THE PRESIDENT 39-47 (1976); B.M. Friedman, Financing the Next Five Years of Fixed Investment, *Hearings before the Committee on Ways and Means of the House of Representatives*, 94th Cong., 1st Sess., at 710-26 (1975); K. H. Jones, Capital Requirements of Business, 1974-75, *Hearings Before the Subcommittee on Economic Growth, Joint Economic Committee* 93d Cong., 1st Sess. (May 8, 1974); DATA RESOURCES, INC., SPECIAL STUDY: THE CAPITAL SHORTAGE (1975); NEW YORK STOCK EXCHANGE, THE CAPITAL NEEDS AND SAVINGS POTENTIAL OF THE U.S. ECONOMY: PROJECTIONS THOUGH 1985 (1974).

While this may sound like a modest increase, historically it represents a pronounced shift in the distribution of United States output.

To meet the need, there must be an incentive to build the new factories and to equip them, as well as a reasonable prospect that the financial wherewithal will be available to facilitate such an expansion in our productive facilities. Professor Solomon and Mr. Belzer perceive the latter issue as beyond the scope of our capital markets. I do not agree and herein lies the sharp divergence in our views of appropriate public policy.

The process of credit allocation when relying on the market mechanism is straightforward (and more completely and professionally discussed in the following sources[4]). Credit will flow to those areas willing to pay the highest rate on a risk-adjusted basis. The willingness of prospective borrowers to incur the fixed obligations of debt depends directly upon the sales and profits prospects of the product or service being produced. This in turn depends on the willingness of the millions of potential consumers to pay the price. In short, this diffuse and impartial system of credit allocation ultimately depends on the desires of consumers for the goods or services being produced. The system matches in an efficient and systematic way the wishes of millions of consumers with the willingness of millions of businesses and workers to produce those goods or services.

Will this process, though, channel credit to those areas most in need in the potential capital problem ahead? The answer is that it will. Credit will be allocated to those areas where prospects are most promising (taking account of risk) in direct reflection of people's wants.

Accordingly, the rationale for taking such a process out of the market system and putting it into the hands of a government agency rests on the premise that either the mechanism cannot function as envisioned (no evidence for this view was cited) or else that the collective will of the people somehow does not represent what is socially good for the people (whatever that means). In other words, it is implied that someone or some group has a better grasp of what is in the best interests of the people than the people themselves have.

For some ill-defined reasons, the economic criteria of cost, benefit, efficiency *et cetera* within our democratic processes and reflected in our market system are inadequate to the task. Therefore, some other criteria must be relevant, only what they are, is uncertain.

III. Vague Criteria of Allocation by Government

Who is to decide what areas and which businesses are worthy of credit, and what criteria will be applied if not market criteria? Specifically, who decides whether a swimming pool in the inner city is worth more to our society than several new homes in the suburbs or a small factory in the solar energy field located in the Southwest? Moreover, it is doubtful that this government credit allocation process will be any different than deciding where a new post office or

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4 M. E. POLAKOFF, FINANCIAL INSTITUTIONS AND MARKETS (1970); R. I. ROBINSON & D. WRIGHTMAN, FINANCIAL MARKETS: THE ACCUMULATION AND ALLOCATION OF WEALTH (1974); J. C. VAN HORNE, FUNCTION AND ANALYSIS OF CAPITAL MARKET RATES (1970).

military base is to be located; decisions often plagued with political pressures.

What has the government's actual record been on such schemes? Should and can the government decide the hundreds of thousands of credit and economic decisions? And the fact that the government already affects such credit markets is no excuse to justify even more interference. Indeed, there is sentiment that just the opposite is true. This is a problem that needs hard economic analysis and not simplistic sloganeering or a blind faith in benevolent government.

Rather than belaboring the virtues of the free market (or even the real world one that is not textbook perfect) let me offer a typical illustration of where the government has directly influenced the operations of an industry and why credit rationing schemes could well follow the same pattern. The clear intent in establishing the agency was to improve the operations of the industry concerned so that consumers would get better products and even lower prices. But the sad reality is that exactly the opposite has occurred and without (to my knowledge) any of the taints of either corruption or undue political influence that Professor Solomon and Mr. Belzer admit might be a problem in such a credit scheme. I fear that credit allocation by government will not lead to the most "deserving" getting their needed funds but rather will ultimately lead to higher costs and a less than optimal use of scarce resources so that our whole society will suffer.

