THE G·A·O JOURNAL

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ETHICS AND THE DEFENSE INDUSTRY
A Round Table Discussion Featuring David Packard

THE U.S. TRADE DEFICIT
Costly Lessons for the 1980's

AIDS IN THE WORKPLACE
GAO's Approach

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C O N T E N T S

FROM THE COMPTROLLER GENERAL 3

ETHICS AND THE DEFENSE INDUSTRY 4
A Round Table Discussion Featuring David Packard 041824

THE U.S. TRADE DEFICIT AND THE PASSING ILLUSION OF ECONOMIC SOVEREIGNTY 11
Allan I. Mendelowitz and Joseph J. Natalicchio 041825

THE EVOLVING FINANCIAL SERVICES INDUSTRY 19
Craig A. Simmons and John R. Schultz 041826

THE MONEY CULTURE 27
Felix Rohatyn 041827

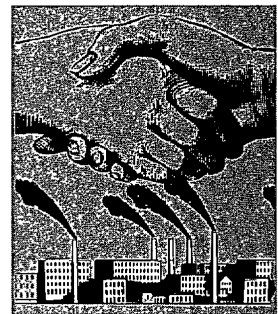
GAO's APPROACH TO AIDS IN THE WORKPLACE 31
Eleanor Chelimsky 041828

A JUDGMENT CALL: MEASURING THE SAFETY OF THE AIRLINES 39
Dave Balderston 041829

THE CLASH OVER MEDICAL MALPRACTICE 48
Susan Kladiva 041830

A NEW CODE FOR ACCOUNTANTS *American Institute of Certified Public Accountants, New York, September 1987* 55
George D. Anderson 041831

William Julius Wilson, *THE TRULY DISADVANTAGED: THE INNER CITY, THE UNDERCLASS AND PUBLIC POLICY, reviewed by Lowell Dodge* • Oxford Analytica, *AMERICA IN PERSPECTIVE, reviewed by Kathy Karlson* • Daniel Callahan, *SETTING LIMITS: MEDICAL GOALS IN AN AGING SOCIETY, reviewed by Eleanor Liebman Johnson* • Tom Forester, *HIGH-TECH SOCIETY: THE STORY OF THE INFORMATION TECHNOLOGY REVOLUTION, reviewed by Timothy P. Bowling* • 60



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From The Comptroller General

Our basic mission at the General Accounting Office is to help Members of Congress and other decisionmakers enhance the effectiveness of federal programs. Beyond that, however, is the role we play in informing the public and promoting the discussion of public issues.

Some time ago, we saw the need for a new way of communicating about the work we do. In recent times, with GAO's involvement in such high-visibility issues as Contra aid and the stock market crash, the public has taken a great deal of interest in GAO's studies of public-policy issues and federal programs. People at GAO, by virtue of both their work on these studies and their professional training, often acquire special expertise or insights worth sharing with a broader audience. In the past, we published for mostly internal circulation a quarterly called *The GAO Review.* It seemed to us that to establish a new journal, aimed at a larger outside readership, would not only provide our staff with the appropriate forum, but contribute directly to the performance of our mission.

That, in a nutshell, is the thinking behind our new quarterly. In searching out topics and writers, most of our choices will fall into one of three categories: (1) We will feature public-policy issues of interest or importance—generally ones in which GAO has had some involvement or anticipates some involvement in the future. (2) We will explain how GAO goes about its work, both in its role as an employer and more specifically as the investigatory arm of the Congress, so that others will better understand the agency and its rationale. (3) We will spotlight people whose thoughts or accomplishments warrant the sort of visibility we can provide.

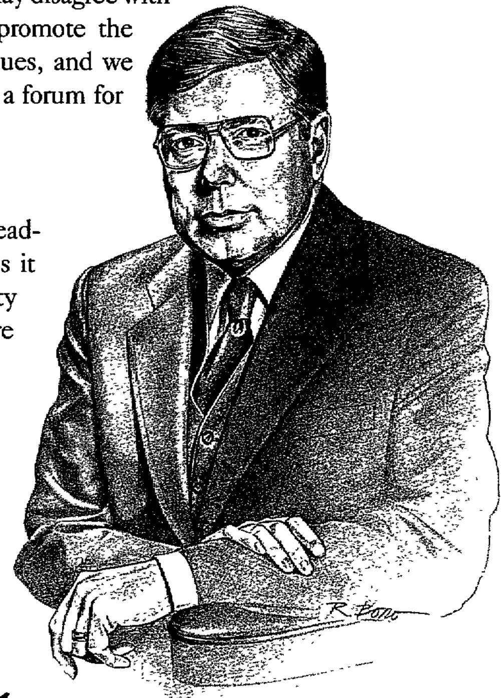
Our first issue includes examples from all three categories. This and future issues will also feature presentations drawn from the professional organizations in which so many GAO staff play an active role. The first such presentation is by George D. Anderson, cofounder of the accounting firm of Anderson, ZurMuehlen & Co., speaking before the American Institute of Certified Public Accountants on ethical standards for CPAs. This issue also includes a wide-ranging essay on the general state of American ethics by noted financier Felix Rohatyn.

Ethics are also the focus of a round table discussion that took place in our offices last November. We invited David Packard, a founding partner of the Hewlett-Packard Company, Deputy Secretary of Defense from 1969–1971, and most recently Chairman of the President's Blue Ribbon Commission on Defense Management, to discuss the often troubled relationship between the defense industry and the Department of Defense (DOD).

Joining us were two other key members of the DOD team at the time of Mr. Packard's tenure: former Secretary of Defense Melvin R. Laird and former Assistant Secretary of Defense (Comptroller) Robert C. Moot. Our own Assistant Comptroller General for National Security and International Affairs, Frank C. Conahan, completed the group. We think you will find the discussion well worth reading.

You may have noted that *The GAO Journal* looks rather different from other GAO products. The difference is intentional. We have taken care to underscore the fact that this is a quarterly *sponsored by* the General Accounting Office. The contents of its articles should not be attributed to the agency, but to the writers whose names appear over the titles. Some of these writers may take positions beyond those with which GAO is entirely comfortable. Others, particularly those drawn from outside GAO, may disagree with us altogether. Our intent is to promote the informed discussion of public issues, and we will do all that we can to provide a forum for responsible writers.

We hope you will enjoy reading *The GAO Journal* as it establishes its identity over the next few issues. We are fortunate to have an Editorial Advisory Board whose members will track our progress and point out the ways in which we can improve. We invite you to do the same.



Charles A. Bowsher

041824

ETHICS AND THE DEFENSE INDUSTRY

A Round Table Discussion

DAVID PACKARD, Chairman of the Board of the Hewlett-Packard Company and former Deputy Secretary of Defense, chaired the President's Blue Ribbon Commission on Defense Management.

MELVIN R. LAIRD, former Member of Congress, Secretary of Defense, and Counsellor to the President for Domestic Affairs, is Senior Counsellor for National and International Affairs, The Reader's Digest Association.

ROBERT C. MOOT, former Assistant Secretary of Defense (Comptroller) and member of the Federal Cost Accounting Standards Board, is a director of the Procurement Round Table and a trustee of the Logistics Management Institute.

CHARLES A. BOWSHER is Comptroller General of the United States.

FRANK C. CONAHAN is Assistant Comptroller General, National Security and International Affairs Division.

BOWSHER: What was the origin of the President's Blue Ribbon Commission on Defense Management?

PACKARD: We were appointed by President Reagan when all the horror stories about defense procurement began to undermine the credibility of the Defense Department. Everyone was hearing about these ridiculously high prices for spare parts, cost and schedule overruns, test deficiencies, and other reports of malfeasance by defense contractors. The curious thing is that they'd come to light largely because, at the beginning of this administration, Defense Secretary Weinberger had turned inspectors general loose on the defense industry. The Congress had supported him on this. He'd done it in the hope of eliminating fraud and waste in defense procurement. Afterwards, both the President and the Secretary thought they should get credit for bringing these things to light, instead of being blamed for what they had uncovered.

BOWSHER: I guess it's the image of the $600 toilet seat that people remember. The spare parts issue got the highest visibility.

PACKARD: We made the high cost of spare parts an early priority in our work. Most of the high prices, it turned out, were caused by DOD regulations. Suppliers were simply doing what they were required to do. The problem stemmed primarily from

two bad practices. First were the regulations that called for the same kind of documentation, elaborate packaging, and detailed instructions on one item that were required for a large number of items. You'd take some two-bit part and tack on $200 in unnecessary costs. The other bad practice was that of special-ordering a small number of items for manufacture, which always leads to high unit costs. We pointed out that the use of a little more common sense by both the Department and the industry would have corrected the problem, and this seems to have already been done.

A CODE OF ETHICS FOR A DEFENSE COMPANY INVOLVES NOT JUST WHAT'S IN THE CODE, BUT HOW WELL MANAGEMENT GETS IT ACCEPTED AND ENFORCED THROUGHOUT THE ORGANIZATION.

DAVID PACKARD

BOWSHER: So you don't see it as a serious issue.

PACKARD: Serious in principle, but it never caused the sort of losses that some of the other problems did. One of these was the problem of defense contractors mischarging costs. Many, if not most, defense contractors had established a perverse set of incentives for their lower-level managers. Their performance was measured by the performance of their division or department, and so they had an incentive to switch labor and material costs from one contract to another to make their performance look good. In most cases this was a violation of their contractual agreements and a civil violation of the law, although not necessarily a criminal violation as the Department often charged. These managers were seldom given a clear message by top management that, when it came time to evaluate their performance and set their compensation levels, integrity would hold more importance than financial results.

BOWSHER: Did the Commission find fraud to be a common problem?

PACKARD: Among the large defense contractors the major problems were the ones we just spoke about. But there were a large number of cases of serious fraud that came to light among the lower-level defense suppliers, such as the substitution of used or defective materials, falsification of tests, that sort of thing. But the problem wasn't all on the industry side. Some of the worst situations came up at the supply depots where there had been some real collusion between people working at those depots and people on the outside. For instance, there was a case where a fellow wanted a new fire engine, so he got somebody at one of these bases to order one, declare it surplus, and sell it to him for almost nothing. In another instance a small contractor bought some surplus nylon cord, dyed it to look like new parachute rope, and sold it back. These were cases that didn't involve the big defense contractors at all, but some of those thousands of small operators that you'll never be able to track as closely as you might like.

CONAHAN: Are you saying you found that fraud was as serious a problem within the Defense Department as it was among the defense contractors?

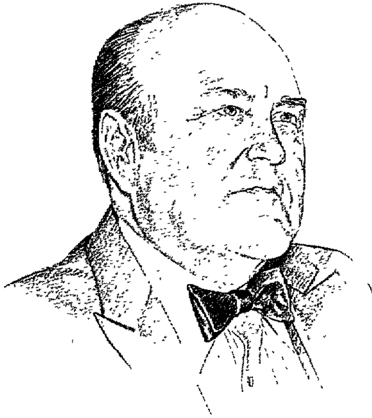
PACKARD: It was certainly as much a problem inside as out. Maybe more so. I think Weinberger tried to put it all on the contractors. I don't think you can make the Department look good by making the industry look bad. We concluded, those of us on the Commission, that what was needed was a commitment by both the Department and the industry to more ethical behavior.

BOWSHER: Which is where your call for voluntary codes of ethics came in . . .

PACKARD: That's right. Let me go back a little bit. You may recall that when I first came to the Defense Department they had a problem with some of the southern

textile mills meeting the government's equal opportunity requirements. I'd been involved in similar situations out on the Coast and I had come to the conclusion that pushing regulations on people wasn't the way to solve the problem. They might try reluctantly to meet the minimum requirements of the regulations, but they wouldn't establish the kind of environment in their organization that would fulfill the real intent of the law. I believed a better way to deal with it was to get a commitment from the chief executive officers of these companies that they and all the people in their organizations were committed to trying to do something positive. I called up the heads of some of these textile companies and got a personal commitment from them on hiring. It worked. So by the time I headed up the President's Commission I'd already gotten the feeling that this was the way to go about these things.

In the spring of 1985 we met in Hot Springs with a dozen or so of the chief executives of the major defense firms and we talked about these procurement problems. It was quite evident that they were all anxious to take some positive action to correct the deficiencies in their performance. A number of them decided voluntarily to establish and enforce company codes of ethics, and they recommended that all defense contractors be encouraged to do likewise.



THE WAY INCENTIVES ARE SET UP, EACH MANAGER IS TRYING TO SHOW PERFORMANCE AT THE BOTTOM LINE. THOSE PERFORMANCE INCENTIVES SOMETIMES HAVE A TENDENCY TO CORRUPT ETHICAL STANDARDS.

MELVIN R. LAIRD

BOWSHER: They saw it as being in their own interest to do so?

PACKARD: Sure. Some of them already had similar codes in place. People respond to what they perceive to be the incentives. These CEOs have a large incentive to eliminate the kinds of problems that have been exposed. The bad publicity they receive from these acts of malfeasance tarnishes their reputation with the Defense Department, the Congress, and their commercial customers, who are likely to assume that if the government is being cheated, the cheating probably doesn't stop there. By the time the Commission got into things, the publicity was beginning to have a negative effect on the morale of the defense contractors' employees. It was almost approaching the point where the most capable people would not want to work for defense firms. If this should happen it would be a serious problem for our country, because the Defense Department would find it more difficult to obtain the highest quality of goods and services for the armed forces.

What some of these CEOs came up with is the Defense Industry Initiative, which identifies six critical elements for effective self-governance: codes of conduct, employee training, reporting of violations by employees, procedures for voluntary disclosure, responsibility to the industry, and public accountability. The initiative was endorsed privately by President Reagan and Secretary Weinberger, and I think it deserves the support of the Department and the Congress.

Look at what nonvoluntary measures accomplish. When you try to deal with procurement problems through ever-increasing inspections and the imposition of penalties, you can do serious damage. We found that purchasing people and contractors had already become much more cautious. Contracts that should have been negotiated in a few months were taking a year or more. This added to costs, simply because time is money. But much more importantly, the delay in placing contracts reduced our technological lead over the Soviets, which had already been shrinking in recent years.

BOWSHER: It's been almost 2 years since the Commission recommended these voluntary measures. We get the impression that some companies have done quite well in pushing ethics voluntarily, but that some others have backed off.

PACKARD: It's the way to go, though, and I think we'll see more of it primarily

because nothing else works as well. There will need to be a measure of trust built up between the industry and the Department that isn't there yet. I remember that when the CEOs we met with in Hot Springs got back to their offices, the company lawyers warned them that there were risks in taking this course of action. Voluntary disclosures, they felt, might get them into more trouble with the Department than they were already in. If companies are going to have the incentive for voluntary disclosures, the Department and the industry are going to have to develop an appropriate way of dealing with these things.

One of the offshoots of this is the matter of 'whistle-blowers,' the lower-level people in an organization who try to bring problems to the attention of the top managers. The Defense Department has not handled this problem well, and whistle-blowers have traditionally been given a hard time there. Industry has not done much better, but if CEOs will encourage people at all levels to report problems to them, or if they'll establish and support a group of people to listen to the whistle-blowers, corrective actions might be taken before things get out of hand.

ONE THING TO CONSIDER IS THE SHEER SIZE OF THESE ORGANIZATIONS. GETTING THE MESSAGE DOWN INTO THE ORGANIZATION, WHETHER IT'S IMPROVED BUDGETING OR IMPROVED ETHICS OR WHATEVER, IS GOING TO BE THE SAME PROBLEM WHETHER IT'S A MAJOR DEFENSE FIRM OR THE DEPARTMENT OF DEFENSE ITSELF.

CHARLES A. BOWSHER

LAIRD: It's astounding what some of these operations will uncover. I'm on the Audit and Ethics Committee at a major contractor. We've got an ethics officer with an 800-number and four or five people working full time on ethics. The company's really trying to shape things up. The ethics office is getting a large number of inputs a month from employees. About 15 of these are valid and need investigation. That doesn't mean that top management isn't trying its best. In fact, it shows how much they're working at it. But the way incentives are set up, each manager is trying to show performance at the bottom line. Those performance incentives sometimes have a tendency to corrupt ethical standards.

BOWSHER: I guess one thing to consider is the sheer size of these organizations. Getting the message down into the organization, whether it's improved budgeting or improved ethics or whatever, is going to be the same problem whether it's a major defense firm or the Department itself.

PACKARD: You're quite right. A code of ethics for a defense company involves not just what's in the code, but how well management gets it accepted and enforced throughout the organization.

CONAHAN: I think that's the important part. I was at the National Contract Management Association conference in early November, and General Dynamics had a display on their ethics program. We've all heard [General Dynamics Chairman] Stan Pace's speech on ethics. They've got a whole new program out now, with lot of time and honest effort involved. You can tell their management has bought into it.

LAIRD: They had to. It's experiences like the one General Dynamics had with Electric Boat a few years back that helped make the whole industry conscious of just how pertinent these ethical considerations have become.

MOOT: Another part of the problem, industry people tell me, is that the government changes the ground rules so often. What used to be acceptable behavior isn't anymore. For the industry, it's a matter of training people according to tighter standards than they're used to.

BOWSHER: That gets at a perspective problem. Is there more corruption and fraud

than there used to be, or are we just doing a better job of uncovering it?

MOOT: I think there's a lot more of it. There's a lot more money being spent on defense, and it's spread wider, too. There are something like 60,000 prime contractors and hundreds of thousands of other suppliers and subcontractors.

PACKARD: Remember, I differentiate between all those thousands of low-level suppliers and the major defense firms. One hundred contractors get about 70 percent of the Department's business. The real problem is with the small, fly-by-night guys. They're the ones who really do the damage. Preaching ethics in that area won't do any good. We can only hope to enlist the top people from the big firms,those who have a good enough feel for their public responsibility that they'll make the effort to get the word down into their organizations.

Take testing, for instance. You've just got to have a rule that anybody who fudges results gets kicked out. Once you get that rule enforced in the company you'll minimize the problem. These managers who meet every month on their profitability and so forth—the industry has to let them know there are some priorities higher than showing a profit every month.

GAO HAS LOOKED INTO THE 22 CURRENT CONTRACTS FOR SHIPBUILDING, AND 19 ARE GOING TO EXCEED THE TARGET PRICE.

FRANK C. CONAHAN

BOWSHER: I think testing is one area in which the Defense Department comes in for a lot of blame. The services, historically, have been willing to ease up on some of the testing to keep these programs going. And I think it's been especially true in recent times when so much money has been made available for defense and everybody has wanted to get it obligated.

LAIRD: There's a real breakdown in ethics there.

BOWSHER: There certainly is, because if the Air Force program officer or the Navy program officer is willing to lower standards, then there's lots of incentive for the industry guy to go along with it. He gets the money and the program keeps going. Of all the areas GAO's gotten into in defense in the past 5 or 6 years, I've been most disappointed in what we've seen in the testing area. And although the Department's created a new office of operational testing, the attitude doesn't seem to have changed a great deal.

PACKARD: The operational testing issue is a dificult one because testing takes time. In principle, what you'd like to do is get the testing done before you start production. But in practice, things don't fit in nice, neat packages like that.

BOWSHER: I've got a magazine article here from 1969 that says Laird and Packard are going to get all these defense-acquisitions problems straightened out. Mel, you were especially hard on the Navy that day. The article quotes you as saying, 'Shipbuilding program costs on existing orders will eventually total $600 million to $700 million above original expectations.'

LAIRD: I'd probably be saying the same thing today, but the numbers would be higher.

CONAHAN: We've looked into the 22 current contracts for shipbuilding, and 19 are going to exceed the target price.

PACKARD: The problem is, you're trying to do something almost impossible when you make estimates on these big programs ahead of time, especially if it's some

weapon or system that hasn't been developed yet. But I don't think there's any way around it. The Congress always wants you to give them a figure before you've really gotten started.

MOOT: And what compounds the issue, Dave, is that the pressure's on, inside the Department and out, to keep the figures low. It isn't just at the beginning of programs that you see this happening, but throughout the life of the programs, even when people know better.

SOMEONE OUGHT TO ASK WHY WE HAVE TO MAKE COMPANIES ACT DIFFERENTLY WHEN THEY DEAL WITH THE GOVERNMENT THAN THEY DO WHEN THEY'RE OUT THERE ACTING INDEPENDENTLY—AND SUCCESSFULLY—IN THE PRIVATE SECTOR.

ROBERT C. MOOT

BOWSHER: Like the B-1 bomber. They kept saying all through the program that they'd be able to stay within the $20 billion target, and now . . .

PACKARD: Right. While our Commission was at work, of course, they were holding up the B-1 program as a shining example of how to run these things. We accepted what they told us. By the time we left town, all the problems started showing up. What they should be doing is finding the guys in Air Force Systems Command responsible for these estimates and firing them. Do that a few times and you might start getting more reliable estimates.

MOOT: You know, what nobody's really looked into are the basic premises of the relationship between the government and the defense industry. Take Hewlett-Packard or any of the top firms doing business in the private sector. They're very successful. They take their own risks, they're not subsidized, they work on their own, they find their own markets, they're responsible for their own products. As soon as these firms come to the government, we say they have to act differently. We give them some things—facilities, research and development money, subsidies of various sorts. Then we take some of their prerogatives away, put them under a lot of regulations, and wind up complaining because they don't deliver, or they deliver shoddy goods or run late or exceed their estimated costs. It seems to me, someone ought to ask why we have to make them act differently when they deal with the government than they do when they're out there acting independently—and successfully—in the private sector. What differences are justified and which ones aren't? For example, how much does the lack of a stable budget situation in the Congress justify the way long-term relationships are set up? An analysis of the relationship between the government and the defense industry is long overdue. For instance, you've got to look at the incentives that people inside the government have. They're not Hewlett-Packard's usual customers. They don't have a bottom line to watch. How do you find them the right incentives? How do you get government people to settle for nothing less than the best value for the money? The incentives aren't in place for government people to do the best job in a commercial sense.

