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Interest Groups and the United States Economy

The effects of interest groups are not always readily visible because extensive, deliberate efforts are made to conceal them. That is not surprising, as typically the efforts of interest groups are dedicated to satisfying the few at the expense of the many. But there is one area in which the cumulative effects of special interests are highly visible—the tax code. The Federal Tax Code runs to more than one thousand, tightly packed pages. The *Dictionary of 1040 Deductions for 1982* lists over eighteen hundred exclusions, exemptions, deductions, and credits. As a result, an estimated *half* of all personal income escapes federal income taxation.

Interest groups undermine the tax code. Practically all of the loopholes represent concessions made to one interest group or another. The tax breaks for various categories of individuals (from veterans to United States citizens working overseas) in tax year 1984 are estimated to amount to \$203.5 billion; those for investors, business owners, and farmers, an additional \$35.6 billion; and for corporations, a further \$67.9 billion. All breaks total \$327.5 billion. This is 299 percent higher than the 1974 total of \$82.0 billion, an increase in tax breaks much faster than that in the Consumer Price Index or in federal budget receipts (estimated, for the same period, to be 114 percent and 151 percent, respectively).

Quite a few favor only very narrow-based special interests. The 1982 tax bill contained an exemption from certain record-keeping requirements in the leasing of equipment that made it easier for American Motors Corporation to get \$100 million in tax breaks on equipment for an Ohio plant. It backdated a provision of the leasing rules that applied to paper plants, and thus saved Scott Paper Company several millions of dollars. It extended certain deductions for hotel firms, a provision favorable to Marriott Corporation projects that had fallen behind schedule. A twist in new rules concerning the tax treatment of acquisitions benefited the Beatrice Foods Company. It granted other special concessions to certain athletic clubs and veterans' groups. In 1982 alone, members of Congress introduced some 1,846 bills seeking tax deductions, credits, or exclusions.

Economists have estimated that if there were no exemptions the "flat" tax rate could be as low as 19 percent and still yield the same revenue. It is widely agreed that a lower tax rate would have enormous economic benefits, since high tax rates are discouraging people from working hard, saving, and investing. Lower rates would also free up money locked into tax-shelter investments that make little sense for economic reasons. And the ingenuity and resources often dedicat-

ed to tax avoidance would be used to spur the economy.

Equally troubling is the eroding sense of legitimation. A tax code, even more than other government actions, rests inherently on the willing compliance of the millions affected. Forcing payment from millions of unwilling people would turn a country into a police state, filled with tax inspectors, frequent foreclosures, and jails. Willing compliance by most citizens rests, in turn, on a sense that taxes are fairly imposed and not excessive. This sense of fairness has been eroding in the United States in recent years, as special interests have gained more and more favorable exemptions, unavailable to most taxpayers.

The point of all this is that although it is true that interest groups have been with us "always," that they are "part of the system," their recent cumulative effects have done more than bend the system or damage it here or there; *they have made effective tax policy nearly impossible.* For decades, the response to loopholes was tax reform. But for every loophole closed (rather few) or narrowed (a few more), numerous new ones opened. As we have seen, the cost of loopholes is

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rising faster than budget receipts or inflation, making the code ever more leaky and unfair.

Since 1981 there has been a growing consensus that the United States tax code is beyond repair. Instead of vainly attempting to fix it, we should scrap it, and a new tax code, free from loopholes, such as a flat tax or a consumption tax, should be instituted. However, the same interest groups that have riddled the tax code with overlapping holes (until it looks like an overused rifle target) are the ones that have prevented effective tax reforms and have so far successfully blocked all attempts even to give serious consideration to shifting to a different tax system.