A. An Example: The Interstate Commerce Commission

One of the oldest regulatory agencies in the United States is the Interstate Commerce Commission (ICC), established in 1887.[5] It controls the surface interstate movement of goods by regulating railroads, trucking companies, bus lines, water carriers, oil pipelines and a host of other transportation functions. Its primary purpose supposedly is to assure safe, economical and dependable transportation to the American public, yet the actual record is distressing in this respect.[6] For example, rail rates were frequently kept unnecessarily high for many years (to protect water carriers) and many miles of rail lines were deliberately kept in service despite the fact that there was no longer sufficient traffic to cover even out-of-pocket expenses. The whole purpose of such regulations ostensibly was to assure a broad range of alternative modes of transportation, but in the end they greatly contributed to the near bankruptcy of railroads and ultimately raised the cost of services to our people. By thwarting sensible economic responses such a regulatory body only created even more serious long-run problems. (The same thing is happening today in the regulation of natural gas.[7])

5 Interstate Commerce Commission Act, 24 Stat. 379-83 (1887), presently codified in 49 U.S.C. §§ 1-22 (1970).

6 R. Fellmeth, The Interstate Commerce Commission (1970).

7 The Natural Gas Act of 1938, 15 U.S.C. §§ 717 *et seq.* (1970), authorizes the Federal Power Commission to regulate the sale and transportation of natural gas in interstate commerce. (For the reasons behind such regulation see Note, *Legislative History of the Natural Gas Act,* 44 Geo. L. Rev. 695 (1956). Five independent studies, some using totally different analytical frameworks, have concluded that although prices would be higher in the absence of FPC regulation, the supply of natural gas would be significantly larger. E. Mitchell, U.S. Energy Policy: A Primer, 69 (1974). In fact, this was the conclusion reached by a study prepared for the FPC. Khazzoom, *The FPC Staff's Econometric Model of Natural Gas Supply in the United States,* 2 Bell J. Econ. & Mang. Sci. (1971). Several authors have cited FPC regulation as a chief cause of the natural gas shortage and the misallocation of present supplies. R.

Or suppose for a moment that a person living in Chicago borrowed some money to start a small trucking business to carry freight to Cleveland, Ohio. Should he rush out and invest in a few trucks? No, the first thing he must do is file a request with the ICC. That will cost about $350 in filing fees, plus the expenses of a private lawyer. Furthermore, the request will almost inevitably lead to legal hearings and the person will have to prove that existing service to Cleveland is inadequate and that existing carriers cannot be made to provide it. The average request now takes 10 months to process and some have been known to take over three years. Protests by existing carriers often lead the ICC to give only restricted approval to requests from new carriers and, especially along well-traveled routes, to deny many requests altogether.

If the person waits it out and obtains approval, he may decide that the best way to get an advantage on competitors is to reduce the prices charged to customers. But no, such proposed rate reductions will probably be protested by other carriers and then suspended by the ICC. In effect, the government will force the person to charge higher prices, even though he could afford to charge lower ones.

Nonetheless, even with the higher rates suppose he wins a few customers with exceptionally good service, and new customers appear, asking that he carry their goods from Cleveland back to Chicago. Sorry, the ICC won't allow it unless the original certificate specifically authorizes the person to carry those products on the backhaul to Chicago. The ICC requires instead that the person drives back to Chicago with an empty truck—a practice that is still too frequent in a day of growing energy shortages. Despite all of these problems, the person perseveres and customers soon want him to carry their goods not only to Cleveland but also downstate to Columbus, Ohio. Unfortunately, the ICC certificate says he can only go between Chicago and Cleveland; to drive to Columbus, he will have to get a new certificate, and that means starting the whole process over again.