PACKARD: I think you've hit on something there, in that government people look for government solutions. More inspections and penalties will only have a negative effect on the quality of work performed by defense contractors. You know, the Japanese have been teaching us some things. They've achieved both high quality and low costs for their products by more extensive employee participation. Competing with the Japanese has led American firms to give their own employees more freedom in how they do their work, and they're showing the same positive effects. It's not an entirely new principle. We've known for some time that you build quality into a product; you don't achieve quality by inspections. If you get people to do the job right in the first place, you need less inspection, not more.

That carries into the ethics issue as well. I don't expect that adopting and

implementing these codes of ethics within industry and the Department will immediately solve all the problems. But hiring more inspectors isn't going to do it, either.

BOWSHER: It seems that waste and fraud in defense spending have been with us since the Revolutionary War. Do you think we'll ever put them behind us?

PACKARD: I'm not very hopeful, actually. Every administration since the 1950's has made a commitment to improve the management of the Department of Defense, but the situation hasn't really shown much improvement. One source of the problem is the sheer size and breadth of the Department's activities. Another is the political environment in which it exists. The Congress authorizes the Department's budget and appropriates funds. Every Member has a constituency that is influenced by Defense Department activities, and each of the services has its own constituency. Because defense procurement involves expenditures in every congressional district, Members deal with defense procurement to a large extent as if the budget were their personal pork barrel. To make matters worse, too many Members consider themselves experts in defense management. In recent years, that's led to far too much legislation on the sort of management issues that should be left to the Department.

Beyond these problems, though, I think by far the largest cause of waste in the Department of Defense is the complete lack of an effective long-range planning process. We've seen the cancellation of major programs after billions of dollars have been spent. We've seen the stretching-out of other programs, which has caused additional billions in waste over the years. The Commission pointed out the lack of rationale in the way we think through and tie together our security objectives, what we spend to achieve them, and what we decide to buy. It concluded that the administration and the Congress alike need some new procedures to do long-range planning and meaningfully assess what forces are needed.

You're right in pointing out how long the problem of waste and fraud have been with us. Speaking in the broadest terms, I guess all we can hope for is that little steps will be taken here and there and that they'll add up. A $300 billion dollar defense budget is certainly sufficient to keep this nation secure. But we've got to cut out the programs that no longer make sense—battleships, for instance. We've got to cut out the waste and fraud wherever we find it, and we've got to try to establish an environment in which there's no incentive for them to flourish. ●

041825

Allan I. Mendelowitz & Joseph J. Natalicchio

THE U.S. TRADE DEFICIT AND THE PASSING ILLUSION OF ECONOMIC SOVEREIGNTY

Some costly lessons on making economic policy in a vacuum.

AMERICAN ECONOMIC POLICIES of the 1980's appear to have been formulated as if the U.S. economy existed in isolation from the economies of other nations. The thinking that underlay this behavior reflected past U.S. approaches to economic policy. But the world had changed: The integration of world capital markets, rising levels of trade, and the shrinking of America's share of world Gross National Product (GNP) radically altered the consequences of macroeconomic policy. Economic independence had passed from the world scene. The formulation of economic policy under the illusion of economic sovereignty had far-reaching and often unintended consequences for the United States and the world. On the domestic side, taxes were cut, spending increased, national income rose, and the budget deficit ballooned. On the international side, the dollar rose sharply in value, exports stagnated, imports surged, and the U.S. trade deficit soared.

Although most recent discussions of U.S. economic policies have emphasized their negative consequences, not all the effects have been bad. The expansionary fiscal policy did increase U.S. economic growth and employment, and the related trade deficit appears to have inadvertently helped promote economic growth in the industrialized countries, while giving the international debtors among the lesser developed countries (LDCs) an expanding export market in which to earn dollars to service their debts and stave off default and financial collapse. This period also gave the banks, which in 1982 were more vulnerable to a default by LDCs, time to build up their capital and reserves for bad loans.

Nevertheless, the negative effects have been quite substantial. In 1981, the United States was the world's largest creditor nation. Its international accounts were in balance and the trade deficit was less than $20 billion. By 1987, the trade deficit had increased to an unprecedented $168 billion and the United States had become the world's largest debtor nation—several times over. The transformation has probably lowered prospects for the future well-being of the American citizenry, and weakened the ability of the United States to pursue its national interests and simultaneously play its traditional leadership role in sustaining the West's economic systems and preserving the security of the Free World. The question is: How did this change come about?

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Causes and noncauses

In popular discussions, a number of factors have been cited as the causes of the sharp rise in the trade deficit in the 1980's, among them the upturn in the value of the dollar, the relatively strong growth of the U.S. economy, the LDC debt crisis, unfair foreign trade practices, and a loss of competitiveness by the U.S. economy. Some of these were indeed important factors in the rise of the trade deficit. Others, though important trade and economic issues, were not significant causes of the deterioration in U.S. trade performance.

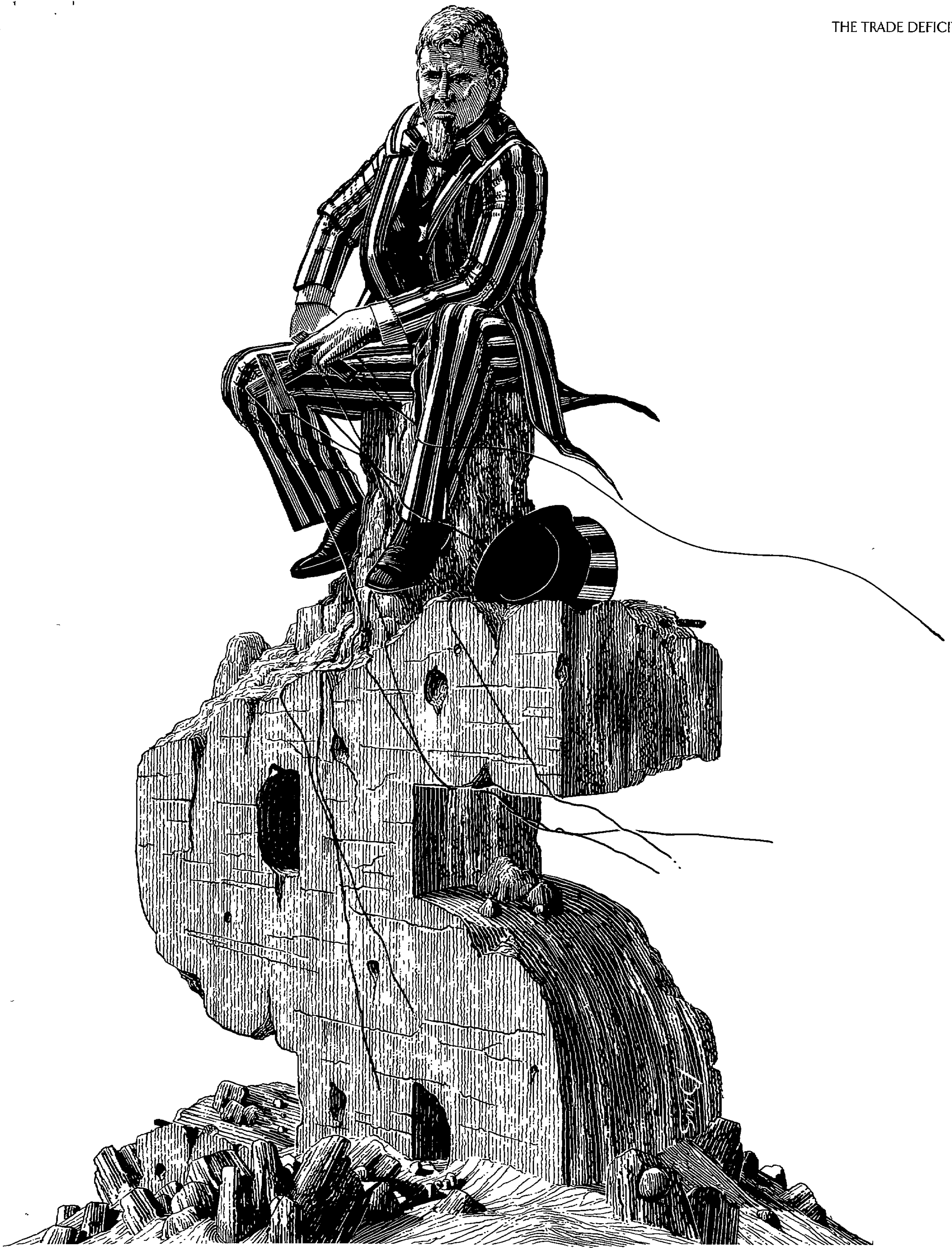
Three factors contributed significantly to the trade deficit. The first was the sharp and sustained rise in the value of the dollar during the first half of the decade; it is generally considered the single most important factor in the rise of the trade deficit, accounting for as much as 50 to 60 percent of the increase. American products simply became too expensive in relation to those of other nations. The second factor was the strong economic growth of the United States relative to that of its major industrialized trading partners. U.S. economic growth contributed some 15 to 25 percent of the increase in the trade deficit: When the economy grows, more of everything is consumed—foreign as well as domestic goods. Finally, the LDC debt crisis accounted for some 10 to 15 percent of the rise in the trade deficit. To come up with the money to service their international obligations, debtor nations cut back on their imports and increased their exports.

Some other popularly cited factors, although very important in themselves, did not play a major role in the decline of America's position in international trade. For example, some blame unfair foreign trade practices for the sharp rise in the trade deficit. Such practices include government subsidies to exporters; nontariff barriers that prevent U.S. goods from penetrating foreign markets; and inadequate efforts by foreign governments to stop their firms from pirating U.S. patents, trademarks, and copyrights. While long-term U.S. interests require a vigorous effort to oppose unfair foreign trade practices and open foreign markets to U.S. competition, these practices played only a minor role in boosting the trade deficit during the 1980's. American goods do face real barriers in other countries, but most of these barriers have existed for many years, and there was no major increase in their number or general effectiveness during the 1980's. In fact, during this period, the U.S. market, with the creation of barriers to imports of cars, steel, semiconductors, and other products, probably saw the greatest increase in barriers to foreign goods.

The purported loss of American industrial competitiveness has also been cited as causing the increase in the trade deficit. It is true that the position of the U.S. economy in the world has declined in the post-World War II era as war-devastated countries have been rebuilt and some developing countries, such as South Korea and Taiwan, have industrialized. There are also case studies that have identified problems of individual industries. Certain U.S. industries have lost competitiveness as costs have risen, quality has declined, and market shares have fallen relative to those of foreign producers. But there has been no sudden collapse in the competitiveness of the U.S. economy in the 1980's. Some U.S. industries—aircraft and computers, for instance—remain very competitive; others, such as automobiles and steel, have lost ground to foreign competition. The same is true for other countries. In Japan, for example, there are certain industries, such as consumer electronic and automobiles, that are very competitive in world markets, and others, such as aircraft and major appliances, that are not. We Americans see only Japan's industrial successes; we are not as aware of the less competitive Japanese industries, simply because their goods tend not to make it to the U.S. market.

In a similar vein, it is often alleged that American workers do not "work hard enough" and that they have lost their commitment to quality. For example, in the automobile industry, which has lost competitive strength in recent years and has been criticized for producing lower quality cars, some have blamed American workers. But Japanese companies building cars in the United States have demonstrated that American workers can produce automobiles that are virtually indistinguishable in quality from those made in Japan. So American labor did not suddenly lose its technical skills or its willingness to work hard; the loss of competitiveness lies elsewhere.

When the burden placed on U.S. firms as a whole by the overvalued dollar is factored into the analysis, it accounts for much of what has been seen as a loss of competitiveness. From 1980 to 1985, for example, unit-labor costs in the United States increased about 11 percent, whereas the average unit-labor costs among the major U.S. trading partners—measured in their own currencies—increased 16 percent. That is, after factoring in productivity increases, the cost of labor rose more rapidly abroad than in the



United States. But when those foreign labor costs are translated into dollars, the sharp rise in the dollar turned a 16-percent increase in the cost of foreign labor into a 20-percent *reduction*. So when the dollar is overvalued, foreign labor costs less than American labor, and thereby contributes to the decline of American competitiveness in today's global market.

The fundamental causes

Despite the importance of some of the causes of the trade deficit discussed above, none should be thought of as a fundamental, or root cause, as virtually all were caused by other factors. The U.S. balance of trade is determined essentially by the fiscal and monetary policies of the United States and its major trading partners. To find the fundamental cause of the U.S. trade deficit during the 1980's, we need look no further on the U.S. side than the record U.S. budget deficits.

Production and consumption

If international trade did not exist, the limit on what the United States could consume would be determined by how much it produced. But with international trade, a country can consume more than it produces by importing the difference from other countries—if it can borrow money from abroad to pay for the desired imports. Before 1981, federal budget deficits did not lead to large trade deficits because the budget deficits were relatively small; domestic savings were therefore adequate to meet the needs of business for investment and of government for borrowing to fund government programs in excess of tax revenues. Basically, the United States consumed about as much as it produced.

Administration policy and premises

This changed in the 1980's with the unprecedented U.S. peacetime budget deficits. During its first term, the Reagan administration did not acknowledge the limits placed on U.S. economic policy by growing international interdependence. It acted as though the international trade and finance implications of its domestic economic policies were of little concern. Indeed, the administration stated that it saw the high value of the dollar as a sign of the relative strength of the American economy, and that there was no need for government intervention.

Many policymakers and analysts believed that the international system of fluctuating exchange rates, ushered in after the 1973 collapse of the Bretton Woods system, made it feasible for the United States unilaterally to pursue domestic economic policy. The Bretton Woods system, adopted after World War II, was based on fixed exchange rates. Countries were expected to try to correct imbalances in their international payments by first changing their macroeconomic policies rather than by devaluing their currencies. Consequently, when trade deficits resulted, countries adopted restrictive macroeconomic policies to slow the consumption of imports. Such policies resulted in economic slowdowns and rising unemployment.[1] Thus, adjusting to international trade deficits exacted a high cost.

With the collapse of the Bretton Woods system, changes in exchange rates were supposed to correct trade and balance-of-payments deficits; the reliance on restrictive macroeconomic policies as a first response was forsaken. The notion that the United States could unilaterally pursue domestic economic policies was based on the premise that under fluctuating exchange rates, international trade flows would always tend toward equilibrium; that is, trade flows would determine changes in exchange rates, which in turn would help to equalize trade flows. For example, a country with a large trade surplus would experience an increase in the exchange rate of its currency relative to those of other currencies. This change would cause its goods to become relatively more expensive in world markets and, as a result, decrease its exports and increase its imports.

The economic events of the past 8 years have shown, however, that what determines exchange rates is far more complex than previously anticipated. Macroeconomic policies and their influence on international trade and capital flows are the most significant determinants of exchange rates. Because of the integration of the worldwide capital and goods markets, nations must develop macroeconomic policies

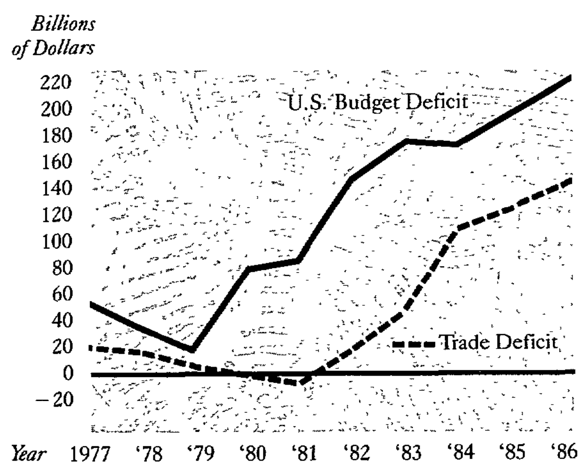
consistent with the economic policies of their major trading partners. A nation that pursues an economic policy inconsistent with those of its major trading partners risks paying a high price in terms of imbalances in its international trade accounts and disruptive swings in the value of its currency.

The United States is not the only country to learn this painful lesson in the 1980's; France had a similar experience at the beginning of the Mitterand presidency. When the French Socialist party came into power in 1981, it tried to expand France's economy and increase domestic employment by adopting expansionary economic measures. However, none of France's European Economic Community partners took similar action. France's unilateral moves led to inflation, increased imports, a rising trade deficit, and a sharp decline in the value of the French franc.

In the United States, the administration sponsored tax cuts while simultaneously increasing government spending. The growth of government spending far outstripped the growth of federal revenues, resulting in the unprecedented peacetime budget deficits and equally unprecedented trade deficits portrayed in figure 1.

Figure 1

U.S. BUDGET AND TRADE DEFICITS



Source: *Economic Report of the President* (Washington, D.C., U.S. Government Printing Office, 1987), pp. 276 and 358.

As shown in table 1, domestic savings and investment remained at roughly the same percentage of the GNP at which they had been for the previous two decades, while the federal budget deficit, as a share of the GNP, reached unprecedented peacetime levels.

Table 1

SAVING, INVESTMENT, AND THE U.S. BUDGET DEFICIT AS A PERCENTAGE OF GNP

Year	Private saving	Private investment	U.S. budget deficit
1971	17.3	15.7	2.0
1972	16.7	16.7	1.4
1973	18.0	17.6	0.4
1974	17.2	16.4	0.8
1975	19.0	13.8	4.3
1976	18.0	15.6	3.0
1977	17.8	17.3	2.3
1978	18.2	18.5	1.3
1979	17.8	18.1	0.6
1980	17.5	16.0	2.2
1981	18.0	16.9	2.1
1982	17.6	14.1	4.6
1983	17.4	14.7	5.2
1984	17.9	17.6	4.5
1985	17.2	16.5	5.0
1986	16.2	16.3	4.8
Average	**17.6**	**16.4**	**2.7**

Source: Compiled from data from the *Economic Report of the President* (Washington, D.C., U.S. Government Printing Office, 1987), pp. 244 and 276.

The United States was now consuming more than it produced, and importing the difference. As table 2 shows, the nation did not generate sufficient savings in the 1980's to support both the budget deficit and the expanding private investment resulting from economic growth. As a result, government and private sector alike needed to borrow from abroad. The United States became a debtor nation. In sum, the budget deficits of the early 1980's caused the U.S. economy's relatively strong growth and the overvalued dollar; these, in turn, caused the trade deficits and turned the United States into a debtor nation.

Table 2

U.S. SAVING-INVESTMENT IMBALANCE

Dollars in billions

	1980	1981	1982	1983	1984	1985	1986
Total saving	$455	$522	$446	$464	$573	$552	$537
Private saving	478	551	557	592	675	688	681
Personal	137	159	154	131	169	143	116
Business	342	391	403	462	506	545	564
Government saving	−35	−30	−111	−129	−102	−136	−143
Federal	−61	−64	−146	−176	−170	−198	−204
State and local	27	34	35	48	69	62	61
Private investment	437	516	447	502	662	661	686
Saving-investment imbalance	8	6	−1	−38	−89	−109	−149
International account balance	2	6	−9	−47	−106	−118	−142

Source: *Economic Report of the President* (Washington, D.C., U.S. Government Printing Office, 1987); saving and investment data, p. 276, and current account data, p. 358.

Despite the widespread support for this analysis, the administration has not made the reduction of the budget deficit its highest priority. While calling for a constitutional amendment to require a balanced budget, the administration has raised the level of military expenditures and refused to accept almost any increase in taxes.

Recognizing the problem

With the move of Secretary James Baker to the Treasury Department early in President Reagan's second term, the administration began publicly to recognize that the overvalued dollar might be a problem and that coordination of economic policy between the major western economic powers should be a key objective. Although the major industrialized powers reached some agreement on desired measures, little concrete action followed. For example, for several years, the United States called for more expansionary economic policies in West Germany and Japan; at the same time, U.S. allies continued to demand that the United States act to reduce the federal budget deficits. By and large, neither side got its wish.

The one area in which agreement led to action was of only marginal significance—initial efforts to reduce the value of the dollar. The dollar reached its peak in February 1985 and then began to decline. Through the Plaza Agreement of September 22, 1985, the Group of Five—the United States, West Germany, Japan, France, and the United Kingdom—agreed to manage a reduction in the value of the dollar—that is, to help push the dollar in the direction that it was already going. However, despite a significant weakening in the dollar's value, the trade imbalance has continued to grow. As a constructive intervention, reducing the value of the dollar is of limited value at best; it addresses a *symptom* of the problem, not the root causes.

When the fall of the dollar began to hurt the major U.S. trading partners, a new exchange-rate agreement was reached. Through the Louvre Agreement of February 22, 1987, the Group of Five, along with Canada, agreed to stabilize the value of the dollar, which by this time had declined in value 30 to 40 percent against other major currencies. More significantly, the six participants agreed to take steps to address the underlying macroeconomic imbalances, i.e., the U.S. budget deficit and slow economic growth abroad, that perpetuated the trade imbalance. However, efforts to maintain the value of the dollar proved futile when the agreed-upon macroeconomic

changes did not take place. No progress was made toward reducing the U.S. budget deficits, and the dollar came under strong downward pressure on foreign exchange markets. Foreign central banks bought billions of dollars in the world's foreign exchange markets in an attempt to prop up the dollar's value. The U.S. government raised the discount rate in what appeared to be an attempt to keep the dollar within the Louvre Agreement's target bands. Many, however, interpreted higher interest rates as a sign of an impending economic slowdown, and the financial markets began to send unmistakable messages of unease. In effect, U.S. monetary policy was held hostage to concern over the value of the dollar. It was only after the collapse of stock market share prices in October 1987 that U.S. monetary policy was eased and the dollar was cut free to decline quickly in value.