Credit allocation. Similar damage caused by interest groups is evident in other main tools of economic policy, although the cumulative damage is not so visible elsewhere as in the tax code. One major tool of economic policy is the distribution of credit. Credit provides much of the capital necessary for industry, commerce, new technology, education, hospitals, housing, and numerous other activities. A significant portion of American public opinion and many economists hold that public allocation of credit is anathema to a free market, a highly damaging form of government intervention. Credit should be granted by lenders to borrowers according to economic logic and no other. Allocation of credit by national policy is considered to be an alien thing, done in Europe and Japan but inherently "un-American."

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As a matter of fact, though, credit allocation in the United States is often affected by actions at the federal government level. While in the United States there is not one central bank that allocates credit according to a national plan, credit is allocated daily in the public realm by scores of government agencies and congressional committees, each close to one or more interest groups. The total amount of credit thus allocated amounted to \$73 billion in 1980, a sharp rise from the 1965-69 average of about \$14 billion.

Credit is usually allocated, not by providing it to some groups while denying it altogether to others but by providing it to interest groups at more favorable terms, which are unavailable to other businesses, industries, and individuals. While typical small businesses in 1980 had to pay 18 percent or more for loans, when available, and large corporations had to pay the 15 percent, prevailing prime rate, students were granted loans interest-free until graduation, then at 5- or 9-percent interest, depending on the program. Large-scale exporters could arrange credit on favorable terms through the Export-Import Bank; and sugar growers, shipbuilders, and many others could get loans guaranteed or subsidized in various ways through government programs.

It is not that the various recipients of special treat-

ment are not "worthy" by one criterion or another. The problem is that the allocations are made, not in line with a national set of priorities or a national economic conception or policy but in line with the relative clout of the private interests involved.

The fate of TAA. In other areas of economic activity, interest-group pressure did not blunt major tools of economic policy, but shattered them. Trade Adjustment Assistance (TAA) was created in 1962 to help workers displaced by imports to readjust, thereby reducing humanitarian and political objections to unlimited imports and facilitating the adjustment of the American economy to shifting international market conditions. Assistance was to be in the form of benefits, supplementary to regular unemployment benefits, paid those who lost their jobs because of increased imports. In addition, workers displaced by imports were to be retrained for other jobs, in nonaffected industries.

Initial qualifications in the program limited the number of participants. Those seeking aid had to prove that foreign competition related to a specific government trade concession was a major factor in their unemployment. Between 1962 and 1974, only 35,000 workers qualified under this standard, at a small cost to the government. The qualifications were liberalized (partly in response to pressures from organized labor) in the 1974 Trade Act, which also authorized the president to cut tariffs up to 60 percent.

Under the 1974 provisions, workers had to demonstrate only that imports were "a substantial cause," rather than a major factor, in their loss of jobs. "Substantial cause" itself was defined in such a way that increased imports need not be the only or even the major cause for an affected industry's problems. Particularly detrimental was the elimination of the requirement that job losses be tied to specific trade concessions made by the government. This widened the scope of the program considerably, undermining its original function of cushioning workers against job losses caused by government actions.

In TAA's first year under the new standard, the program received a much higher volume of applications than previously, covering 347,727 workers. The number of participants doubled. The amount paid in cash benefits alone rose from \$9 million in 1973 to \$69.9 million in 1976 to \$259 million in 1979. The recession of 1980 pushed the cost of the program up to \$1.5 billion.

As the payments rose, others sought to be included in the program, and "copies" were enacted by Congress in other areas. The Redwood Parks Act of 1978, for example, "provided handsome cash, education and medical benefits to loggers who lost their jobs," benefits so generous, reports the *Washington Post*, that "loggers with seniority have been vying to be fired in order to enroll in the program."

By 1980 most of the aid was going, not to the workers in industries that were being reduced by imports but to workers who were merely on temporary layoffs. Thus the program served for the most part only to subsidize a higher level of unemployment benefits for some workers than for others. Very few took advantage of possible retraining benefits: only 3 percent of those qualified ever enrolled, and only 1.2 percent completed the

training.