While it is easy to exaggerate the complexities and frustrations of dealing with a government bureaucracy, the above description is a typical occurrence. I only hope that the new credit allocation bureau responds more promptly and sensibly or else many worthy investments simply will not occur.[8]

HELMS, NATURAL GAS REGULATION (1974); MACAVORY & BREYER, THE NATURAL GAS SHORTAGE AND THE REGULATION OF NATURAL GAS PRODUCERS, 86 HARV. L. REV. 941 (1973); P. STARETT, THE NATURAL GAS SHORTAGE AND THE CONGRESS (1974). A collection of essays considering the pros and cons of regulation is K. BROWN (ed.), REGULATION OF THE NATURAL GAS PRODUCING INDUSTRY (1970). *See generally,* Burck, *The FPC Is Backing Away from the Wellhead,* FORTUNE 108 (Nov. 1972); Douglas, *The Case for the Consumer of Natural Gas,* 44 GEO. L. J. 566 (1956) (supporting regulation); P. MACAVORY, PRICE FORMATION IN THE NATURAL GAS FIELDS (1962); Mays, *Federal Power Commission Allocation of Natural Gas Supply Shortage: Prorating, Priorities, and Perplexities,* 20 ROCKY MT. M. L. INST. 301 (1975); E. NUENER, THE NATURAL GAS INDUSTRY (1960).

For an insight into the legal problems involved in the regulation of the natural gas producing industry, see Swift, *Federal Power Commission Regulation of Interstate Sales by Independent Natural Gas Producers,* 10 S. TEX. L. J. 186 (1968), and Comment, 53 N.C.L. REV. 765 (1975).

8 For a more thorough discussion concerning the relative merits of ICC regulation, see Doyle, *Present Furor Over Regulation,* 38 ICC PRAC. 909 (1971), and FELLMETH, *supra* note 6. As to the general problem of government regulation, see Baker, *Competition and Regulation: Charles River Recrossed,* 60 CORN. L. REV. 159 (1975).

IV. The True Cost of Allocating Credit

The call to socially allocate capital in this country is unquestionably gaining momentum. Special interest groups and politicians see "government banks," "government guarantees" and other devices as a panacea to solve many ills. The logic is simple. By borrowing from the federal government or by using its guarantee or by its allocating credit, you avail yourself of capital which otherwise might not be available in the marketplace or which would be available only at significantly higher interest rates.

Proponents of these schemes will even claim that the federal government gains because it receives a higher rate on its loan than it pays for the money or, in the case of a guarantee, a fee. We know that special areas such as housing or business investment can gain if they are a direct recipient of this allocation of capital. In fact, seemingly everyone gains and no one loses.

But is there really no cost? Can you socially allocate capital to one cause and then another without someone being worse off? No, you cannot—there is a cost. The parties *not* favored in the social allocation formula suffer relatively—that is the cost of channeling savings. Society will not receive the benefits of the goods they would produce had they received the credit.

Furthermore, our nation's financial markets become less efficient from such a process—which, in turn, hurts us all. Also, subsidized credit or guarantees imply direct budget costs which must be paid for with higher taxes or else there is a bigger deficit which is counterproductive since it absorbs the savings needed for capital in the first place. In short, there are very real costs of allocating capital by government, and unless we recognize this fact, we will soon reach the point where what's at stake is no longer the proverbial division of the eggs, but the salvation of the goose.

V. Conclusion

Will a government agency which reallocates the flow of credit do a better job of channeling funds than our existing credit and capital markets? I think not. There are too many examples in government where the original goals are too readily subverted, and there are too many costs not easily perceived. HUD was established to help low and moderate income families get reasonably priced housing[9] and yet its major accomplishment has been to become the biggest slumlord in the world. The FEA[10] is supposed to help us acquire a reasonable degree of energy self-sufficiency and to conserve energy, and yet its policies are moving us in exactly the opposite direction as prices are held at artificially low

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9 Department of Housing and Urban Development Act, 42 U.S.C. § 3531 (1970). With respect to the general problem of financing public housing, see F. deLeeuw, Operating Costs in Public Housing: A Financial Crisis (1970).