Tentative solutions

The fact that the United States is the world's largest debtor nation now constrains the government's economic policy choices and weakens the nation's ability to take a leadership role in economic and security affairs. Independent action on monetary policy or government spending becomes much more difficult because of the constraints—tied to the U.S. budget deficits and international debtor status—that are imposed by the world's capital and foreign exchange markets.

In dealing with the budget and trade deficits the U.S. government will need to make some hard choices, as well as obtain closer cooperation from its allies. It will need to act expeditiously; the longer it waits to make the difficult tax and spending decisions necessary to address the trade and budget deficits, the harder and more costly the choices will be. The need for mutually consistent policies between the United States and its major trading partners is inescapable. Without some form of "macrocompatibility," the necessary U.S. government efforts to reduce the budget deficit will become more difficult and will have some very troublesome consequences, such as a larger than otherwise necessary devaluation of the dollar and a higher risk of recession. The November 1987 White House-Congress budget compromise represents a marginally passable first step. Granted, the budget reductions created by the compromise may well be considerably less than the published estimates, and the agreement lacks the measures necessary to put the budget deficit on a sustained downward path. But it is a beginning.

There are several important lessons to be learned from the experience of the past several years. First, the economies of the world are so interlinked and the global economy so large and complex that countries need to cooperate to solve the world's economic problems. Since the economic policies of other countries contributed to the American trade deficit, the United States will need to obtain the cooperation of other countries to help reduce it. Second, leadership and action by the United States is essential if other nations are expected voluntarily to take the necessary measures. Third, action by the United States can help create economic pressures that will encourage recalcitrant nations to act out of their own self-interest.

The United States will need to take the lead by changing its economic policies before it can expect other countries to take the necessary measures to change theirs. For example, as long as the United States took no action on the budget deficit—the primary governmental cause of the U.S. trade deficit—other nations were unwilling to take steps they viewed as difficult. West Germany, for one, was reluctant to accede to American wishes that it make potentially inflationary steps to expand its economy while the United States was doing nothing to reduce its federal budget deficit. But following the U.S. budget compromise, the government in Bonn cut interest rates and announced a modest new spending program to spur the West German economy.

If the United States takes appropriate action to reduce the budget deficit, it can also create economic pressures that will lead other countries to take appropriate action, such as expanding their economies. However, even the best course of action for reducing the trade deficit—a reduction in the federal budget deficit—could lead to slower growth in the American economy. With the recent sharp decline in the value of the dollar and the related rise in exports, the risk of a U.S. economic slowdown is lessened. However, the combination of a smaller U.S. budget deficit and a weak dollar can create real problems for others. If the United States reduces its budget and trade deficits, other countries will lose sales—and lost sales mean lost jobs. To help maintain employment, those other nations will have to take action to encourage their own economic growth and pick up the slack.

Furthermore, all things being equal, the dollar will be weaker if foreign countries fail to take appro-

priate action than if they do. If the dollar becomes substantially weaker, other countries may find the U.S. market closing to them just as much as if protectionist legislation had been passed.

But if the United States moves to reduce its budget and trade deficits, more than just faster economic growth abroad will be needed. America's allies will need to play a larger role in world economic matters and mutual security efforts. Because of its economic power after World War II, the United States had the resources to play a leadership role in multiple areas: First, the willingness of the United States to open its huge market to the exports of industrialized and developing countries was a prime factor in the economic prosperity of the postwar era. Second, the United States underwrote and sustained the world's primary arrangements for international trade and commerce—the International Monetary Fund, the World Bank, and the General Agreement on Tariffs and Trade. Third, the United States has shouldered a disproportionate share of the burden for the mutual security of the Western alliances.

If the U.S. government is ultimately successful in substantially reducing its budget deficit and correcting its contributions to the world's trade imbalance, the allies will have to do more on both the economic and security fronts. Unless the industrialized countries substantially spur their economies, American efforts to reduce the budget and trade deficits will lead to increased unemployment everywhere. A smaller U.S. trade deficit will mean that the United States imports less and exports more, and as a result, the United States will no longer be the powerful engine of economic growth for the rest of the world. The major U.S. trading partners will, therefore, have to seize this opportunity to expand their economies more rapidly to avoid a recession. Japan and Western Europe will need to absorb that share of the developing world's exports that the United States will no longer take. The world's markets will also need to be willing to absorb an increasing quantity of American exports and to be content exporting less to the United States.

Because a large portion of the U.S. defense budget is used for defending its allies in Europe and the Far East, these countries should shoulder a larger share of the security burden for these regions. American defense spending accounts for a substantially higher proportion of the nation's GNP than that of Japan and the North Atlantic Treaty Organization allies. America's international debtor status, however, makes such leadership increasingly difficult. As the U.S. government searches for ways to reduce the federal budget deficit, it may find itself unable to afford such high levels of military spending. Furthermore, it is hard to believe that if current trade imbalances spill over into a trade war, these mutual security arrangements will survive intact. Trade frictions that turn into beggar-thy-neighbor trade policies go hand in hand with mutual hostility, not mutual cooperation on defense. It was, in fact, the vivid memory of the role that economic competition and hardship played in the origins of World War II that led the allies, under U.S. leadership, to try to create a system of cooperation in both security and trade. All participants stood to gain economically while reducing the risk of conflict and war.

While taking the responsible course of action—making the necessary tax and budget decisions—is difficult, the alternative is much more troubling. There is no end to the dangers of not acting effectively: inflation, unemployment, trade wars, the collapse of mutual security arrangements, and even a worldwide depression. The Great Depression was caused by a lack of cooperation between nations as each tried to shift the burden of unemployment onto others. As a result, everyone lost. For a long time, the recollection of that experience helped keep the world from making the same mistakes. To paraphrase Santayana, it will be unfortunate if we allow ourselves to forget the past and, in so doing, condemn ourselves to repeat it. ●

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1. For more on the Bretton Woods system and its collapse, see Robert Z. Aliber, *The International Money Game* (New York: Basic Books, 1973).

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Craig A. Simmons & John R. Schultz

THE EVOLVING FINANCIAL SERVICES INDUSTRY

Half a century after Glass-Steagall, it may be time to change the rules.

FORCES THAT AFFECT our financial markets are constantly at work, changing in sometimes subtle, sometimes striking ways. Occasionally, either through cataclysm or as a consequence of evolutionary processes, trends emerge that compel change in the structure and regulation of the markets.

The last major reorganization of the financial services industry occurred as a result of the dreadful events of the late 1920's and early 1930's. At that time, perceived abuses in the banking and securities industries, concerns over concentration of power, and fears over the excesses of competition for the nation's fixed supply of savings combined to produce highly segmented financial services markets. Banking and securities activities were segregated and the present regulatory structure was created.

Increasingly, banks and nonbanks are offering similar products, competing on the basis of price and widening their geographic bases.

Today, the interrelated forces of economic change, technology, political/economic philosophy, and the transformation of the financial markets into a single worldwide market have created a new competitive environment for our financial services industry. Many industry participants and regulators are calling for the Congress to redraw the competitive boundaries among the major providers of financial services—depository institutions, insurance companies, and securities and futures firms. New combinations of financial—and perhaps nonfinancial—business lines are emerging as a result of a momentum that will be difficult to repress or reverse.

Many hold the view that the Congress should form a vision of the financial services industry of the future and legislate a path to it. They believe this approach is better than allowing the industry to find its own way, fearing that an unguided and uncontrolled transition might unnecessarily increase the risks to our financial system. But even with a congressional vision and plan, there is an uneasiness about exposing vital banking functions to the overall risks of other kinds of business.

The task of deciding how best to redraw the financial landscape will require careful debate and consideration in light of public policy requirements; the merits of the available empirical evidence; and philosophical, as well as political, soul-searching. We intend here to describe (1) the vital functions performed by the financial services industry, (2) the changes occurring in the industry, and (3) the implications of these changes for both the structure of the industry and the continued provision of these vital functions. We will also discuss the issues affecting regulation and oversight of the industry that must be addressed in moving to a world of expanded banking powers. These views are based on our work in the area but are not official positions of the General Accounting Office.

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The vital liquidity functions of our banking system

The commercial banking system has historically been the mechanism for providing a backstop source of funds to meet borrowing needs when alternative sources are not available. In addition, commercial banks, along with other types of insured depository institutions, are responsible for redeeming insured deposits on demand at 100 cents on the dollar. Currently, only the commercial banking system plays both of these roles. It is largely for this reason that commercial banks are perceived to be special. The steady flow

of insured deposits is necessary to help ensure the availability of short-term financing in times of serious liquidity disruption.

Concerns over expanding the product-offering powers of commercial banks are based on two countervailing scenarios: one, in which risks from expanded activities could jeopardize the ability of the commercial banking system to continue to provide liquidity to borrowers and savers, and the other, in which the profits from expanded activities may diminish the desire of the commercial bank managers to continue to provide traditional liquidity support.

The financial services industry has expanded beyond our national borders. Markets are truly becoming international in scope.

The events immediately following the stock market crash of October 19, 1987, make clear the importance of a reliable source of liquidity in a crisis. After the crash, broker dealers and others responsible for maintaining orderly and continuous markets activated standby letters of credit at banks to obtain needed short-term financing. A point was reached where some banks were unwilling to provide that financing. We are not certain how many banks were unwilling or unable to provide credit, but clearly there was a significant unmet need for liquidity. The Federal Reserve then acted quickly to improve liquidity and meet the immediate needs of specific market participants. While we cannot reach any conclusions about the implications of the stock market crash for decisions on expanded bank product-offering powers, it seems clear that the liquidity function performed by banks and the Federal Reserve was demonstrably important in preventing further disruption in the markets. This experience alone is sufficient evidence of how essential it is to maintain a ready source of liquidity.

New competitive environment for banks and other providers of financial services

The immediate and compelling reason for the current debate on reconfiguring the financial services industry is that competition has increased in the industry, despite legal restrictions on competition. Increasingly, banks and nonbanks are offering similar products, competing on the basis of price and widening their geographic bases. Principal concern centers on the implications of this competition for the long-run viability of the commercial banking sector. In this regard, it is important to understand the new competitive environment that characterizes the financial services industry.

Product competition

Many banks and nonbanking companies have achieved combinations of lines of business that were assumed to have been prohibited by the Glass-Steagall legislation enacted in the 1930's. Some financial conglomerates even offer one-stop shopping for insurance, securities brokerage, and consumer loans. All this has happened with the acquiescence of regulators or through successful court challenges to existing law and regulation. Table 1 shows the growth in direct product competition over the past 2-1/2 decades. An increasing number of financial services organizations are vying for the same pool of customers and a relatively fixed supply of savings.

For both banks and nonbanks, the new product competition has significantly changed the nature of their business, as represented on both sides of the balance sheet. Traditional bank liability offerings—the investment products offered to customers—are now offered by all financial services industry participants. And competition is now based on the pricing of these products rather than their availability or nonavailability from each of the separate industry components. The asset side shows even more profound changes having important implications for the way in which savings are channeled to capital. An increasing portion of assets is becoming securitized. That is, financial intermediaries are using pools of loans as the basis for selling securities to third parties, thus laying off some of the risk of collecting these loans onto these parties. In addition, major creditworthy borrowers, such as large corporations, are approaching markets directly by issuing their own debt instruments rather than by borrowing from banks.

All this has altered the relationship between borrowers and providers of funds. Securities investors are bearing credit risks once borne by banks, which held loans in their own portfolios and relied on their ability to judge credit worthiness to control risks. However, banks are prohibited from underwriting these securities offerings. Some argue that this is causing them to lose an important part of their customer base.

As a result, the composition of bank assets, especially in large banks, is changing. A larger percentage of bank revenues is being derived from new sources, such as swaps, standby letters of credit, financial guarantees between counterparties, and other products.

Table 1

FINANCIAL SERVICES INDUSTRY: 1960-84

	Banks		Thrifts		Insurance		Retailers		Securities	
Products	1960	1984	'60	'84	'60	'84	'60	'84	'60	'84
Checking	x	x		x		x		x		x
Savings	x	x	x	x		x		x		x
Time deposits	x	x	x	x		x		x		x
Installment loans	x	x		x		x		x		x
Business loans	x	x	x	x		x		x		x
Mortgage loans	x	x	x	x		x		x		
Credit cards		x		x		x	x	x		x
Insurance					x	x		x		x
Brokerage/ underwriting		x		x		x		x	x	x
Mutual funds						x		x	x	x
Real estate				x		x		x		x

Source: *Economic Review,* Federal Reserve Bank of Atlanta (April 1984), p. 26.

(Many of these new products, often referred to as off-balance-sheet items, are not recorded on the balance sheet because they represent contingent liabilities that may or may not be realized.) These products may differ significantly in their risks and their accounting treatment from commercial and industrial lending. And state-regulated insurance companies, also acting as financial guarantors to facilitate these new credit relationships, are assuming some of the credit risk that was once largely the exclusive domain of federally regulated banks.

The trend around the world is toward more deregulation of financial markets.

In short, in the product area, the various members of the financial services industry are acting more alike, assuming more of each others' risks, and vying for shares of an increasingly common customer base. The exposure of banking functions to these other products—specifically the vital liquidity function discussed earlier and the insured deposits that support it—is at the heart of fears about redrawing competitive lines.

Price competition

We alluded earlier to the increase in competitive pricing between banks and nonbanks. In 1980, this led the Congress to deregulate the interest rates banks could pay depositors. The new ability of depository institutions to compete on the basis of market interest rates has proven a mixed blessing.

The interest-rate deregulation of bank deposits was designed to arrest the periodic withdrawal of those deposits that had occurred whenever large differences arose between rates on bank deposits and short-term market rates. In solving the problem, however, the depository institutions acquired new ones. Because depositories, particularly thrifts, held portfolios of relatively long-term fixed rate assets, fluctuations in the short-term rates they had to pay in order to remain competitive and attract funds resulted in wide fluctuations in earnings. According to the regulators, this has been an important new cause of depository institution failures since 1982.

Geographic competition

The once imposing barriers presented by state and sometimes county borders have gradually yielded to regional economic pressures on the states and competitive innovation by financial institutions. As American consumers have become more mobile

and more sensitive to geographically remote opportunities for earning higher rates of return, they have demanded full-service interstate banking. Their ability to do so, and the industry's ability to meet this demand, was facilitated by advances in computer and communications technology. All this has had the beneficial effect of moving surplus sources of savings to the areas most in need of these savings.

The states themselves, in order to ameliorate local economic difficulties or enhance their financial institutions' competitiveness, have lowered barriers to outsiders and formed regional banking compacts, which will eventually lead to full nationwide interstate banking.

The financial services industry has also expanded beyond our national borders. Markets are truly becoming international in scope. Between 1980 and 1985, banking offices outside an organization's home country increased markedly, as shown in table 2.

Table 2
FOREIGN BANKING OFFICES BY HOST COUNTRY*

Country	1980	1985
United States	579	783
United Kingdom	214	293
Germany	213	287
France	122	147
Switzerland	99	119
Japan	85	112
Luxembourg	96	106
Belgium	51	57
Canada	0	57
Netherlands	39	40
Italy	26	36

*The data are not fully comparable between countries. In some cases, there is double counting of organizations with more than one office in a country. In other cases, the counts do not include all offices of a particular banking organization.

Source: *Recent Innovations in International Banking,* Bank for International Settlements (April 1986), p. 151.

Other sectors of the financial services industry have become more internationalized, as well. From 1980 to 1985, international bond issues rose about 300 percent (including both foreign bonds and Eurobonds). Corporate equity issues outside their home markets grew from $0.2 billion in 1983 to nearly $8 billion in 1986. Moreover, investors are increasingly placing funds outside their home markets. Foreign investors bought $17.5 billion in U.S. shares in the first 9 months of 1985, up from $3.5 billion in 1982.

This increased internationalization has intensified direct bank/nonbank competition. Many of our foreign competitors do not face the same restrictions on combining banking and nonbanking business. American banks can conduct business in some foreign countries they cannot conduct here. And some foreign banks conduct a broader range of activities in this country over a wider geographic area than can U.S. institutions.

In addition, the trend around the world is toward more deregulation of financial markets. Canada, for example, has just repealed its version of our law prohibiting the combining of commercial and investment banking. With the advent of increased securitization of bank assets and the growth of international securities activities, more pressure is being brought to bear to combine financial services in order to maintain the competitive position of U.S. financial firms.

Key issues for structuring debate on combining financial services

The changes in the financial services industry have heightened the amount of competition to which each of the separate industry components must adapt. And there is no reason to believe that the impetus for change will lessen in intensity in the future. The globalization of markets, a growing preference for securitized products, and vigorous price competition for the nation's transactions balances and savings strongly suggest that the historical approach to regulating the financial services industry needs to be reevaluated.

These changes raise concerns about the ability of our financial system to continue functioning in an acceptable way during turbulent periods. If seekers of funds are increasingly approaching securities markets directly and if commercial banks are increasingly laying off risks onto these markets by securitizing their loans, there is reason to wonder whether the infrastructure that has historically provided a backstop source of liquidity during adverse conditions will eventually be destroyed. In addition, as New York Federal Reserve Bank President E. Gerald Corrigan has pointed out, new patterns of securitized intermediation, which place great distance between the investors and the affairs of the borrower, may not provide an adequate system for monitoring borrower perform-

ance and working out problems that could occur between creditor and debtor during difficult financial periods.

There are other considerations as well. Because banks are constrained by law in the types of products they can offer, some have expressed concern that they are taking on increasing risk in those areas in which they are allowed to operate, while losing business in allowable areas of activity involving less risk. Thus, doing nothing to expand the product-offering powers of banks may well increase the risks to which the commercial banking system is exposed. On the other hand, expanding the powers of banks must be done with sufficient care to ensure the financial system's continued ability to meet the liquidity needs of borrowers. Even advocates of combining business lines agree that preserving and protecting the backstop liquidity mechanism traditionally carried out by banks is essential. And even those who argue that the other business lines—securities underwriting, insurance, and real estate—may not be more risky than traditional banking or may complement banking risks seem to support taking no chances by exposing this vital function.

The challenge for policymakers is to craft changes that recognize today's financial environment while ensuring that the critical functions that have been performed by the banking system continue to be performed.

Thus, the dilemma faced by congressional decisionmakers is how to craft changes that recognize the reality of today's financial environment, while ensuring that the critical functions that have been performed by the banking system continue to be performed. The key to resolving this dilemma will involve creating sufficient capacity for regulation and regulatory oversight to achieve a more competitive financial services industry that continues to meet the needs of borrowers and savers in bad times as well as good.

Areas of financial services industry regulatory reform

In light of these considerations, we will focus on two principal areas of regulatory concern that need to be addressed if the scope of products offered by financial services industry participants is expanded:

- the role of deposit insurance in our financial system and the insulation of deposit liabilities from the presumed risks of certain financial activities, and
- the methods by which federal financial crisis intervention and problem resolution take place.

The role of deposit insurance and insulation strategies

Our system of deposit insurance has been largely responsible for preserving the stability of the banking system. Bank runs, the major reason for many of the bank failures of the 1930's, have occurred only infrequently over the past 50 years. As we have discussed, insured deposits provide an important, if not crucial, source for the continued provision of liquidity during adverse financial periods. Against these benefits, however, deposit insurance subsidizes the insured institutions, giving them a competitive advantage over others. This has become a major rationale for denying commercial banks the ability to expand their range of product offerings. The limits on the uses of insured deposits reflect choices about

- which types of activities should be financed with insured deposits because of the public-policy or social objectives those activities serve;
- which types of products are too risky for the federal government, as insurer, to underwrite; and
- the unfair competition that would result if certain institutions could finance an activity with insured deposits while others could not.

In the debate over expanded powers, the Congress must reexamine these choices as it decides on mechanisms to (1) protect the government's risk exposure as primary guarantor of the safety of those deposits and (2) preserve the backstop source of liquidity for the nation's borrowers.

Three basic approaches to regulatory change have been proposed. All three aim to protect the government's interests as underwriter of insured deposits, as well as provide for liquidity during adverse economic or financial periods.

- Change capital adequacy requirements or the means for setting insurance premium rates to more accurately reflect the risks that may arise from an expanded array of product offerings.
- Fully insulate those functions that are now financed with insured deposits, meaning that insured deposits would not be used to finance an expanded set of activities, such as insurance or securities underwriting.
- Fully insulate and limit the uses made of insured deposits to an even narrower range of activities so as to include only high-grade short-term investments, such as Treasury bills.

Capital Adequacy and Risk Compensation Mechanisms: For a number of years, many have argued for the creation of a risk-based deposit-insurance premium structure. The idea has been to more fully compensate the federal deposit insurance fund for the varying range of risks assumed by different insured depositories and to forestall institutions from excessive risk taking. Virtually all who have studied our system of deposit insurance agree that having all institutions pay the same rate based on a percentage of their total domestic deposits, as is now the case, is inherently unfair. Banks that are careful to avoid risky loans may be subsidizing competitors that are not.