EDA follows. The fate of the EDA has been quite similar. The mission of the Economic Development Administration was to help areas under significant economic distress by funding public-works programs, technical-assistance grants, business loans, and loan guarantees. The "distress" could be a result of economic misfortunes such as a decline in an area's major industry, or of floods or other natural disasters that have had a disruptive effect on a region's economy. In 1965, when the program was started, 12 percent of Americans lived in areas that qualified. However, areas were rarely decertified even when conditions improved, and members of Congress pushed to have their districts included so that lucrative public-works projects could be directed to their areas. By 1979, most of the nation's population (84.5 percent) lived in areas deemed eligible for EDA programs.

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At one point the Carter administration tried to reduce the areas which qualified for EDA assistance so that only 61.9 percent of the population would remain eligible, but the effort failed in Congress. In 1982 the EDA sought to decertify a number of areas, including Beverly Hills, California, in an attempt to cope with the Reagan administration's budget cuts. But Congress blocked the move for review and decertification. As of March 1983, about 85 percent of the nation's population lived in areas that still qualify. The end result has been to destroy the possibility of targeting EDA funds to areas in serious need of economic rehabilitation or redevelopment. A useful economic lever was bent until it became one more barrel of pork.

Interest groups and inflation. There are varying economic theories as to what causes inflation, the nightmare of the United States economy in the seventies. Fear of runaway inflation pushed the country into "sado-masochistic recessions" (Walter Heller's term) four times between 1970 and 1982. One school of economists attributes inflation to excessive "printing of money" (more technically put, to excessive growth in money supply); another school, to high deficits; still another, to low productivity.

These economic theories are challenged by what, lacking a better term, I will call socioeconomic theories. Several social scientists have pointed to the inherent vulnerability of the democratic form of government to inflation. Politicians, they argue, find it easier to yield to public demands for more government services than to reject them. And once inflation is launched, democratically elected representatives find it difficult to administer the painful medicine required to curb long-term inflation.

As I see it, while there is a fair measure of truth in these twin observations, blaming "the public" is far

from wholly justified, since there was a public in periods during which inflation was much lower, for example, in the early sixties. And a public exists in democratic countries such as Switzerland, where inflation used to be quite low. Inflation gets out of hand because countries have become, not more democratic, but less. It rose following the explosion of interest groups—and the decline of countervailing forces—which left the lobbies in a position to pressure the polity to yield to their endless demands.

One proponent of this view is Nobel Prize-winning economist George Stigler, who suggests that "every industry or occupation that has enough political power to utilize the state will seek to control entry" into its field. Examples include not just doctors and airline companies, lawyers and truckers, but numerous other licensed businesses and occupations, from beauticians to dry cleaners, from broadcasters to funeral directors. All use their ability in effect to limit competition, thereby driving up prices.

Almost everybody is so familiar with farm subsidies that we tend to lose sight of their magnitude and significance. They have been in place for fifty years, and have grown greatly in recent years. In fiscal 1982 they amounted to \$11.9 billion, and they were expected to rise to \$15 billion in fiscal 1983. Aside from the direct cost to the taxpayers, the program keeps United States farm prices above world market prices.

There are numerous other ways, not reflected in these statements, by which interest groups make people pay more than a free market would require. Take one: a regulation promoted and protected by the milk lobby that imposes a prohibitive surcharge on reconstituted milk (made from milk powder), which is cheaper than fresh milk. According to 1980 estimates, using reconstituted milk could save consumers \$399 million a year and reduce the government's annual stockpiling costs by another \$230 million.

Labor unions use their organizational and bargaining power, including their ability to strike, not merely in the marketplace. They also use it in the political arena to lobby for such items as the Davis-Bacon Act, which inflates wage rates in the construction industry.