10 Federal Energy Administration Act of 1974, Pub. L. 93-275, 88 Stat. 96 (May 7, 1974). The FEA's decisions are of great significance to American industry. *See generally,* Panel Discussion, *The Implications of Long-Term National Energy Policy Alternatives for American Business Law,* Bus. Lawyer 539 (1975).

levels. The list could go on—the CAB and airlines,[11] OSHA and health,[12] EPA and clean environment,[13] *et cetera.*[14] But the overwhelming evidence in case after case is that such government decisions reshaping market flows have not worked well and have often been costly, if not counterproductive.[15]

Furthermore, to allocate credit is to make decisions in growth, output, industry size, geographic income, and other choices for our society which corresponds to a de facto form of planning. Which industries deserve the credit to grow? Which areas are worthy of credit? What goods should be produced for our people? What things should our people be permitted to have? (If credit is given to a firm to make extra shoes, I only hope that enough extra credit is extended to the industry making shoe laces.) Shortfalls and divergences from plans become difficult to correct and can all too readily lead to government suggestions, then orders and ultimately to a fair degree of coercion on what to produce and consume. The implicit threat to personal liberties of such a process is frightening.

The capital problem our country faces ahead is serious but manageable. The credit flows related to these problems are enormous but capable of resolution with balanced government policies involving only limited interference. The efficient channeling of these flows can be handled by our financial structure and certainly does not warrant the establishment of an extensive government agency or board. Our market system may not be perfect but it is relatively impartial, possesses a reasonable dispersion of economic power and greatly minimizes the potential inefficiencies, costs, political pressures, and loss of freedom inherent in establishing another very powerful government bureaucracy.

In summary, it is important to recognize, if we do not already, that the cries for the social allocation of capital such as those from Professor Solomon and Mr. Belzer[16] are increasing. The political appeal seems irresistible—there apparently is no cost, or at least the cost is so hidden as to be illusive. We all want to do what is socially right with respect to our cities, pollution, the less fortunate, our

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11 *See* Hector, *Problems of the CAB and the Independent Regulatory Commissions,* 69 YALE L. J. 931 (1960).

12 Occupational Safety and Health Act of 1970, Pub. L. 91-596, 84. Stat. 1590 (Dec. 24, 1970) (codified in scattered sections of titles 5, 15, 18, 29, 42, and 49 U.S.C. (1970)). *See generally,* Moran, *The Legal Process for Enforcement of the Occupational Safety and Health Act of 1970,* 9 GONZAGA L. REV. 349 (1974); Oldham, *OSHA May Not Work in "Imminent Danger" Cases,* 60 A.B.A.J. 690 (1974).

13 *See* Sax, *The (Unhappy) Truth About NEPA,* 26 OKLA. L. REV. 239 (1973). *See generally,* Murphy, *The National Environmental Policy Act and the Licensing Process: Magna Carta or Agency Coup de Grace?,* 72 COLUM. L. REV. 963 (1972).

14 There is a growing skepticism toward government regulation and regulatory agencies. *See* M. KOHLMEIR JR., THE REGULATORS 290 (1969); H. SEIDMAN, POLITICS, POSITION, AND POWER 224 (1970).

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> [S]ome of the defects of regulation are inherent in its very nature. . . . Regulation does not prescribe the quality of service or require innovation. . . . It does not induce efficiency; it offers no incentive to good administration, imposes no penalty on incompetence. It comes to serve the interests of the regulated industries. It is backward-looking, slow to adapt to change. It expands controls when it could contract them. It exercises power without accepting responsibility. Its operations are cumbersome and costly, its decisions are made only after long delays.

C. WILCOX, PUBLIC POLICIES TOWARD BUSINESS 815 (4th ed. 1971).

16 Solomon & Belzer, *supra* note 1, at 274-86.

future capital needs or what have you. But there is a cost—though it is not readily apparent.

As a result, hard decisions are necessary in judging the benefits of a plan to socially allocate capital in relation to the "opportunity cost" to taxpayers, to other borrowers, and to savers. It is paramount that these costs be recognized and the actual operations of a government bureaucracy be evaluated before a decision is made. In that old vernacular, "there is no such thing as a free lunch," and that principle has retained validity in market-oriented solutions to these problems.