Virtually all who have studied our system of deposit insurance agree that having all institutions pay the same rate based on percentage of their total domestic deposits, as is now the case, is inherently unfair.

The idea of adjusting deposit insurance rates with the riskiness of individual institutions has enormous appeal, but its implementation has proven illusive for the following reasons:

- It is virtually impossible to prospectively measure gradations of risk.
- For the most risky institutions, the premium rates needed would be so high as to put them out of business. Rates would be punitive rather than deterrent in their effect.
- Since the government is a monopoly insurer, it would be impossible for those who are dissatisfied with premium assessments to shop elsewhere for better rates.

An alternative to changing the deposit insurance premium structure is to alter capital requirements in a similar way. That is, institutions that have greater risk would be required to provide a greater cushion of capital to absorb the greater risk of losses. Many of the shortcomings of risk-based deposit insurance premiums are also found in risk-based capital proposals. Nevertheless, the regulators have proposed a relatively straightforward risk-based capital system that divides risks into a small number of categories and raises or lowers capital requirements in increments on the basis of the composition of individual institutions' assets.

Our purpose here is not to define a workable approach to accurately assessing costs on institutions for the risks that they undertake, either through deposit insurance premiums or capital requirements. But before we move to a world of expanded powers, this issue needs to be carefully thought through. The ability to estimate the riskiness of a depository institution could be dramatically affected by decisions about how the expanded activities would be organized in relation to the insured depository, as well as the allowable uses of insured deposits.

Insulation of Current Activities: Bank regulation currently provides for legal, economic, and other types of restrictions designed to prevent the use of insured deposits of banks for financing certain types of activities. The bank-holding-company form of organization is generally believed to provide the greatest protection, though it is also generally agreed that no structure designed to insulate deposits from other activities is completely fail-safe. Some think that, if banks are allowed to engage in securities, insurance, or real estate business, the most effective way to protect insured deposits is through insulation mechanisms. Such mechanisms would limit or prohibit loans between the bank and its affiliated or subsidiary institutions engaged in the other lines of business. Some, such as the Federal Deposit Insurance Corporation, argue that the insured depository can be protected from risks associated with expanded activities with only minor changes in regulation, rather than more fundamental changes in bank structure. Others, such as former Citicorp Chairman Walter Wriston, believe that no organization will let any of its subsidiaries fail without bringing to bear all practicable resources, including bank resources. As discussed below, this view seems well founded. During the market crash of October 19, 1987, the First Options Subsidiary of Continental Illinois National Bank received a large cash infusion from the bank to fund massive losses it had incurred. This violated several banking regulations, including legal lending limits on loans to subsidiaries, raising significant questions about the reliability of insulation strategies. On the one hand, it is probably too much to expect that, under the same circumstances, a bank would not come to the aid of a troubled affiliate. For that matter, if the restrictions were rigorously enforced, the securities affiliates of banks could have serious difficulty finding backstop sources of liquidity in future market crises like that of October 19 and 20, 1987. On the other hand, failure of the insulation strategy clearly would increase the risks for the depository institution and its federal insurer.

Greater Limitations on Uses Made of Insured Deposits: Another proposal for change would, somewhat paradoxically, limit the uses of insured deposits to only high-grade short-term assets. Under this proposal, a financial services conglomerate could engage in the full range of financial activities, but insured depository affiliates could engage in only relatively short-term investment in high-grade government or corporate securities. All other activities of the conglomerate would be financed with uninsured deposits or investments. Under this plan, savers would have a

clear choice between low-yielding insured deposits and higher-yielding uninsured deposits or investments. Since the insured depository affiliate or subsidiary could not make commercial loans, it would be illegal for it to loan money to any affiliate or subsidiary of the financial services conglomerate.

This proposal has quite a bit of appeal, but certain serious drawbacks as well. Since insured deposits would be used only for investment in relatively risk-free assets, problems of capital adequacy and inadequate deposit insurance premiums for risk exposure would be solved. The problems that expanded powers pose for the federal government's risk exposure as insurer would be similarly resolved, if the insulation imposed could be effectively overseen. The major drawback is that this proposal would, unless amended to include other uses for insured deposits, completely break the link between insured deposits and the backstop source of liquidity that banks have traditionally provided under adverse economic circumstances. The proposal raises important questions as to whether relatively low-yielding insured deposits would continue to play an important role in the economy and the continued ability of our financial system to provide for liquidity needs in turbulent times. Overcoming these important drawbacks might require expanding the uses of insured deposits to short-term emergency affiliate financing or increasing the reliance placed on the Federal Reserve as lender of last resort (LLR) and developing new channels through which that function could be operated.

Crisis intervention and problem solving

Regulators must be able to detect problems at institutions and intervene if necessary to correct them.

Regulators must be able to detect problems at institutions and intervene if necessary to correct them. Their ability to do so in today's sophisticated market is of paramount importance in the congressional debate. We begin this discussion with the Federal Reserve's role as LLR to the financial system and then address issues of regulatory oversight.

The Role of the Federal Reserve as Lender of Last Resort: With limited exceptions, the Federal Reserve has, as a matter of tradition rather than law, provided liquidity assistance to the economy during troubled periods through the banking system. In other words, regardless of where a crisis has originated, its effects have been dealt with by providing assistance to banks. This assistance, in turn, has been channeled by the banks to troubled segments of the financial markets. Even open market operations that are designed to provide economywide liquidity channel reserves to the banking system because Federal Reserve purchases of Treasury securities create deposits. In a world of expanded powers, consideration needs to be given to whether the Fed should continue to channel LLR assistance strictly to and through the banking system. No matter how configured, financial services conglomerates of the future will be offering a full range of financial products and services. It is worth considering whether the scope of the Fed's assistance should be expanded to securities broker dealers, market makers, and others that would be affiliated with banking functions. This question is particularly important if (1) there is concern about the continued ability of insured deposits to fund liquidity needs during adverse periods because of limitations on their use; (2) the speed of transmission of a crisis becomes so rapid that channeling assistance through the banking system may not be sufficiently swift; (3) a crisis can originate in the financial sector without passing through the banking system; or (4) in the financial services conglomerate of the future, it is impossible to distinguish between banking and other functions.

The Crucial Role of Oversight: We think that, regardless of how the new rules of the game are formulated, regulatory oversight of compliance with the rules will become even more important than it is in today's more restrictive banking environment. In our view, the Congress should not move forward on the powers question until it is satisfied that the regulators can effectively oversee compliance in the new environment.

We are concerned about regulatory oversight capabilities for a number of reasons:

- The bewildering array of new products and services is acknowledged to be severely testing the regulatory agencies' oversight expertise. Risks from new products offered in domestic and international securities and lending markets are simply not well understood by the regulators at present.
- The regulatory agencies' resources are severely strained. Resources are no longer adequate to examine even problem banks with sufficient frequency. And the large number of bank failures since 1982, the growth in the number of banks experiencing problems, and the attention that needs to be devoted to liquidating the assets of failed banks have diverted regulatory resources away from day-to-day oversight of the banking industry. Furthermore, the resources of the Securities and Exchange Commission have not increased in the past 7 years despite staggering growth in market activity.

- The recent incident involving the First Options subsidiary of Continental Illinois National Bank raises serious questions about just how far a financial services conglomerate might go in rescuing one of its subsidiaries. The regulators knew about this situation because they were told about it by the bank, and it was rectified. Nevertheless, the case is troublesome because there is no assurance that such abuses (if they are defined as such) will be revealed or detected in the future.
- Financial decisions are being executed faster than ever due to advances in computer and communications technology. Funds can flow into and out of markets and institutions very rapidly, thus affecting their condition. Regulators must be able to detect problems and act more expeditiously than ever.

We are not nearly so concerned about the regulatory turf issues that sometimes seem to dominate the thinking of the regulators as we are about the resources and expertise needed to buttress regulatory oversight capabilities. Clearly, the current federal and state bank regulatory structure can be streamlined. Opportunities may also exist to more rationally organize the regulatory structure around product lines as opposed to the current institutional alignment. Such opportunities should be explored, but not at the expense of failing to resolve more important issues.

Conclusion

We believe it is absolutely crucial to preserve the ability to supply liquidity in an emergency, a function that has traditionally been performed by the banking system. It is not terribly important, in our view, that the function be performed by banks (at least as we currently define them). It is important that the ability to convert transactions and certain types of savings accounts to cash on demand and to provide a source of short-term financing to facilitate business activity during troubled periods be preserved and performed by someone. To provide a reasonable assurance of this result, decisions need to be made about capital adequacy and risk-compensation mechanisms, the organization of expanded powers, the uses made of insured deposits, the Federal Reserve's role as LLR, and the oversight capabilities of the regulatory agencies that will be responsible for ensuring the continued smooth functioning of the financial system. •

041827

Felix G. Rohatyn

THE MONEY CULTURE

In a world of disposable values, personal ethics are indispensable.

I AM AN INVESTMENT banker. That has been my profession, with the exception of 2 years as an army sergeant, for almost 40 years. For 35 of those 40 years, telling my neighbor at dinner or in an airplane that I was an investment banker was a sure conversation killer. The person next to me at the table would give me a somewhat vague look and turn away at the earliest opportunity. On a plane, the statement guaranteed total bliss—namely, peace and quiet on the entire New York-Los Angeles flight. More recently, the statement evoked a rather different reaction. My tranquility on airplanes ended. I was forced to keep telling my neighboring passengers that, no, I could not, and would not, give them tips on the stock market. In the last year, however, since the sordid revelations of the insider-trading cases and the Boesky scandal, something at least superficially similar to the old reaction has returned. The person at dinner says, "I'm so sorry," and quietly turns away. At Kennedy International, as I come off an overseas flight, the customs agent says: "Investment banker? You should be leaving the country, not coming back."

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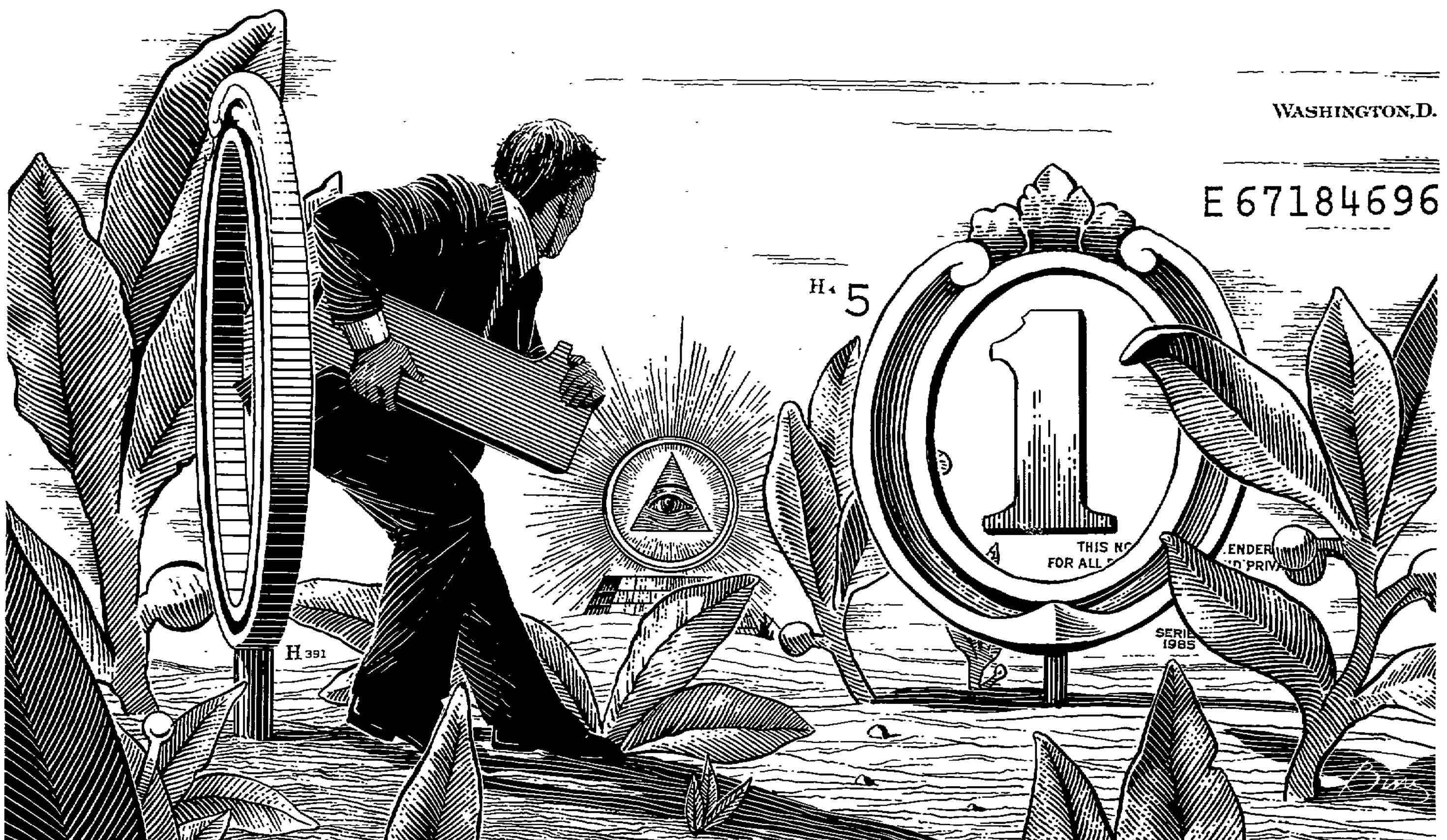

All this may serve to underline one of the realities of the so-called service society. Whereas making things—and the activities related to making things—were the main preoccupations of prior generations, making money—and the activities related to making money—are the driving forces of the current society. To be wealthy is not sinful, nor is poverty a virtue. However, power and the pursuit of wealth are so pervasive today as to create something that may be entirely new: namely, a money culture. When such a culture grows cheek by jowl with extreme poverty, as it does in the United States, it is potentially quite dangerous.

A recent article indicated that business schools are going to encourage the study of ethics as part of their curricula. If graduate schools have to discover ethics, then we are truly in serious trouble. I doubt that ethics can be taught past the age of 10, any more than I believe in the teaching of so-called creative writing. There are some things that one is born with, or is taught by one's parents, clergyman, or grade-school teacher. But not in college or graduate school. I believe that we in business should go back to basics in our recruiting, forget about the business schools, and recruit the best

MOVEMENTS OF CAPITAL, AND THE PAPER ECONOMY RELATED TO IT, USED TO BE THE RESULT OF INDUSTRIAL AND COMMERCIAL ACTIVITY; NOW THEY ARE THE CAUSE.

young liberal arts students we can find. We can teach our trade to a gifted historian or a musician who wants to learn. We will make our own judgments on the ethics of our recruits and try to provide a framework wherein, we hope, our own conduct and our own standards will set the tone.

There is, however, no guarantee of immunity from the cancer of greed and corruption. For example, despite all our efforts, my own firm has been the victim of a corrupt employee, who, in collusion with an employee from another firm, burglarized our offices in the dead of night, searching for sensitive information.

It seems to me that the issue of ethics, both in business and in politics, takes on a sharper focus in the money culture of a service economy than in our earlier, industrial days. Our society's main economic activity consists of buying and selling stocks, bonds, commodities, real estate, insurance, mutual funds, foreign exchange, and futures in anything imaginable, with every possible variation. Most of the time, the product being bought or sold exists only on a computer screen or as an electronic impulse on a magnetic tape. No test or discipline is applied to the activity other than its ability to generate profit. There is no testing for quality, for elegance of design, for durability, no economies of scale created by new processes. Movements of capital and the paper economy related to it used to be the result of industrial and commercial activity; now they are the cause.

In a strange way, war and commerce have become equally depersonalized, carried on by individuals who never see each other, often located in windowless rooms, talking into telephones, and looking at computer screens, thousands of miles removed from each other. In the case of commerce, they only buy and sell. In the case of war, they can incinerate the Earth, without ever seeing the face of another human being.

For the businessman as well as the politician functioning in such an environment, perhaps the only real discipline available is one's personal ethics. Financial scandals are not new, nor is political corruption. Today, however, the potential profits—and their apparently easy acquisition from insider trading, market manipula-

tion, conflict-of-interest transactions, and many other illegal or unethical activities—are too great and too pervasive to be ignored. At the same time, those institutions that historically have provided the ethical basis to the society—namely the family, the church, and the primary school—have grown weak. Hence, our dilemma.

It is often the case that ethical behavior coincides with enlightened self-interest, that the honest businessman does better than the dishonest one, that the clean politician wins out over the corrupt one, and that virtue is good business and good politics. But in too many cases, it is not. Anyone who lives around New York City has become a sophisticated student of political corruption over the last couple of years. Anyone who reads the papers has learned that spying is now a business quite unrelated to ideology. And the financial pages now read more like a police blotter than a reflection of business trends. But while we read about the ones who are caught, we know that many more will flourish.

The application of ethics is made even more difficult by the increasing importance of rapidly changing technology as applied to major problems in our society. How does a lay person deal with the questions raised by the Strategic Defense Initiative (SDI), genetic engineering, acquired immune deficiency syndrome (AIDS), and the myriad issues concerning the availability and affordability of life-saving drugs and other medical technology? Clearly one cannot abdicate to the technocrats the responsibility for making one's own judgments on these issues. An educated person with basic values can understand the technical arguments and arrive at a balanced judgment. That is the essence of democracy.

There are two important risks in the absence of a value system when dealing with a money culture and high technology.

The first risk is that more and more people will turn to radical religion and radical politics. People always search for frameworks that provide a certain amount of support. If they do not find it in their families, schools, traditional places of worship, or themselves, they will turn to more absolute solutions. Religious fundamentalism and far-right politics, in this country, are the most likely refuges. What is easier than to adopt the black and white dicta of biblical teachings, the total prohibition against abortions, and similar absolutes? What is simpler than the sterile view of an eternal struggle with imperial communism, or the notion that the only valid role for government is to deliver the mail and to deliver bombs?

A DEMOCRACY CANNOT FLOURISH HALF RICH
AND HALF POOR, ANY MORE THAN IT CAN FLOURISH
HALF FREE AND HALF SLAVE.

The second risk is the polarization of society. We have presided over the greatest explosion of financial speculation ever—greater even than in the 1920's. We have created hundreds of paper millionaires and quite a few billionaires, and alongside the wealth and glamour of Manhattan and Beverly Hills, we have seen the accelerated growth of a semipermanent or permanent underclass.

In the inner cities and rural areas, blacks, Hispanics, poor whites, and immigrants are falling further and further behind. Inadequate education, a welfare system that destroys family structures, and drugs on the one hand, and the higher and higher skills required by the jobs with a future on the other: All condemn more and more

people to a permanent condition of need. A democracy cannot flourish half rich and half poor, any more than it can flourish half free and half slave.

Traditionally, we have rather simplistically characterized ourselves as conservatives or liberals. The conservative ethic emphasized freedom and the creation of wealth; the liberal ethic, freedom and fairness in the distribution of wealth. Today, conservatives and liberals alike have participated in the greatest borrowing binge in this country's history. We have not created permanent wealth; we have borrowed from the future to indulge ourselves today. Freedom consists of more than freedom from foreign domination. It consists of freedom from dependency on foreign capital and the ability of all citizens to fulfill their destinies. That is not the case in America today. As a country, we are no longer independent economically. As individuals, too many Americans are condemned, from birth, to being economic wards of the state and educationally underequipped to compete.

The most important function of higher education is to equip the individual with the capacity to compete and to fulfill his or her destiny. A critically important part of this capacity is the ability to provide an educated and critical evaluation to a political process badly in need of greater public participation. This brings me back to the subject of teaching ethics in graduate schools.

HISTORY, PHILOSOPHY, LOGIC, AND LITERATURE ARE MORE IMPORTANT IN DEALING WITH TODAY'S PROBLEMS THAN GREAT TECHNICAL COMPETENCE.

Ethics is a moral compass. Ideally, it should coincide with enlightened self-interest, not only to avoid jail in the short run but to avoid social upheaval in the long run. It must be taught early, at home, in grade school, and in places of worship. It is highly personal. I doubt that it can be taught in college. What is desperately needed, however, in a world dominated by technicians and increasingly complex technology, is the skepticism and sense of history that a liberal arts education provides. History, philosophy, logic, and literature are more important to deal with today's problems than great technical competence. They must combine, with an ethical sense acquired early in life, to provide the framework needed to make difficult judgments. We most certainly need the creativity of great scientific minds. But not all of us can be experts, nor do we need to be. Technical experts are not in short supply; the financial world has a plethora of them. The same is true in defense, politics, trade—you name it. These experts are seen on television talk shows and on the op-ed pages of newspapers. They sell knowledge but not judgment. Beware of experts; in the last analysis, only judgment, tempered by a sense of history and a healthy skepticism of cant and ideology, enables one to make the difficult choices.

I confess that I have never been as uncertain and troubled as I am by what I see around me today. At the same time, the opportunities created by dramatic technological breakthroughs at home and the possibility of significant change abroad—as in our relations with the Soviets—cannot be ignored. I have to make my own judgments every day about the ethics of my business; its profitability; and the validity of various arguments on subjects as diverse as SDI, trade with Japan, AIDS, abortion, euthanasia, and bilingual education. Occasionally, a ray of light does shed some obvious truth for which one must be grateful. But otherwise, when there is no clear signal, one must rely on the ethics learned early in life, the history and philosophy learned later on, and one's own good judgment. ●

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Eleanor Chelimsky

GAO'S APPROACH TO AIDS IN THE WORKPLACE

How one public employer developed a strategy for coping.