A major engine of American inflation is health costs, which for years have been rising more rapidly than other costs, thus exacerbating inflation in general. Hospital costs per patient day rose on the average about 16 percent a year through the seventies, while the Consumer Price Index rose on the average about 8 percent a year. Several factors propel health-cost inflation, top among them interest groups. One of the best accounts of interest groups' power is contained in a new study of American medicine by Paul Starr, a Harvard sociologist. He found that in earlier decades the American Medical Association (AMA) sought to keep doctors scarce and salaries high by lobbying for low enrollments in medical schools and against federal aid to medical students. (At one point the AMA was indicted for violating the Sherman Antitrust Act by fighting the rise of more economical group-practices.) In recent years, the AMA has opposed most schemes that would have reduced health costs through the use of public-health nurses, prenatal care, and a score of other cost-control

measures. In 1983, lobbyists for the hospital industry fought to continue to maintain a provision of the Medicare legislation which required the government to *secure* profit-making hospitals a return on equity that in 1982 averaged 19 percent of their investment. (It was above 15 percent in mid-1980 and almost 23 percent in

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late 1981.)

If such interest-group capacity to semi-administer prices were limited to a few items, it would not be of great consequence, but numerous items in the economy are managed to one extent or another. Labor costs amount to roughly two-thirds of all production costs, and these are often set by multi-year contracts, negotiated by labor unions. Utilities, from local telephone service to subways to electricity, are in effect regulated monopolies, affected by power politics, not governed by the market.

Free competition may be vital for a vigorous economy, but interest groups often pay lip service to it while limiting imports from overseas (beef, sugar, textiles, shoes, steel). Nor do interest groups necessarily welcome domestic competition. A case in point is the soft drink-industry lobby, which pushed an exclusive distribution-franchise bill through Congress in 1980. This allows distributors to negotiate exclusive territorial contracts with individual soft drink manufacturers—what amounts to a legalized monopoly. Soon the beer distributors lobbied for the same setup.

All these mechanisms directly inflate prices. In addition, they *indirectly* push up labor costs (by jacking up cost-of-living allowances) and government expenditures that are indexed to inflation, including very large military and civilian pensions and Social Security payments.

Economist Mancur Olson, in his 1982 book *The Rise and Decline of Nations*, finds that interest groups, in mature industrial societies like ours, seek to control wages, fix prices, and protect their members from competition by limiting free trade. They also work to slow down the introduction of new technology, to hamper the flow of resources, and to win subsidies. As their political clout grows, overall economic efficiency diminishes and economic growth slows. Finally, the interest groups focus on increasing their share of the take, not the total of what is to be had; they seek reallocation rather than growth.

Olson provides data to show that in countries where interest groups are stronger, such as the United States, economic growth is slower than in countries where they are weaker, such as Japan. And he shows that within the United States, regions where interest groups are stronger, such as New York City and the Northeast, do less well economically than those where they are weaker, such as the Southwest.

Olson finds interest groups at the root of a phenomenon that has puzzled economists: the combination of high inflation and high unemployment, stagflation. Presumably, if unemployment is high, workers will agree to work at lower wages; hence labor costs, and with them prices, will fall. However, Olson finds that pressure from interest groups prevents the sides from reaching “mutually advantageous bargains,” as labor unions pressure their members not to lower their wages, and industries seek to protect their share of the market by forcing competition out (for instance, by limiting imports), rather than by lowering prices.

There is room to debate *how much* control interest groups have over the marketplace and the tools of national economic policymaking, and which interest groups are most to blame. Some observers point to labor unions, social groups, and environmentalists; others, to corporations, banks, and farmers; still others, to long lists of small groups that hold society up for ransom, from fourteen thousand sugar farmers to a bunch of independent oil corporations.

In toto, though, there can be little doubt that interest groups distort the nation’s economy, from the way taxes are raised to the way credit is used, prices are set, and international trade is conducted. It is difficult to see how economic policy can be effectively fashioned and implemented until interest groups’ power is curtailed. Meanwhile, more than the economy is undercut. The difficulties in forming a viable and fair economic policy are a major source of resentment. This, in turn, undermines the work ethic, fouls the investment climate, and heightens distrust in the democratic form of government. NF