Catastrophes are common things, yet it's hard to believe in them at first, even when they come crashing down upon your head. There have been as many plagues in our history as there have been wars. And still, plagues and wars always find people completely unprepared.

Albert Camus, The Plague

IN THE LIGHT OF current reactions to the advent of AIDS (i.e., acquired immune deficiency syndrome), it seems that we in America are still at the stage described by Camus—not quite sure of what has fallen on our heads. Many people today are still uninformed about the nature of AIDS, and especially about its modes of transmission. Even our most learned scientists cannot predict the eventual scope of the AIDS epidemic, nor do any of us understand the changes it will precipitate in American life. We do know, however, that if fear and ignorance of the disease are allowed to flourish, they may pose as great a peril to our society as the disease itself.

With this in mind, public agencies are beginning to recognize the need to confront the issue of AIDS in the workplace. At the General Accounting Office, for example, we began implementing our own policy on AIDS in December 1987. As the disease continues to spread, it may be useful to other agencies to know how we proceeded at GAO and with what logic we arrived at the principles we eventually recommended and adopted. This article, then, has been written to share our experience in coming to grips with a complex, potentially divisive, and already excessively politicized subject.

In December 1986, the Comptroller General, concerned about the rapid spread of the AIDS epidemic, established a GAO Task Force to consider the problems posed by AIDS in the workplace and, if necessary, to develop a plan for addressing them. The Task Force was composed of 11 GAO officials who had expertise in divisional and regional operations, research and methods, law, medicine, employee benefits, cost accounting, and personnel.[1]

ELEANOR CHELIMSKY, Director of GAO's Program Evaluation and Methodology Division, chaired the agency's Task Force on AIDS in the Workplace.

Beginnings

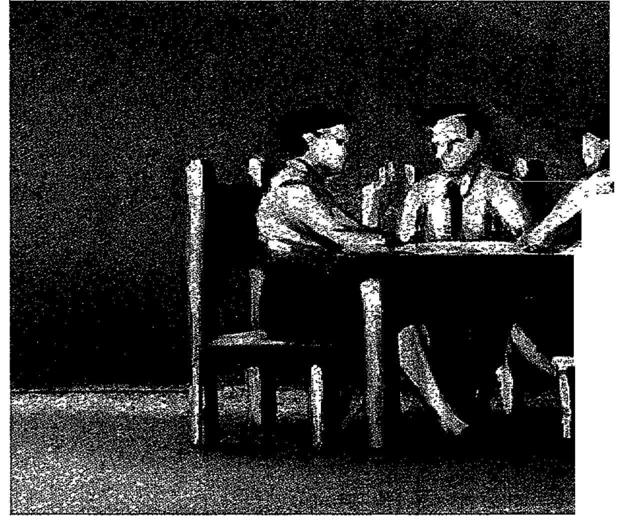
As we started our work, we asked ourselves how we could know whether any plan or policy we might come up with would be a good one. We decided that a good policy would have to meet four objectives:

- Maintain a safe and healthful work environment for all employees.
- Treat an employee with AIDS fairly and humanely.
- Avoid disruptions to GAO productivity.
- Help managers deal efficiently and sensitively with AIDS problems in the workplace.

Before considering how those objectives could be met, we knew it would be necessary to develop a clear understanding of AIDS itself: what it is, how it is transmitted, what is known and unknown about it, and how that understanding could be related to the specifics of AIDS in the workplace.

This disease, unlike most communicable diseases, is within the control of an individual to avoid.

Between December 1986 and March 1987, a good deal was published about AIDS. As we became steeped in the scientific and medical literature, certain points became influential in our thinking. We saw, for example, that it was important to bear in mind that AIDS is a recent phenomenon: AIDS was recognized as a disease only in 1981; the causal retrovirus HIV (i.e., human immunodeficiency virus) was pinpointed only in 1984; and the ELISA (enzyme-linked immunosorbent assay) test, which identifies persons who have produced antibodies to HIV, was developed only in 1985. As recently as 1983, a mere 1,500 cases of AIDS had been reported worldwide, whereas in August 1987, there were already 41,000 cases and 24,000 deaths in the United States alone. The lesson here for policy-making in the workplace is that current experience is not yet definitive. We are still learning about AIDS.

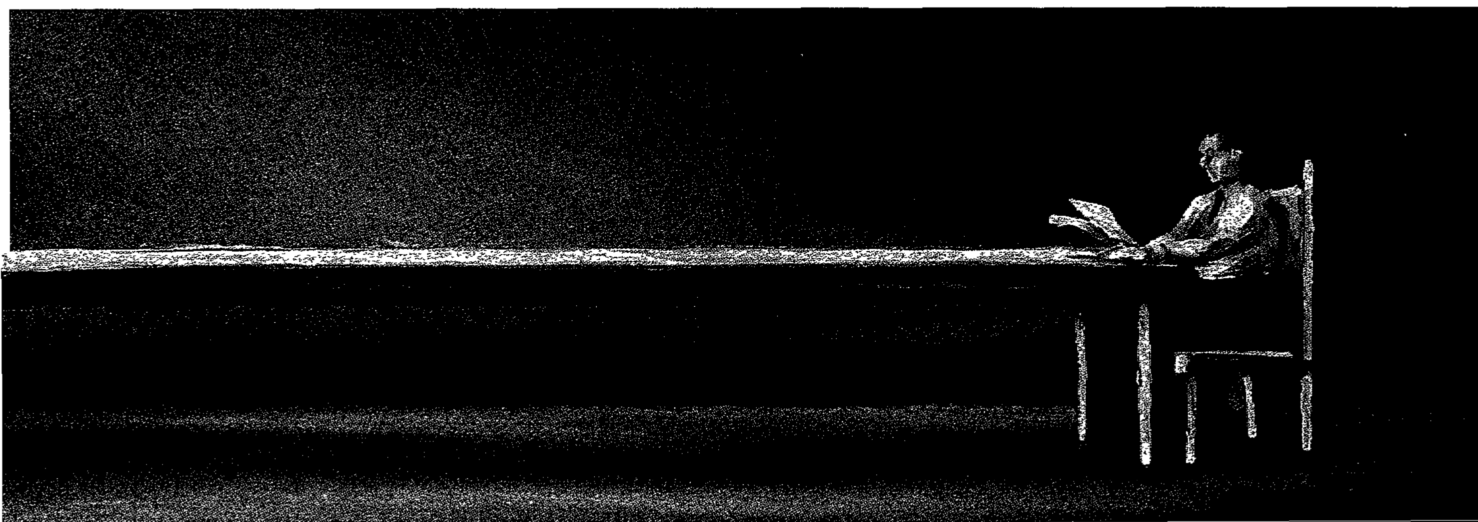


But we also saw that there are points relevant to workplace policy about which there is strong scientific and medical consensus. For example, we know that AIDS is both infectious and invariably fatal; there currently exists no cure or vaccine; over 90 percent of AIDS patients are homosexual men or intravenous drug users or both; HIV is not robust, cannot live long in the open air, and is easily killed by ordinary household cleansing agents; and the only documented transmission mechanism for HIV is through the exchange of bodily fluids (i.e., through blood-to-blood contact as with transfusions or the sharing of needles in drug use, through sexual contact, or from mother to infant—either at birth or through breast milk).

HIV has *not* been transmitted by coughs and sneezes, like the flu; casual contact, like smallpox; insects, like the bubonic plague; or contaminated water, like typhus. In other words, even though nothing can yet be done to cure someone with HIV or AIDS, this disease, unlike the plagues of the past, is within the control of an individual to avoid. Prevention can be achieved by refraining from sexual or blood-to-blood contact with HIV-infected persons. (This is not, of course,to suggest that there is no *theoretical* risk of any other mode of HIV or AIDS transmission. Such a risk can always be argued; however, there is no documentation or empirical evidence to back it up after more than 6 years of following the etiology and development of the disease.)

Finally, we saw a number of important gaps in the knowledge about AIDS that had clear significance to our assignment. For example, planning is made difficult by a number of factors: It is not known how many people in the United States are now infected with HIV (estimates run from 1 million to 2 million people); it is not known how many of those now infected with HIV will go on to develop AIDS (estimates vary from 30 to 70 percent) or when they will develop it (AIDS may not manifest its presence for as long as 10 years after HIV antibodies have been produced); forecasts of the number of future AIDS cases are themselves quite uncertain because of all the other uncertainties in the models used (the Centers for Disease Control estimates a total of 270,000 cases of AIDS and a total of 179,000 deaths from AIDS over the 1981–91 period and 54,000 deaths annually from AIDS starting in 1991); and—perhaps most important of all—the rate at which AIDS will spread into the U.S. heterosexual population is unknown (only 4 percent of cases, in 1987, were the result of heterosexual transmission). These uncertainties meant that our Task Force would have to allow for considerable flexibility in any policy it came up with to accommodate future changes in knowledge about the disease.

On the basis of our initial work, we reached three preliminary conclusions. First, the epidemic was of sufficient magnitude to warrant serious workplace attention; we could find no reason to expect that any



sizable organization was likely to be spared its share of AIDS cases. Second, everyone in the GAO workplace needed to understand the disease's transmission mechanisms in order to prevent as many new cases as possible.[2] Finally, we realized that, given those mechanisms, there was, in fact, little or no risk of getting AIDS or HIV in the typical office workplace.

The study plan

Returning to our four objectives, we proceeded to develop a study plan. To address the goal of maintaining a safe and healthful work environment, we saw that it would be necessary to answer three questions:

1. What public health issues need to be confronted in dealing with AIDS?

2. What concerns do GAO employees have with respect to AIDS?

3. What role could testing play in minimizing the incidence of AIDS in the GAO workplace?

To address the second objective of treating employees with AIDS fairly and humanely, we identified four more questions:

4. What kinds of workplace problems have been faced most often by employees with AIDS?

5. What problems occurred when employees at GAO developed AIDS?

6. How well do GAO's health and other benefits cover the needs of an employee with AIDS?

7. How sizable are the costs of treating AIDS?

Looking at the first and second objectives together, we asked another question:

8. What are the legal rights of employees with AIDS and their coworkers?

Finally, we addressed the last two objectives regarding GAO productivity and the ability of managers to respond to AIDS in the workplace. The following questions arose:

9. What have other organizations done to develop workplace policies on AIDS? What problems have they experienced? What is their advice?

10. What do GAO managers think about a GAO policy on AIDS?

11. What do public health management experts feel is the best way to maintain productivity in the face of AIDS?

The most common concern voiced by employees is the need for counseling and confidentiality.

Although much popular literature is available, the Task Force could find no survey data on AIDS in the workplace.

To answer these questions, we developed specific research assignments for the Task Force members. The questions and associated activities constituted the study plan that guided our data collection efforts over the 9-month study period. Here are some of our findings.[3]

(1) Public health issues

From our review of public health issues, we learned that the presence of AIDS in the ordinary office workplace is not considered a public health hazard. The Public Health Service states that "there is no known risk of AIDS virus transmission" for "persons in settings such as offices, schools, factories and construction sites.[4] Even in the case of food-service workers, the Centers for Disease Control (CDC) sees no public health reason why workers infected with AIDS should be restricted from preparing or serving food and observes that following recommended standards of good personal hygiene and food sanitation suffices in this area. In contrast, CDC has issued detailed guidelines for health-care workers who are likely to come into contact with AIDS-infected blood. These workers are urged to avoid risks of accidental needlestick injury or mucous membrane exposure to infected blood.

(2) Employee concerns

Our consultations with GAO employees revealed concerns in three major areas: blood screening (or testing) for AIDS, the demands of privacy and confidentiality versus the desire of coworkers to know about AIDS cases, and the availability of competent and confidential counseling both for AIDS-infected employees and their coworkers. Of the three concerns, the one most often raised was that of counseling and the critical need to guarantee confidentiality. Many employees recommended against duplicating services available elsewhere in the community and suggested referrals to outside agencies. Employee groups generally favored a program that strengthened the counseling services within GAO and publicized other community resources.

By way of an immediate response to this concern, we enlisted the help of GAO's Counseling and Career Development Branch to develop guides to community facilities for counseling and testing, along with information about cost and confidentiality, for all of GAO's geographical locations. The resource guide for Washington, D.C., was distributed in August 1987; the 14 regional guides, in November.

(3) The role of testing

We investigated the appropriateness of testing the blood of GAO employees or of applicants for employment for the presence of the HIV antibody. We wanted to look at this issue because of interest among GAO's employee groups and because of the mandatory testing for certain groups currently practiced by the Departments of Defense and State and by the Job Corps.

On the basis of an analysis of the legal issues (see item 8, below), a review of the literature on testing, and consultation with experts in the field, we concluded that blood screening for AIDS is not presently advisable at GAO for these reasons:

- AIDS is not considered a health hazard in the ordinary office workplace.
- Current tests do not screen for AIDS itself but rather for antibodies to HIV.
- A positive (or negative) test result for HIV could not provide a proper basis for a personnel action.
- Testing employees or applicants for employment would likely be viewed as discriminatory under current law.

(4) Literature on AIDS in the workplace

When we turned to the literature on AIDS in the workplace, we assumed that we would find at least one or two studies looking empirically at the problems that have been faced by employees with AIDS. But we were reminded once again that AIDS is a recent phenomenon; although much popular literature is available, we could find no survey data on AIDS in the workplace—published or unpublished. We decided, therefore, to supplement our literature search by interviewing persons with extensive experience with the problem.

Through the literature review and interviews, we learned that five workplace problems commonly confront employees with AIDS: job discrimination (i.e., discrimination either in hiring or, if already employed, at work); loss of confidentiality (coworkers often think that they have a right to know about any real or suspected AIDS case in the workplace and that

the ordinary rules of privacy do not apply in this situation); stigmatization (coworkers who refuse, directly or indirectly, to work with an employee who has AIDS); the designation of a nontraditional agent (managers are sometimes unprepared to deal with an employee agent who is not a relative); and behavioral manifestations of the disease (managers and coworkers sometimes misunderstand psychological symptoms of AIDS, such as depression, confusion, and hostility). As a consequence of these findings, we decided to develop special guidelines for managers.

(5) Case studies of AIDS at GAO

The Task Force carefully reviewed what had happened in four prior cases of AIDS at GAO. One important discovery we made was that not one of the four GAO employees who suffered from AIDS had approached management with that information. (In two cases, however, a supervisor had elicited the information from the employee.) Another point was that financial hardship due to health-care expenses—something we had been concerned about—apparently was not a problem in any of the four cases. On the other hand, disability-retirement paperwork did take a long time to process through the federal Office of Personnel Management. GAO managers tried hard to accommodate employee needs when requested, making special arrangements that included flexible work schedules and temporary reassignments. But managers did experience some uncertainty and confusion about how to proceed and about what alternatives were available. In all cases, confidentiality was observed.

We concluded that the four cases of AIDS at GAO generally had been well handled by managers. However, we thought the management of future cases would likely be improved if focal points could be clearly identified where an employee with AIDS or his or her supervisor could go, without fear of disclosure, to seek counseling and assistance with workplace difficulties. Also, expediting the disability retirement process, not only for employees with AIDS but also for all seriously ill GAO employees, seemed a necessity.

(6) Adequacy of benefit policies at GAO

The Task Force conducted a detailed review of GAO's benefit policies to see whether they met the needs of employees with AIDS. The review found that such benefits are substantial. While medical costs are not completely covered under the Federal Employees Health Benefits Program, the potentially disastrous financial implications of an AIDS diagnosis can be greatly mitigated by taking full advantage of benefits. However, the employee, like any other employee seeking health insurance, would need to examine carefully the details of available plans and choose one suited to his or her likely health-care needs. Since the plans are quite complex, the employee is unlikely to be able to develop the optimal package of benefits without help. Therefore, it is crucial that the employee seek assistance as early as possible in the course of the illness. The Task Force concluded that it would be important to identify in writing the major health-care concerns of the typical employee with AIDS and to make this information available with the plan-comparison booklet distributed annually during "open season," when employees select health plans. Also, we concluded that employees with AIDS who are considering disability retirement need to seek counseling well in advance in order to choose appropriately and avoid unnecessary delays in receiving benefits.

(7) Costs of AIDS

In examining the health-care costs for AIDS, the Task Force found that the average annual cost is estimated at between $60,000 to $140,000, depending on the form the disease takes and on the types of health-care facilities used. On average, life expectancy after diagnosis of AIDS is about 11 months. This period may be extended with new experimental (and currently very expensive) medication that is expected to prolong the patient's life but not cure the disease.

(8) Legal issues

The Task Force performed a comprehensive analysis of the legal issues related to AIDS in the workplace. We concluded, on the basis of this work, that AIDS appears to be a handicapping condition protected from discrimination under the Rehabilitation Act of 1973. The legal review further concluded that it would be prudent to treat persons who test positive for the HIV antibody as entitled to the same protections, pending further clarification of the law on that issue.

AIDS appears to be a handicapping condition protected from discrimination under the Rehabilitation Act of 1973.

This means that no person with AIDS can be refused employment or be terminated from

We had hoped to find some striking examples of innovative workplace programs. We didn't.

employment because of AIDS, so long as he or she can do the work and presents no reasonable probability of harm to others in the workplace. The act, therefore, appears to preclude mandatory testing for the presence of the antibody, since its mere presence would neither prevent successful job performance nor pose a substantial risk to others.

The legal review also made clear that, because AIDS is not communicable in the ordinary office environment, GAO staff will be expected to continue working relationships with any fellow employee recognized as having AIDS. With regard to breach of confidentiality, the legal review also pointed out that administrative penalties would apply to a supervisor or a coworker who disclosed the condition of an employee with AIDS without official reason to do so. Finally, the review noted that the principles concerning how employers, supervisors, and coworkers deal with an employee who has AIDS are still evolving.

(9) AIDS policies in other organizations

The Task Force's survey of other public and private organizations was aimed at finding out what their experience had been with AIDS. We learned that, in general, the objectives of organizations that had chosen to establish policies were to decrease fear of AIDS in the workplace, protect the rights of employees with AIDS, and apply personnel rules consistently. These organizations relied primarily on education programs, counseling, and community referrals to accomplish their objectives.

Except for the respondents in the three government agencies that had developed testing programs, all respondents thought that testing was "a bad idea." No problems were reported in implementing AIDS policies except by the State Department, which is undergoing an employee lawsuit challenging its testing policy.

We had hoped, in our survey of other organizations, to find some striking examples of innovative workplace programs. We didn't. On the other hand, we did find general agreement about the importance of having an education program and of maintaining confidentiality. However, while confidentiality was considered essential by all the organizations surveyed, most organizations with policies did not specifically stipulate employees' rights to confidentiality.

(10) Managers' views

We learned from our survey of a sample of GAO managers that they strongly supported the issuance of guidelines on AIDS and suggested that the Task Force consider such issues as education for managers and staff, privacy and confidentiality, testing, the desire of coworkers to be informed of AIDS cases, health-care benefits, safety of the workplace, sick leave, and disability. An overriding concern of these managers was that the existence of guidelines should not be seen as a substitute for careful consideration of the circumstances of each case. Another concern was the need for continued monitoring. Given current uncertainties about AIDS, managers felt the Task Force should consider the need for ongoing educational updates to employees, ongoing monitoring of GAO benefit packages and their utility, and ongoing review of the development of testing and treatment for AIDS.

Finally, managers felt that an important thing for the Task Force to do to maintain productivity at GAO would be to spell out succinctly the responsibilities of managers in the event of an individual case of AIDS.

(11) Public health views

The Task Force held some discussions with public health experts about maintaining productivity in an office workplace in which a case of AIDS had occurred. Two points of advice especially struck us. First, we were cautioned to think carefully about whether any policy we might plan to adopt could cause divisiveness in the workplace. Second, great emphasis was given to the need for managers to use education and counseling not once but often. The point was that both repetition and a certain amount of time are needed before people can grow accustomed to the facts about AIDS, can understand that they won't "catch it" by being near an employee with AIDS, and can accept the prospect of witnessing a fellow worker's steady decline toward death. Against these difficulties, the only weapons available are education and counseling, and we concluded that these should be used and reused in helping employees cope with AIDS.

Task Force recommendations

We made two recommendations to the Comptroller General: first, that GAO guidelines concerning the rights and responsibilities of managers, of employees with AIDS, and of their coworkers be promulgated and, second, that an action plan be implemented to inform GAO staff and ensure that the guidelines are followed consistently throughout GAO.

Guidelines

We recommended that the following policy be adopted at GAO and a copy distributed to every employee:

> On the basis of available medical and scientific information, the U.S. General Accounting Office recognizes that acquired immune deficiency syndrome (AIDS) is a life-threatening illness that is not transmissible under ordinary GAO work conditions. Therefore, GAO has determined that the following four principles will guide its personnel procedures:
>
> - GAO intends to maintain a safe and healthful work environment for all GAO staff.
> - Freedom from AIDS is not a condition for hiring or continued employment.
> - An employee's health condition is private and confidential.
> - GAO will make every effort to offer reasonable accommodation for the employee with AIDS.

Action plan

We recommended an action plan having the following major components:

Education and Counseling—GAO should initiate special education sessions for all employees and make expert and confidential counseling available to employees with AIDS and to their coworkers. In addition to the Surgeon General's report and the resource guides that had already been distributed to all employees, the Task Force recommended that its own report be widely disseminated across GAO.

Managerial Guidelines—We prepared special guidelines to help managers deal with AIDS cases in the workplace. These guidelines focus on the practical problems managers face, using a question-and-answer format. They should be made available to managers within each unit at their request.

Managerial Focal Points—An individual at the level of the deputy for operations or assistant regional manager should be designated in each unit to act as a focal point for AIDS, handling personnel issues and serving as a resource person and intermediary.

Monitoring—Because of the rapidly expanding state of knowledge about AIDS, GAO should continue to monitor scientific and legal developments related both to AIDS and to the successful implementation of agency guidelines. A standing group composed of three GAO officials (the Director of Personnel, the Chief Medical Advisor, and the General Counsel) should monitor problems continuously, and the Task Force as a whole should meet once a year, or more often if circumstances warrant.

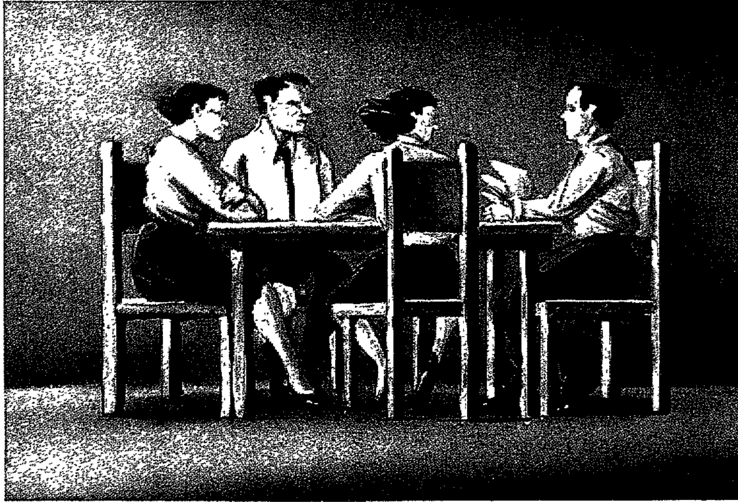
Conclusion

Several points should be borne in mind about the guidelines and action plan the Comptroller General has adopted.

First, evaluation is built into it. While we on the Task Force believe we have carried out our mandate and addressed our four objectives, how well we have done so can be assessed only over time. After a few years, we will need to examine whether we have in fact maintained a safe and healthful workplace, treated employees with AIDS fairly and humanely, avoided disruptions in our productivity due to AIDS problems, and helped managers deal successfully with AIDS cases. The monitoring function to be performed by the standing group and the Task Force will take on considerable importance in helping us evaluate how the policy is working.

How well the Task Force achieved its goals can only be assessed over time.

Second, the guidelines and action plan are tailored to the present parameters of AIDS. If those parameters (e.g., current law or the transmission mechanisms of the disease) should change in



GAO has sought to avoid building walls that might divide employees, but instead, to preserve the bonds between them.

important ways, the policy may have to change as well.

Finally, in a broad sense, GAO's guidelines and plan reflect an important lesson of history that derives from accounts—such as those of Daniel Defoe, George Duby, and Francis Aidan Gasquet—of the medieval plague years in England and France. The reader of those accounts is struck by the realization that, as the plague spread (one-third of Europe's population eventually died of it), it wrought major changes in the behavior of the living. The most ordinary acts and thoughts came, little by little, to be seen essentially within the context of the plague. Right now, in the United States, AIDS may have only begun to make its presence felt. If the predictions of future AIDS cases are at all accurate and if there should be a major spread of the disease among the general population, it seems likely that, as in the 14th century, many if not all aspects of our lives could similarly come under the shadow of the disease.

A critical lesson of the 14th-century experience is that it was fear of contagion that altered people's habits and produced such thoroughgoing changes in their lives. The same fear could affect us unless we can attain—as medieval Europeans could not—a clear understanding of the facts. One of the worst effects of 14th-century fear was the creation of an unbridgeable gulf between those who did and those who did not have the plague. By trying to disseminate the facts rapidly and by treating AIDS like any other life-threatening disease, GAO's Task Force sought deliberately to avoid building walls that might divide our employees, but instead, to preserve the bonds between them.

On the basis of its work, the Task Force believes that the major source of AIDS problems in the workplace will not be the disease itself, but anxiety and misinformation about it. Our success in parrying this problem will be a function of our ability to inform employees early and effectively of the facts about AIDS. If we can do this—and we think we have a head start vis-a-vis the spread of the disease—then there is considerable hope that GAO will be able, despite AIDS, to maintain its work force cohesiveness, based on concern both for the welfare of all staff and for the humane, sensitive treatment of individual employees suffering from AIDS. •

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1. Serving with me on the Task Force were Felix R. Brandon II, Director of Personnel; Richard L. Brown, Director of General Services and Controller; John R. Cherbini, Deputy Director for Planning and Reporting, Accounting and Financial Management Division; Judy England-Joseph, Assistant to the Assistant Comptroller General for Operations; Ira Goldstein, Assistant Comptroller General for Operations; Murray Grant, Chief Medical Advisor, Human Resources Division; Mary Hamilton, Regional Manager (New York); James F. Hinchman, General Counsel; David A. Littleton, Deputy Director for Operations, National Security and International Affairs Division; and Herbert R. McLure, Associate Director, Resources, Community, and Economic Development Division.

2. Therefore, when the Surgeon General's report on AIDS was published in January 1987, the Comptroller General approved its immediate dissemination to all GAO employees.

3. For a complete discussion of all our findings in this and other matters included in this article, see the Task Force's full report, *Coping With AIDS in the GAO Workplace* (December 1987).

4. Summary: Recommendations for Preventing Transmission of Infection with Human T-Lymphotropic Virus Type III/ Lymphadenopathy-Associated Virus in the Workplace," *Morbidity and Mortality Weekly Report*, CDC, Vol. 34, No. 45 (Nov. 15, 1985), pp. 681–95.

041829

Dave Balderston

A JUDGMENT CALL: MEASURING THE SAFETY OF THE AIRLINES

As fliers grow more concerned, aviation experts search for comparable and objective safety indicators.

FOR MANY OF US, the perils of flight come vividly to mind as we hurtle down a mile of concrete runway in the white-knuckled company of a couple hundred of our fellow citizens. Safety always has been *the* issue in air travel. But today, more than at any time in recent memory, it seems less an abstract concern than a cause for real anxiety.

Is that anxiety well-founded? How accountable are the airlines for the safety of their operations? How well does the government monitor their safety efforts? What aspects of airline operations affect safety performance, and how accurately can they be assessed? The General Accounting Office has been looking into these questions, most recently in response to a request by Representative Barbara Boxer.[1] Evaluating airline safety efforts, we have found, depends more on the judgment of airline executives, Federal Aviation Administration (FAA) inspectors, and other aviation experts than on objective measurements. We have also concluded that the government needs to improve the way it manages the inspection program and handles the data it generates.

Ten years of deregulation

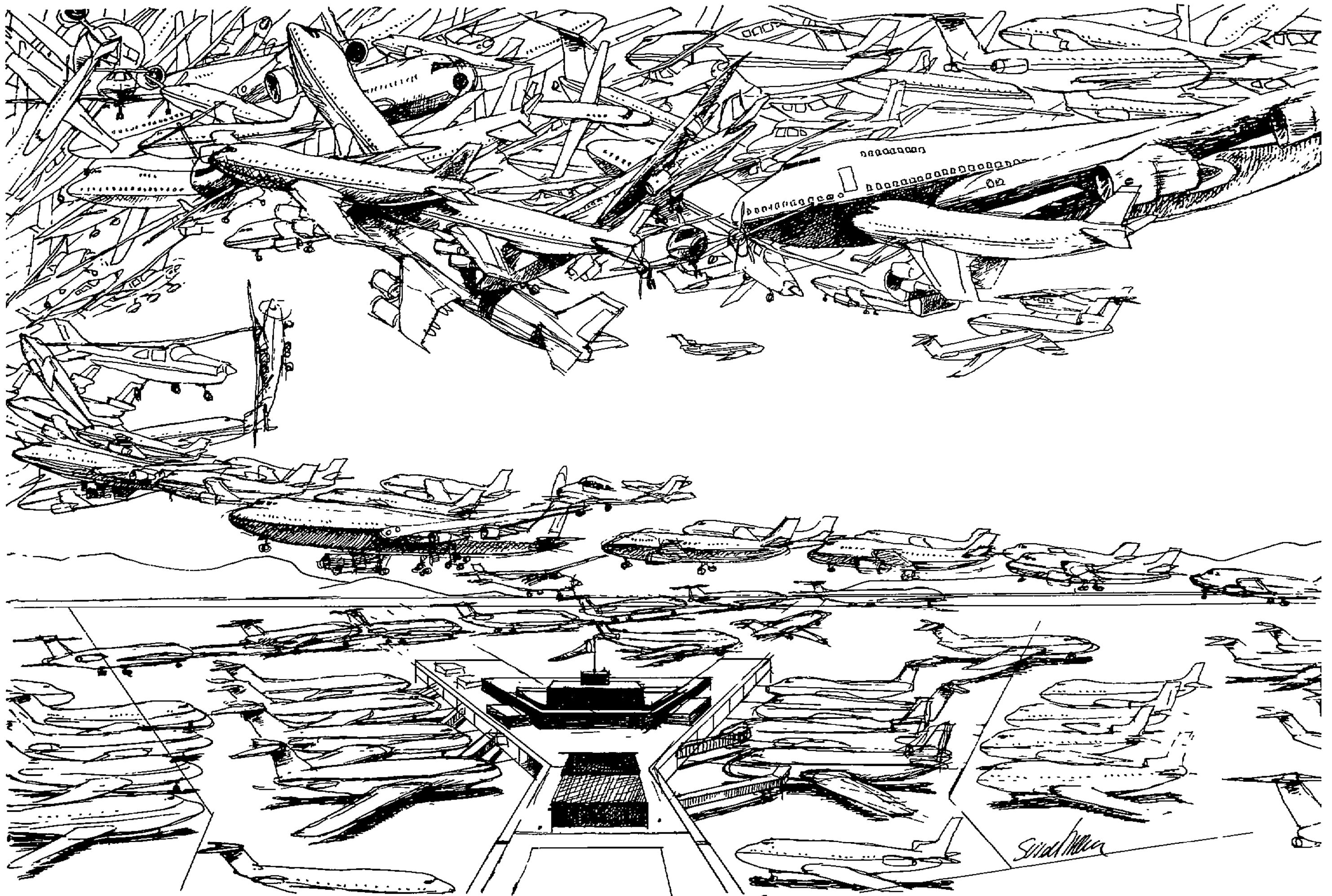
A decade has passed since the Congress loosened the regulatory reins on the airline industry, granting carriers the luxury of setting their own schedules and fares. But while the Airline Deregulation Act of 1978 introduced market competition to the industry, it did not change the government's oversight authority in the area of safety. This remained the province of FAA, which continued to run the air traffic control system and oversee airline operations and maintenance. Even with deregulation of the industry, FAA retained all its powers to impose and enforce safety standards.

One of the most striking results of deregulation has been an enormous increase in the volume of passengers. A decade ago, only 1 American in 10 had ever flown in an airplane. Today, 30 percent of the population flies each year. From 1978 to 1986, the annual volume of airline passengers grew from 275 million to 419 million. Seventy-two percent of the increase has come in the past 3 years.

Other big changes have occurred as well. From 1978 to 1983, the number of airlines flying large planes grew from 36 to 98. By the end of 1986, their number was down to 74. Some airlines went broke; others were swallowed up in mergers. In the aftermath of the wave of mergers that occurred at the end of 1986, seven large airlines now carry almost 90 percent of the passengers.

As the airline industry struggled to cope in the 1980's with ever-growing passenger loads and organizational flux, FAA encountered its own turbulence. In 1981, 11,000 of FAA's 15,000 air traffic controllers went out on strike and were fired. So just when the nation's airports faced unprecedented air traffic, FAA faced the task of rebuilding its controller work force. Five years after the strike, the National Transportation Safety Board (NTSB) and GAO studied the situation and warned that, despite FAA's having doubled the number of fully trained controllers from the immediate poststrike level, the aviation agency could not be sure its controller work force would be able to keep up with the growing number of takeoffs and landings.

DAVE BALDERSTON, an evaluator in GAO's Resources, Community, and Economic Development Division, worked on aviation issues from 1985 through 1987.



Bottlenecks at the big hubs

The logical consequence of so much traffic is congestion. The number of flights has far outstripped any expansion in airport capacity. To make matters worse, airlines have adopted a "hub-and-spoke" operating strategy under which flights are channeled into a small number of airports—such as Denver, Dallas-Ft. Worth, Chicago, and Atlanta—where passengers change planes before flying on to their destinations. This strategy is a more efficient use of airplanes, but it often leads to bottlenecks at the big hubs, especially at peak travel hours. In the hub-and-spoke approach, schedules are highly interdependent, so a morning backup at one hub can trigger delays all over the country for the rest of the day.

Predictably, travelers have become increasingly fed up with the hassles of delayed flights and missing baggage. During the past year, they have more than doubled their complaints to the Department of Transportation (DOT). More unsettling, though, is the suspicion that the inconveniences of flying are a symptom of something more serious. As one prominent *Washington Post* columnist wrote following an especially memorable flight, "How can you trust an airline to get you there safely when they can't even keep track of your luggage?"

Sources of concern

There have been more visceral sources of public concern as well. While industry and government alike tried to cope with the changes growing out of deregulation, a string of air catastrophes added fuel to the

public's fears. At the beginning of 1982, an Air Florida plane crashed while taking off in a Washington snowstorm. Through television, millions of Americans watched the stunned survivors struggle to escape the wreckage in the icy Potomac River.

Other disasters followed. In 1985, an Air India flight crashed in the Atlantic, a Delta flight crashed in a thunderstorm while trying to land at Dallas-Ft. Worth, and a Japanese airliner crashed after its tail assembly failed. Largely because of these events, 1985 came to be seen by many as the worst year in commercial aviation history. The significance of these crashes has been disputed, but their impact on the public's perception of the effects of deregulation upon air travel safety has been undeniable.

Although deregulation did not lessen the government's role as watchdog, FAA's inspection force was cut back just as its work load was increasing. Airlines were growing, new airlines were being started, and others were flying into new airports. But under tightening budgets in the early 1980's, FAA actually reduced the number of airline inspectors. The need to certify new airlines left FAA's shrinking staff with even less time to inspect the airlines that were already operating.

Starting in 1984, a series of FAA and GAO studies showed the need for a major overhaul of FAA's airline inspection program. They called for adding new inspectors, rewriting inspection guidance, rebuilding the training programs, and installing effective management controls. FAA's management approach was so decentralized at the time of our 1984 study[2] that no one in FAA Headquarters could say how many times a given airline had been inspected. The aviation agency has since taken many steps to strengthen the program, including hiring more inspectors and developing better inspection guidance and training programs. But these, by definition, are long-term efforts. They will take time to implement.[3]

Even with deregulation of the airline industry, FAA retained all its powers to impose and enforce safety standards.

Ironically, one of FAA's new inspection strategies may well have contributed to the public's misgivings concerning airline safety. FAA started to use special inspection teams to provide intensive coverage of selected airlines. The inspections led to widely publicized, multi-million-dollar fines. Naturally enough, many fliers wondered just how safely those that had been fined had been operating.

But the broader question is: Just how safely are *all* the airlines operating? Many people are asking: Is one carrier safer than the next? And is flying, by and large, less safe than it was before deregulation? One person stressing the importance of getting the answers is new FAA head Allan McArtor, who last August called for a "Dow Jones of aviation safety."

What accident rates tell us

For those studying the problem, the search for answers begins with a look at the accident rate, the most widely accepted measure of airline safety because it is a direct measure of the risks of flying. To examine the accident rate is to look back in an attempt to see forward. In other words, the rate is a historical analysis of risk, and it is used to judge safety by assuming that trends and patterns that have existed up to now will continue.

The problem with using accident rates as a safety measure is that very few accidents occur: good news for fliers, bad news for safety analysts. Accident rates are very useful in examining long-term trends for broad sectors of the airline industry. However, they are not so good for measuring safety over short periods or for comparing the safety of individual airlines, simply because accidents occur so infrequently that the results are not statistically significant.

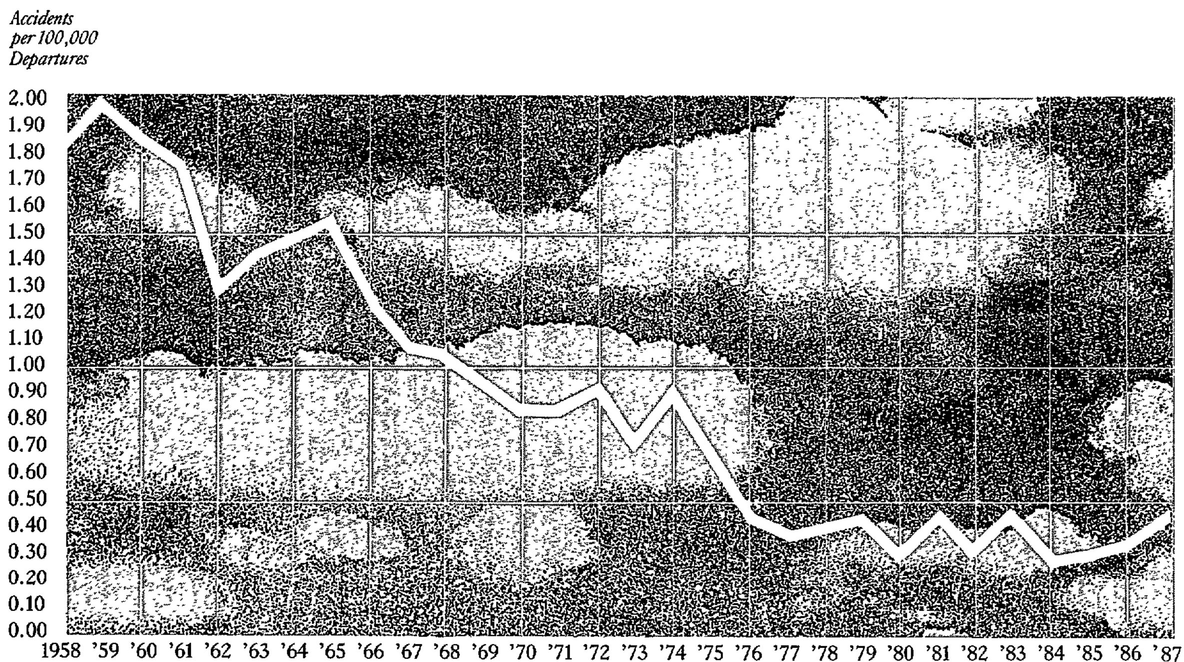
Their shortcomings notwithstanding, what do the rates tell us? For one thing, airlines in the United States have accident rates much lower than those of other countries. Within the U.S. airline industry, the scheduled airlines flying large aircraft—the airlines that carry over 90 percent of all passengers—operate more safely than the commuter airlines. But perhaps most significantly, after declining steadily for over 20 years, *the overall accident rate for large aircraft operators in the U.S. has remained at about the same level since the late 1970's.* Between 1978 and 1987, accident rates fluctuated between .22 and .48 per 100,000 departures, with no consistent trend in either direction. This despite deregulation and despite public perceptions of increased flying risks.

Figure 1, which reflects the overall U.S. airline accident rate each year from 1958 to 1987, is particularly interesting in what it tells us about 1985. It tells us that the accident rate in 1985 was fairly typical. What led to the public perception of crisis was the high number of fatalities; two accidents (the Arrow Airways crash at Gander, Newfoundland, and the Delta Airlines crash at Dallas-Ft. Worth) accounted for 391 deaths, or 60 percent of the year's U.S. airline fatalities. Some other air disasters that made the news simply did not involve U.S. carriers or air space. The point is that the number of U.S. airline fatalities (there were 71 in 1986, of which 64 involved small, unscheduled air taxis) has varied widely from year to year, but the number of accidents has not.

The U.S. airline industry is divided into two main groups. One consists of operators of large aircraft that are subject to part 121 of the Federal Aviation Regulations (FARs). Aircraft in this category carry 30 or more passengers, or a cargo payload of at least 7,500 pounds. The other group, often referred to as "commuter" airlines, operates smaller, propeller-driven air-

Figure 1

U.S. AIRLINE ACCIDENT RATE, 1958-87
(U.S. Air Carriers Operating under Part 121, FARs, All Scheduled Service)



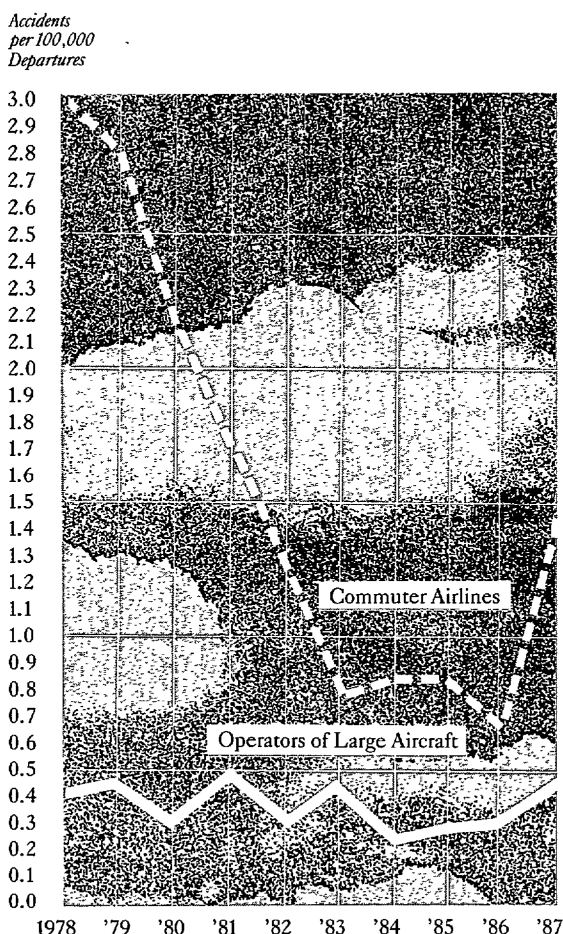
Sources: 1958-74 data from Nancy L. Rose, "Financial Influences on Airline Safety," paper prepared for the Conference on Deregulation and Transportation Safety, Northwestern University (June 23-25, 1987). 1975-86 data from NTSB.

craft, which carry fewer than 30 passengers, or a payload of less than 7,500 pounds. The airlines in this second group are covered by part 135 of the FARs.

As figure 2 shows, the accident rate for commuter airlines has been higher than for airlines operating large aircraft. It also shows that the accident rate for commuter airlines dropped steadily from 1978 to 1986, before increasing in 1987, while the accident rate for part 121 air carriers stayed fairly constant.

Figure 2

COMPARISON OF ACCIDENT RATES OF COMMUTER AIRLINES WITH THOSE OF OPERATORS OF LARGE AIRCRAFT, 1978-87



Source: NTSB

The data needed to compute the accident rates among foreign airlines are not readily available. The International Civil Aviation Organization (ICAO) publishes aggregate accident data covering all countries, rather than data specific to individual nations. Using ICAO data, DOT officials, in 1986, compared the U.S. airline accident rate with a composite of those of other airlines and concluded that the fatal accident rate for U.S. commercial aviation is about one-third the rate for the other countries. Table 1 shows the fatal accident rate for U.S. airlines and other airlines from 1980 to 1985.

Table 1

COMPARISON OF U.S. AND OTHER AIRLINES

(Fatal Accidents per 100,000 Aircraft Departures)

Year	U.S.	Other
1980	.11	.38
1981	.19	.27
1982	.11	.57
1983	.08	.48
1984	.10	.28
1985	.13	.32

These data are based on ICAO data that exclude the Soviet Union and from which U.S. data have been subtracted.

Source: DOT's Office of Transportation and Regulatory Affairs (unpublished data) for 1980-84. 1985 rates calculated from NTSB and ICAO data.

Other evidence confirms that the safety record of U.S. carriers measures up well against those of other nations. At the beginning of 1987, jet aircraft of European airlines were destroyed by accident about twice as often as those of U.S. airlines, based on flying hours. Jet aircraft of airlines in Canada, Asia, Africa, and Central and South America were destroyed by accident about four times as often as those of U.S. carriers. This reflects a long-standing pattern that precedes deregulation; a 1973 study[4] concluded that the United States was one of only two countries (the other was the Netherlands) with an accident rate significantly below the worldwide average.

Finding the safety factors

At this point the attentive reader might say, "That's all very heartening, so far as it goes. But accident rates reflect only what's happened in the past, and because so few accidents actually occur, they offer no valid statistical basis on which to compare the safety of individual airlines. Isn't there some better way to measure safety levels?"

In fact, industry executives, government officials, and air travel experts are struggling with the same question. When GAO looked into it, the agency could find no experts who believe there exist any comparable and objective measures of airline safety other than the accident rate. For airline executives, safety is just one of the many areas of operation in which they must continuously make subjective assessments. Experts within and outside FAA perform safety audits on airline operations, and insurance brokers analyze the safety of airline operations as part of their underwriting responsibilities. These experts told us that when they need to assess the overall competence of an airline's pilots or the quality of its maintenance program, they rely upon their own judgment. There are simply no objective measures for comparing the safety of individual airlines.

But there are four aspects of airline operations that experts generally agree are very important to safe operations: pilot competence, maintenance quality, financial stability, and management attitude. We looked at these four areas to see whether comparable and objective information on the safety of individual airline operations might be developed. But we found that many problems hinder the development of safety measures in these areas.

No one doubts, for example, that pilot performance is a key factor in many accidents. A study by the Boeing Corporation found that errors by flight crews were the primary cause of over 70 percent of the accidents that resulted in the loss of Boeing-built aircraft.[5] But experts we interviewed pointed out the difficulty of assessing the competence of pilots or of the airlines' pilot-training programs. While training programs must receive FAA approval, they differ from one airline to the next. University researchers, an NTSB staff member, and even the research director of the Airline Pilots Association all told us how difficult it is to assess the training programs of individual airlines. One university researcher put it this way:

> "Although airline pilot training is heavily regulated and each airline's training program is very similar, the methods of applying training and measuring the results are all different."

Under FAA regulations, all airlines must have comprehensive and systematic maintenance programs. Since deregulation, two factors have increased concern over how well airlines maintain their fleets. First, airlines have made increasing use of contractors to perform maintenance, leading to new management problems and creating difficulties for FAA inspection. Second, airlines have made more intensive use of their aircraft, increasing the amount of maintenance required while simultaneously reducing the amount of time available.

So how does one measure the quality of an individual airline's maintenance program? One way might be to keep a tally of the maintenance problems it encounters. But while FAA has data bases on maintenance-related incidents, it has serious concerns with the quality of its information. More on that later.

Another suggestion has been to measure the amount each airline spends on maintenance. But while larger airlines must report their maintenance expenditures to DOT, their expenditures may not be a valid measure of their maintenance efforts. Why not? Because airlines differ in such things as labor costs, accounting practices, and the ages of their fleets. An airline with a newer fleet, for example, may need to spend less on maintenance, simply because newer aircraft require less maintenance than older ones. Because FAA does not require smaller airlines to report maintenance costs, the maintenance effort of these airlines cannot be measured at all.

But maybe the level of expenditures on maintenance doesn't correlate with the level of safety, anyway. A 1987 study[6] found that between 1955 and 1983, airlines that spent more on maintenance per mile flown actually had a higher accident rate than other airlines.

Since deregulation, much of the academic research on airline safety has focused on whether the financial health of airlines can be related to the safety of their operations. Even as the Congress was considering deregulation of the airline industry, legislators were concerned that market pressures could lead some airlines to spend too little money to maintain safety. An airline in financial difficulty, for instance, might not be able to finance adequate training and maintenance programs. This line of reasoning still makes sense to many. FAA, in fact, has identified the financial condition of an airline as an important consideration in determining whether more intensive inspection surveillance is needed.

But studies of the effects of an airline's financial condition on its safety record have produced mixed results. One study, completed by DOT staff in 1986,[7] did not identify any relationship between an airline's financial condition and its maintenance expenditures. The study was an update of one performed in 1979 that yielded similar results.[8]

Another 1986 study,[9] covering the years 1974-78, concluded that the accident rate for airlines was not related to their financial strength. On the other hand, an FAA-sponsored study[10] found that the performance of airlines in FAA's nationwide 1984 National Air Transportation Inspection did coincide with their financial condition. A study completed in 1987[11] concluded that, between 1955 and 1983, there was at least a weak relationship between airline profitability and accident rates.

Management's attitudes have an important impact on the safety of an airline's operations. But while airline executives, university researchers, and other aviation safety experts agree on that, they also agree there are no objective ways to compare the attitudes among airlines or to determine their precise effect on safety levels.

Can ways be found to measure airline performance in the areas of pilot competence, maintenance practices, financial stability, and management attitude? We decided to analyze the potential of FAA inspection results as an indicator of airline safety and to examine DOT data bases on unsafe incidents and airline finances.

Inspection results may offer clues

Airlines in the United States operate under the FARs, which cover not only pilot competence and maintenance quality but also—though indirectly—financial stability and management attitudes. (Adequate financial resources and management emphasis on safe operation are necessary if an airline is to comply with the FARs.)

FAA regards compliance with the FARs as crucial to safe airline operations. Other aviation safety experts agree. During the past 2 years, FAA inspections have led to fines of up to $9.5 million against airlines for failing to comply with the FARs. During the same period, the aviation agency has suspended the operating licenses of several smaller airlines.

Because the FARs serve as the standards that airlines must meet in areas important to flight safety, compliance with the FARs may provide a way to compare the safety of individual airline operations. FAA, however, does not now have objective and comparable information about how well airlines

comply with the FARs.[12] Looking into the issue last spring, we found three main limitations on FAA's data on airline inspections: (1) because FAA lacked standardized inspection procedures, inspection results were not comparable; (2) there was no comprehensive national data base of inspection results to permit comparison among airlines; and (3) FAA lacked procedures to classify, and thus point out the significance of, the safety problems uncovered during inspections.

FAA's guidance to its inspectors, we found, was not sufficiently comprehensive or understandable to ensure that inspectors in different district offices performed inspections in comparable fashion. Also, inspectors needed more training in inspection procedures.

We also found that the data base that FAA maintains on inspection results contained deficiencies. There were problems with data accuracy and computer hardware. In addition, FAA had not yet developed a national data base of recent inspection results that would permit the systematic comparison of all airline inspections. FAA currently collects nationwide data on inspections performed to meet FAA's minimum inspection requirements, but these are only a small portion of the total number of inspections performed on larger airlines.

"How can you trust an airline to get you there safely when they can't even keep track of your luggage?"

Quality control in the reporting of inspection results has also been a problem. For example, a panel reviewing the results of FAA's special 1984 National Air Transportation Inspection found deficiencies in the quality of over 40 percent of inspection reports. Our review of inspection reports found similar quality problems. FAA managers acknowledged the problems, attributing them to inadequate supervisory staffing and poor guidance and training.

The FAA has agreed with our recommendations for improving the quality of data on inspection results. It has established a comprehensive long-term approach to overcoming weaknesses in the airline inspection program, with particular emphasis on preparing handbooks and developing training courses for inspectors.

We have shown how FAA can improve the usefulness of its inspection results by characterizing the seriousness of violations cited during its inspections. Eastern Airlines, for example, claimed that many of the infractions that had led to its record $9.5 million fine were trivial "paperwork" violations. Those who must assess and compare inspection results, both within and outside FAA, need to know which violations touch directly upon the safe operation of the airlines and which do not.

Problems with the data bases

Some safety experts have suggested that existing DOT data bases may be useful in developing measures of airline safety. One starting point may be the FAA data bases on unsafe incidents. Another may be DOT's data base on airline finances—the primary source for research on whether the financial stability of an airline affects its safety performance.

There has been widespread newspaper and television coverage of unsafe airline incidents that have not resulted in accidents, particularly some heavily publicized near-collisions between airliners. Because these unsafe events occur much more often than accidents, several experts suggested to us that analysis of unsafe incidents—sometimes called nonaccidents—could lead to useful safety indicators if ways could be found to measure and compare them. The incidents recorded in these data bases might indicate weaknesses in areas important to safe airline operation, such as pilot competence or maintenance quality.

FAA maintains several data bases on unsafe incidents that occur during airline operations.

- The Accident and Incident Data System, the most comprehensive data base, contains information on accidents, as well as a wide range of other unsafe events. This data base includes incidents that could reflect either lack of pilot competence or maintenance quality. For example, it would include an incident in which a pilot ran off the runway while landing or a takeoff that was aborted due to a maintenance-related mechanical failure.
- The Near Mid-Air Collision data base contains pilot reports of apparently dangerous encounters with other aircraft during flight.
- The Pilot Deviation Data Base, now under development by FAA, contains incidents in which

pilots fail to respond to air traffic control directives.

- The Service Difficulty Reporting System contains airline reports of equipment malfunctions and other maintenance problems, such as failures in engine components.
- The Aircraft Utilization and Propulsion data base has information on engine problems in flight, such as engine shutdowns.

The incident data bases cover a range of situations, but they share something in common: *At present, none provides a satisfactory basis for comparable, objective measurement of how safely individual airlines are operating.* The data they contain are unreliable, important information is missing, reporting practices are inconsistent, and the safety significance of specific incidents is difficult to assess. We found that documentation of the contents and operation of the data bases was inadequate and difficult to obtain. FAA officials told us the data bases are intended primarily for looking at specific safety problems (such as aircraft design flaws) and were not designed for analyzing the safety performance of individual airlines.

At the initiative of Administrator McArtor, FAA began to evaluate its incident data bases in October 1987. Improvements can be made, but it is not certain they would lead to comparable and objective measures of how safely individual airlines are operating. For one thing, there is doubt among some experts that the number of recorded incidents would ever be sufficient to permit statistically valid comparisons among airlines. In addition, airline industry representatives questioned whether currently reported data could be the basis for maintenance quality indicators.

Conclusions

Can ways be developed to measure pilot competence, maintenance quality, financial condition, and management attitudes? Management attitudes are so intangible that comparable and objective measurement is probably not possible. While the financial condition of the airlines is more susceptible to comparable and objective measurement than management attitudes, research has not demonstrated the relationships between specific financial indicators and airline performance. Also, financial data are lacking for commuter airlines.

In the areas of pilot competence and maintenance quality, FAA inspection results have potential for use as comparable and objective measures of airline safety because the inspections are based on regulations that set safety standards. However, well-documented problems now limit the worth of inspection results for measuring airline safety. FAA is now making improvements to its inspection process that could make inspection results more useful for measuring the safety of airline operations. The agency is planning improvements for its data bases as well.

Ultimately, where does this leave anxious fliers? We can say only that accident rates for scheduled airlines in the United States are as good as they were before deregulation and continue to compare favorably with those of the rest of the world. While 1987's higher accident rates fall within the range experienced over the past decade, their increase fuels the public's concern over safety. Comparable and objective ways must be developed for measuring the safety of airline operations *before* accidents occur. Developing those measures will not be easy, but FAA's recent efforts are a sign of progress in that direction. •

1. *Aviation Safety: Measuring How Safely Individual Airlines Operate* (GAO/RCED-88-61, March 1988). See also *Department of Transportation: Enhancing Policy and Program Effectiveness Through Improved Management* (GAO/RCED-87-3, Apr. 13, 1987) and *Aviation Safety: Needed Improvements in FAA's Airline Inspection Program Are Underway* (GAO/RCED-87-62, May 19, 1987).

2. *Compilation and Analysis of the Federal Aviation Administration's Inspection of a Sample of Commercial Air Carriers* (GAO/RCED-85-157, Aug. 2, 1985).

3. GAO/RCED-87-62.

4. "Towards an Overall Safety Index?" *Flight International* (Nov. 28, 1974), pp. 768-769.

5. L. G. Lautman and P. L. Gallimore, "Control of the Crew Caused Accident," *Boeing Airliner* (Apr.-June, 1987), pp. 1-7.

6. Nancy L. Rose, "Financial Influences on Airline Safety," paper prepared for the Conference on Deregulation and Transportation Safety, Northwestern University (June 23-25, 1987), p. 18.

7. Peter Belenky, "Preliminary Investigation of the Statistical Relationship Between Airline Finances and Maintenance, 1976-1984" (May 7, 1986) (unpublished).

8. David R. Graham and Marianne Bowes, "Do Finances Influence Airline Safety, Maintenance and Services?" Report to the Civil Aeronautics Board under Contract 78-C-60 (Apr. 16, 1979).

9. Devra L. Golbe, "Safety and Profits in the Airline Industry," *Journal of Industrial Economics* (March 1986), pp. 305-318.

10. *An Evaluation of the Relationship Between Air Carrier Financial Condition and Safety Posture*, Advanced Technology, Inc., prepared for FAA under Contract DTFA01-84-R-09598 (April 1986).

11. Rose, p. 26.

12. GAO/RCED-87-3 and GAO/RCED-87-62.

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Susan D. Kladiva

The Clash over Medical Malpractice

No prescription yet for one of medicine's thorniest problems.

IN THE SUMMER of 1987, the health-care delivery system in South Florida was in trouble. For about 3 weeks, many specialists who perform high-risk surgery refused to answer calls from hospital emergency rooms. As a result, most of the region's hospitals reportedly could not offer specialty care, such as neurosurgery. Patients were turned away. Physicians were signaling that they were fed up with the high cost of malpractice insurance. The St. Paul Companies, insurer of most of the state's physicians, had raised premiums 43 percent, effective July 1. The increases brought the annual premium rate for South Florida physicians to $89,300 for anesthesiologists, $100,200 for general surgeons, $165,300 for obstetricians, and $209,000 for neurosurgeons. Notwithstanding these increases, the insurer announced plans to stop writing malpractice coverage in the state at the end of 1987. Company officials said that Florida was not a profitable market. To get physicians back into the emergency rooms, the governor promised to call a special legislative session to review the situation.

Florida's experience, while it may have been the most dramatic example, was not unique. Doctors across the country say they cannot afford malpractice insurance. Some claim that the rising premiums are driving them out of practice. Insurers say that rate increases are necessary because the number and cost of claims continue to rise. Some insurers declare the markets are unprofitable and withdraw. Patients in some areas are finding obstetrics and emergency medical care difficult to obtain. Legislators are under pressure to provide relief.

Problems such as these prompted requests in 1984 from Representative John E. Porter and Senator John Heinz for GAO to review the medical malpractice situation in the United States. As project manager for the ensuing 3-year study that produced a series of 11 written reports and 1 video report,[1] I can appreciate the frustrations of policymakers trying to understand the problem and formulate a workable solution. The level of activity on this issue across the country during 1987 and its continued prominence on state legislative agendas testify to the problem's resistance to resolution. This article seeks to explain why the problem is so intractable.

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Ineffectual lawmaking

The medical malpractice crisis is not a new phenomenon. In the late 1960's, the number and cost of malpractice claims began escalating rapidly, culminating in the malpractice crisis of the mid-1970's. In state after state, malpractice insurers announced rate increases as large as 300 to 400 percent. In some states, they withdrew from the market entirely. The effect on physicians was immediate, prompting strikes in California and New York. Physicians in other states were threatening to do the same. The malpractice insurance crisis demanded action.

Between 1975 and 1978, almost every state legislature enacted at least one medical malpractice statute. The emphasis was on measures to create alternative

sources of insurance and tort reforms to reduce the number and cost of claims. Some states also established commissions to study the underlying causes of the crisis and enacted measures designed to improve medical-care quality-assurance programs.[2] The problem appeared to be solved. Over the next decade, malpractice insurance was readily available in a market dominated by physician- and hospital-owned companies that were established to fill the void created by the withdrawal of traditional malpractice insurers. Although for the most part the number and size of claims continued to climb, premium increases were tempered by the income that insurance companies earned on investments made at historically high interest rates. This changed abruptly, however, when interest rates plummeted in the mid-1980's. Rising claims costs were no longer offset by investments, causing insurance companies to boost their medical malpractice premiums sharply. It became apparent that the legislation enacted in the mid-1970's had not resolved the fundamental concerns underlying the malpractice issue of how to guarantee quality medical care and to compensate patients for medical injuries. Under pressure, once again, to do something about the symptoms of the malpractice problem, state legislators responded in 1985, 1986, and 1987 with another round of legislation. It was generally of the same sort as that enacted in response to the earlier crisis. The ink was scarcely dry before some of the legislation was challenged by special interest groups and undone by the courts. In Florida, for example, a provision enacted in 1986 to cap damage awards at $450,000 for noneconomic losses was in effect for less than a year before it was overruled by the Florida Supreme Court.

Legislators have been particularly frustrated that the recently enacted tort reforms have had little or no apparent effect on premium rates. Insurers, recalling successful court challenges to earlier reforms, have been reluctant to base current rates on any potential that the reforms may have for future cost savings. If a particular tort reform provision is held unconstitutional, insurers' liability will be determined on the basis of preexisting law, even if the premium was calculated on the basis of reformed law.[3]

Legislators continue to wrestle with the problem. Despite 3 years of intensive legislative activity, malpractice reform still ranked as a top priority for legislatures in 34 states during the latter half of 1987.[4]

Roadblocks to solutions

Policymakers face substantial obstacles as they look for a long-term solution to the malpractice problem. First, empirical data on critical aspects of the problem are either nonexistent or outdated. Second, the objectives of the tort system—to deter and compensate—conflict with the objective of the liability insurance system, which seeks to protect personal assets. Third, legislating policy in a crisis environment has prevented both a comprehensive study of the various aspects of the malpractice insurance dilemma and a thoughtful review of all the possible solutions. Finally, medical, legal, and insurance interests, often at odds with one another, advocate solutions to the medical malpractice dilemma that are not mutually acceptable.

Lack of data

Legislators formulating responses to crises must use the best data available at the time. In the case of medical malpractice, current, meaningful data on the medical, legal, and insurance aspects of the problem have been in woefully short supply. Available data are frequently fragmented, inconsistent, inadequate, and confusing. Legislators in the line of fire are pelted by interest groups with conflicting statistics that often turn out to be anecdotal, out of date, or out of context.

The malpractice data obstacle did not suddenly emerge in the mid-1980's. Data inadequacies have plagued policymakers for as long as malpractice has been recognized as a significant societal problem. New York's Special Advisory Panel on Medical Malpractice faced the data problem in the mid-1970's. They concluded that because there was no central source of information or way of relating fiscal and medical data, there was no "solid base for planning changes in the present tort/insurance/and injury prevention systems."[5] The Panel attributed the data inadequacies, in part, to an "insufficient perception of the need for a data system that integrates insurance, medical, and legal information with health services, health financing, and public finance information."[6] These views notwithstanding, the Panel acknowledged that in a crisis it is not possible to suspend policy decisions until the perfect data system is developed.

When efforts to collect and analyze data begin only after the crisis has emerged, the data produced are likely to be "too little, too late" for those scrambling to formulate a response. A comprehensive study of the malpractice issue in the early 1970's by a commission reporting to the Secretary of Health, Education, and Welfare[7] and subsequent studies of the mid-1970's crisis produced a massive amount of data. Little, if any, of that data were current, however, when the first signs of the mid-1980's crisis began to emerge. Basic descriptive data on injuries, claims, costs, and compensation were absent. Empirical assessments of the effects of states' responses to the mid-1970's crisis were virtually nonexistent.

Conflicting objectives

Litigation in the tort system has been the primary means of deterring unacceptable behavior and compensating its victims. In the mid-1970's, New York's Special Advisory Panel on Medical Malpractice examined the tort system and its relationship to liability insurance. It concluded that the widespread use of liability insurance to protect personal assets from claims has weakened the deterrent aspect of the tort system.[8] Others have also concluded that the tort system is not an effective means of guaranteeing high-quality medical care, particularly when insurance premiums are not linked to an individual physician's performance.

Although the tort system enables victims to seek compensation for losses resulting from malpractice, it does so inefficiently and at great burden to the insurance mechanism itself. The cost of pursuing a claim through the tort system is so high that injured patients receive less than half of each malpractice premium dollar. The New York Advisory Panel also contended that the tort system, funded by insurance premiums, often is expected to be a generalized compensation system providing a source of funds to fill needs not met by other compensation systems. The Panel concluded that the problems and defects attributable to the tort system and the liability insurance mechanism stemmed from conflicts among their objectives—deterrence, injury compensation, and protection of assets. Incremental changes through tort reforms, such as limitations on damage awards and shortening statutes of limitations, have not resolved these conflicts.

The crisis environment

"Societies in crisis search not so much for understanding as for relief."[9] State legislators have been motivated to enact most malpractice reforms in an environment that does not lend itself to a full exploration of all the problems and their causes or the merits and tradeoffs involved as possible solutions.

As the mid-1970's crisis intensified, legislators could see the potential for disruption in medical services if malpractice insurance became unavailable or unacceptably expensive. Something had to be done. Forty-nine states enacted legislation aimed primarily at correcting the perceived deficiencies in a tort system that many believed was responsible for the crisis. The reforms, which included shorter statutes of limitations, caps on damage awards, and mandatory offsets of awards by amounts received from collateral sources, had the immediate effect of dissipating the crisis atmosphere. However, much of the legislation was targeted at features of the tort system where changes might not be expected to have a substantial effect on the number or size of claims. In addition, many of the reforms were subsequently repealed, allowed to expire under sunset provisions, or overruled on constitutional grounds by state courts. Glen O. Robinson, law professor at the University of Virginia, concluded after examining individual reforms adopted by the states that most of the legislative activity was more show than substance and that some of the major enactments were more codifications than modifications of common law. He stated:

> "It is hardly unknown for legislatures to seek the appearance, but not the reality, of effective legislative response to what some of the legislators' constituents perceive to be a serious problem. There is some evidence that this is precisely how most legislatures responded to the malpractice crisis and that legislators got credit for affirmatively responding to the medical profession's concerns without delivering very much actual relief."[10]

The crisis of the 1980's prompted renewed legislative activity. In 1986, for example, 42 states sought tort reform and related liability relief; victories were scored in at least 28.[11] In the first 6 months of 1987, over half the state legislatures had enacted at least one tort

reform measure.[12] The federal government's Tort Policy Working Group concluded that "it seems evident that strong tort reform measures, if given sufficient time, can have a very substantial impact on the insurance market."[13]

Clash of viewpoints

In 1985, GAO surveyed groups representing medical, consumer, legal, and insurance interests. Each had its own narrow perspective; GAO found no agreement on the problems or the solutions:

- Medical groups are concerned about the high cost of malpractice insurance. They believe that tort reforms may help moderate premium increases, but they also believe alternatives to the tort system are needed for resolving claims.
- Consumers are concerned about the quality of medical care. They believe more actions are needed to protect patients from providers who deliver inadequate care.
- Trial lawyers are concerned about attempts through tort reform to limit the rights of injured patients to sue to recover for damages. They believe the tort system should remain unchanged but that change is needed in the way insurers classify and rate physicians.
- Insurers are concerned about the effect the unpredictability of the tort system has on ratemaking. They believe tort reforms would help stabilize the claims environment for rate-making purposes.

Medical Groups: Insurance Costs and Tort Reform. Malpractice insurance for health care providers is expensive and is growing more so. GAO reported that, in aggregate, malpractice insurance costs for physicians and hospitals increased from $2.5 billion in 1983 to $4.7 billion in 1985, an 88-percent increase.[14] Physicians' premiums increased 48 percent, from an average of $7,100 in 1983 to $10,500 in 1985.[15] From 1983 to 1985, physicians' insurance costs rose from 3.5 percent to 4.4 percent[16] of their average gross income. Premiums vary, however, by specialty and location of practice. GAO found that the highest premiums, as of July 1, 1985, were generally paid by three high-risk specialties—obstetrics and gynecology, orthopedic surgery, and neurosurgery—and by physicians in Florida, Illinois, Michigan, New York, and the District of Columbia.[17] When the two trends converge, premium costs can be enormous. High-risk specialists in Florida, for example, pay about 23 percent of their gross income for malpractice insurance.[18]

In July 1987, the nation's largest malpractice insurer, the St. Paul Companies, increased rates by an average of 30 percent in about half the states where it insured physicians.[19] To explain the increases, Joseph B. Nardi, president of the medical services division of the St. Paul Companies, pointed to a continuing growth in the number and cost of claims. Nationwide, the number of claims reported per 100 doctors insured by the St. Paul Companies increased from 13.5 in 1982 to 17.2 in 1986, while the average loss per paid claim (excluding the amount above $1 million for any single claim) climbed from $45,421 to $72,703.[20]

The St. Paul Companies estimated that in 1987, malpractice insurance would cost the average general practitioner $1.23 per patient visit; the average orthopedic surgeon, $158.63 per surgical procedure; and the average obstetrician, $461.37 for each baby delivered.[21]

It is becoming more difficult for physicians to pass along premium increases to their patients. Physicians are under severe competitive pressure to hold down fees because of the greater numbers of physicians; the widespread development of preferred provider organizations and health maintenance organizations; and more sophisticated medical cost controls by the government, employers, and health insurers.[22] Medical interests, including those representing hospitals, believe that tort reforms will lead to lower rates. Both the American Medical Association (AMA) and the American Hospital Association (AHA) have recommended a number of tort reforms, including capping noneconomic damages; offsetting awards by amounts received from collateral sources, such as health insurance; paying large awards over time; and limiting the portion of awards that go to plaintiffs' attorneys.[23] Reforms have also been recommended by the Tort Policy Working Group and by the Department of Health and Human Services (HHS) Task Force on Medical Liability and Malpractice.[24] GAO believes reforms have merit.[25]

While use of the tort system for claims resolution has advantages, such as protecting patients' right to due process, it also has limitations, such as the need for an injured party to retain a lawyer to gain access to the

system. There is a growing recognition that alternative dispute resolution mechanisms may protect the rights of injured patients and resolve claims with more efficiency, equity, and predictability than the tort system. However, a number of questions about their cost-effectiveness and merits remain unanswered. GAO has recommended that HHS fund several demonstration projects to test alternatives to the tort system for resolving malpractice claims. The Robert Wood Johnson Foundation, a national philanthropy that funds research related to health issues, awarded grants in 1987 for several such projects, and both the AMA and the AHA are developing proposals for alternatives.

Consumers: Quality and Discipline. The American Association of Retired Persons testified in congressional hearings that consumers expect the medical profession to be technically competent, to maintain good doctor-patient relationships, to maintain institutions and procedures for monitoring care, and to take corrective action when necessary. It also testified that neither the medical profession nor the state licensing agencies have been effective in regulating providers to ensure that quality medical care is actually being delivered to the patients.[26]

Others have reached similar conclusions. A June 1986 report by HHS[27] stated that state medical boards rarely impose disciplinary actions against physicians for medical incompetence because of the legal intricacies of the cases and the variations that often exist in defining acceptable medical practice. Most disciplinary actions, HHS reported, were directed at inappropriate prescription practices.

On the basis of data obtained from the Federation of State Medical Boards, GAO concluded that medical boards took relatively few disciplinary actions for any reason. For example, a mere 2,108 disciplinary actions were taken in 1985 against a nationwide physician population of 552,716.[28] GAO recommended that more aggressive actions be taken to discipline or remove from practice physicians providing inadequate care. The Health Care Quality Improvement Act of 1986, which requires the Secretary of HHS to establish a national clearinghouse of data on physician competence and professional conduct, will help identify these physicians.

GAO also recommended that state agencies and professional groups expand and strengthen risk management programs designed to help health-care providers reduce the incidence of patient injury. The AMA recommended bolstering state medical boards' resources for performing their investigative and disciplinary functions and stressed the need for physicians to participate actively in risk management and peer review activities.[29] One barrier to aggressive peer review for quality assurance has been the concern of physicians that they may subject themselves to litigation and legal liability for actions they take against other physicians.[30] It is too soon to tell whether the Health Care Quality Improvement Act, which provides limited immunity from suits stemming from involvement in peer review activities, will increase the willingness of physicians to participate.

Lawyers: Rate-Setting and Merit Rating. The Association of Trial Lawyers of America (ATLA) has been especially vocal on the malpractice issue, stating that

> ". . . the medical profession has a poor record of disciplining the few, repeatedly careless doctors and . . . it is important, therefore, to preserve the tort system which by finding fault and assessing damages against negligent providers sends all providers a signal that discourages future carelessness."[31]

While ATLA agrees that the tort system is not functioning efficiently to deter careless behavior, it believes this inefficiency stems from the insurers' general practice of basing premiums on specialty groupings rather than on the performance of individual physicians. This practice, ATLA contends, has permitted consistently negligent physicians to spread the risks among "their more careful fellow doctors."[32]

One method of assessing premiums on the basis of past experience is through merit rating. Merit rating plans generally impose a premium surcharge on individual physicians on the basis of their prior claims history. Commenting on merit rating from the actuarial perspective, Mark Sobel, an actuary with Touche Ross and Company, has explained that the underlying principle is a frequency concept, i.e., the number of claims is considered to be predictive of the number of future claims, but the size of the claims is fortuitous.[33] With regard to its utility for insurers, merit rating, according to Sobel, is of less value to those that have the right to refuse coverage than to those that do not. For insurers

such as medical malpractice joint underwriting associations that cannot deny coverage to any licensed physician, a merit rating plan gives them the limited ability to underwrite through the pricing mechanism, i.e., insurance is available, but the surcharge makes it so expensive that physicians who repeatedly engage in malpractice are priced out of practice.

The HHS task force concluded that merit rating "may provide a deterrent effect for the claims-prone physician and offers psychological benefits to the other physicians in the risk pool."[34] According to the task force, physician-owned insurance companies generally use merit rating. Some states require it; others are considering it.

ATLA further argues that the variation in risk-classification systems insurers use is a major reason for the wide variation in premiums among physician specialties.[35] The HHS task force also believes that the choice of rating method determines how the cost of malpractice is distributed. Classes that include small numbers of physicians, such as neurosurgery, spread losses among fewer insureds; larger classes, such as general/family practice, spread the losses more widely. The effects on individual physicians' premiums can be dramatic. According to Florida's Academic Task Force,

> "The existing classification system has served a purpose up to this point, but the level of loss payments in certain specialties may have become too large in relation to the number of physicians available to pay for the losses. Stated differently, there may be insufficient spreading of the risk of loss among certain high-risk specialties."[36]

Insurers: Adequate Rates and Predictable Claims. Obtaining adequate rates is of fundamental concern to all companies writing medical malpractice insurance. At best, malpractice insurance is difficult to price accurately, but the unpredictability of the tort system compounds the difficulties.

Rate-making is an attempt to predict future claims and expenses on the basis of past experience. Because the medical malpractice insurance market is small and consists of a number of relatively small companies (many write insurance in a single state), the statistical base used by any one company for making estimates of future losses is also small. Adding to the uncertainty is the lengthy period that often elapses between the occurrence of injuries and the settlement of the resulting claims; the data on which estimates of future losses are based may not reflect the current situation.[37]

The outcome of claims filed in the tort system is unpredictable. Some injured patients filing suits are overcompensated; others are undercompensated. GAO's study of closed claims suggests that the more severe the injuries, the more likely patients were to receive some compensation, but the less likely they were to recover all their economic losses. The study also found that 57 percent of the claims were closed with no payment at all.

The effect of the unpredictability of the tort system was assessed by the Tort Policy Working Group, which concluded that

> "This uncertainty as to what the rules of tort liability applicable to any particular company, person or activity will be in future years makes it extremely difficult for the insurance industry to assess risk (and establish appropriate premiums) with any degree of confidence."[38]

Conclusion

Given these obstacles, the prospect of a long-term solution arising out of the mid-1980's reprise of the mid-1970's crisis does not seem promising. If the malpractice problem were easy to solve, it would have been solved long ago. Enough effort has been devoted to that end. The quality and timing of the effort are crucial now.

By beginning today to collect the data that will be needed to monitor the ongoing malpractice situation and evaluate the effects of reforms, policymakers can ensure that they have adequate information. This is a critical first step toward understanding the dynamics of the problem and formulating a workable solution. Also, to resolve the conflicting objectives of the tort system and liability insurance systems, it may be necessary to develop new systems to prevent medical injuries and remove incompetent providers from the health-care system and to compensate those who are injured as a result of medical treatment, whether or not

the injury was caused by negligence. Finally, policymakers can profit from the concerned interest groups' diverse positions, which, taken collectively, provide a comprehensive exposition of malpractice problems and solutions. Their challenge is to find common ground between these divergent views and the public interest. ●

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1. GAO has issued the following reports on medical malpractice: *No Agreement on the Problems or Solutions* (GAO/HRD-86-50, Feb. 24, 1986), *Insurance Costs Increased but Varied Among Physicians and Hospitals* (GAO/HRD-86-112, Sept. 15, 1986), *Six State Case Studies Show Claims and Insurance Costs Still Rise Despite Reforms* (GAO/HRD-87-21, Dec. 31, 1986), *Case Study on Arkansas* (GAO/HRD-87-21S-1, Dec. 31, 1986), *Case Study on California* (GAO/HRD-87-21S-2, Dec. 31, 1986), *Case Study on Florida* (GAO/HRD-87-21S-3, Dec. 31, 1986), *Case Study on Indiana* (GAO/HRD-87-21S-4, Dec. 31, 1986), *Case Study on New York* (GAO/HRD-87-21S-5, Dec. 31, 1986), *Case Study on North Carolina* (GAO/HRD-87-21S-6, Dec. 31, 1986), *Characteristics of Claims Closed in 1984* (GAO/HRD-87-55, Apr. 22, 1987) and *A Framework for Action* (GAO/HRD-87-73, May 20, 1987). The video report entitled *Medical Malpractice: A Framework for Action,* was released Sept. 25, 1987.

2. Peter E. Carlin, *Malpractice: A Snapshot of 1980 State Laws,* Intergovernmental Health Policy Project (Washington, D.C.: the George Washington University, n.d.), p. 1.

3. *An Update on the Liability Crisis,* Tort Policy Working Group (Washington, D.C.: U.S. Government Printing Office (GPO), March 1987), p. 90. The Tort Policy Working Group consists of senior administration officials of 11 federal agencies, 7 of whom serve as the chief legal officers of their agencies.

4. Telephone conversation with Brenda Trolin, National Conference of State Legislators (Dec. 17, 1987).

5. *Report of the Special Advisory Panel on Medical Malpractice,* p. 234.

7. *Report of the Secretary's Commission on Medical Malpractice* (Washington, D.C.: Department of Health, Education, and Welfare, January 1973).

8. *Report of the Special Advisory Panel on Medical Malpractice,* pp. 13-14.

9. Gerald S. Adler, *Medical Malpractice in Sociological Perspective* (New York: Columbia University, 1979), p. 46.

10. Glen O. Robinson, "The Medical Malpractice Crisis of the 1970's: A Retrospective," *Law and Contemporary Problems,* Duke University School of Law, Vol. 49, No. 2 (Spring 1986), p. 28.

11. "1986 Special Legislative Report," *Medical Liability Monitor,* Vol. 11, No. 9 (Sept. 30, 1986), p. 1.

12. "Malpractice Still at the Top of State Agendas," *State Health Notes,* Intergovernmental Health Policy Project, The George Washington University, Vol. 75 (July-August 1987), p. 1.

13. *An Update on the Liability Crisis,* p. 5.

14. GAO/HRD-86-112, p. 2.

15. GAO/HRD-86-112, p. 28. and Martin L. Gonzalez, "Trends in Physicians' Professional Liability Claims and Insurance Premiums," *Socioeconomic Characteristics of Medical Practice 1986* (Chicago: American Medical Association (AMA), p. 16.

16. GAO calculation from data obtained from AMA's Socioeconomic Monitoring System. Physician gross income was calculated by summing the average net income and the average professional expenses of self-employed physicians.

17. GAO/HRD-86-112, p. 30.

18. *Preliminary Fact-Finding Report on Medical Malpractice,* Academic Task Force for Review of the Insurance and Tort Systems (Gainesville: State of Florida, Aug. 14, 1987), p. 237.

19. *Physicians' and Surgeons' Update,* St. Paul Fire and Marine Insurance Company (July 1987), p. 1.

20. *Physicians' and Surgeons' Update,* pp. 1 and 8.

21. *Physicians' and Surgeons' Update,* p. 7. AMA data were countrywide averages reported in *Socioeconomic Characteristics of Medical Practice 1986.* St. Paul data were its own proposed average countrywide mature claims-made rates for insurance coverage of $1 million per occurrence and $3 million in aggregate.

22. *Preliminary Fact-Finding Report,* pp. 32.

23. *Professional Liability in the 1980's Report 3,* Special Task Force on Professional Liability and Insurance (Chicago: AMA, March 1985), pp. 12-13, and *Medical Malpractice Task Force Report on Tort Reform and Compendium of Professional Liability Early Warning Systems for Health Care Providers* (Chicago: AHA, May 1986), pp. 18-19.

24. *Report of the Tort Policy Working Group on the Causes, Extent and Policy Implications of the Current Crisis in Insurance Availability and Affordability* (Washingtn, D.C.: GPO, February 1986), p. 4; *An Update on the Liability Crisis,* p. 98; and *Report of the Task Force on Medical Liabilty and Malpractice* (Washington, D.C.: Department of Health and Human Services (HHS), August 1987), pp. 32-43.

25. GAO/HRD-87-73, p. 34.

26. American Association of Retired Persons, statement before the House Committee on Ways and Means, Subcommittees on Health, on H.R. 5400, Alternative Medical Liability Act (June 28, 1984), p. 5.

27. *Medical Licensure and Discipline: An Overview* HHS, P-01-86-00064 (Boston: June 1986), pp. ii and 13.

28. GAO/HRD-87-73, p. 13.

29. *Professional Liability in the 1980's, Report 3,* pp. 15-16.

30. *Report of the Task Force on Medical Liability and Malpractice,* p. 99.

31. Thomas G. Goddard, "The American Medical Association Is Wrong—There Is No Medical Malpractice Insurance Crisis," (Washington, D.C.: ATLA, Mar. 5, 1985), p. 8.

32. Goddard, p. 8.

33. Speech by Mark Sobel on merit rating presented to the National Coordinating Committee on Medical Malpractice Joint Underwriting Associations (Long Boat Key, Florida: Oct. 2, 1986), p. 1.

34. *Report of the Task Force on Medical Liabilty and Malpractice,* p. 150.

35. Meeting between representatives of ATLA and GAO in Washington, D.C. (Mar. 25, 1987).

36. *Preliminary Fact-Finding Report,* p. 97.

37. GAO/HRD-86-50, p. 69.

38. *An Update on the Liability Crisis,* p. 51.

041831

George D. Anderson

A NEW CODE FOR ACCOUNTANTS

IN NEW YORK: The AICPA Centennial Members Meeting and Exposition, September 1987

In January, members of the American Institute of Certified Public Accountants overwhelmingly ratified a set of six proposals to redefine professional standards. The proposals were the work of the Special Committee on Standards of Professional Conduct for Certified Public Accountants, chaired by George D. Anderson. While the proposals were still pending, Mr. Anderson explained their rationale at the AICPA's centennial meeting.

OVER THE PAST 10 or 15 years, great changes have taken place in the social environment in which certified public accountants (CPAs) operate. For one thing, many people have come to feel that there should be increased competition among the members of the professions. Some have come to view the professions as monopolies working only for the economic good of their members. Also, the lessening enthusiasm for government regulation in all sectors of our economy has had its effect upon the professions. And the rise of consumerism has placed all businesses and professions under fire, including CPAs.

The questions have been asked: Do the licensing of professionals and the ethics restraints that the professions adopt benefit the public or only the members of the professions? Does it really serve the public interest to ban advertising, solicitation, and competitive bidding? Do such bars really affect the quality of work of a professional? Or are these artificial and unnecessary restraints that, in fact, do harm to the public interest?

These questions have been asked in court, and the courts, in effect, have held against the professions, reasoning that the licensing of professionals and the subsequent monitoring of those licensed is in the public interest, but that self-imposed restraints relating to advertising, solicitation, and competitive bidding are not needed to ensure the performance of quality work, and in fact may constitute a restraint of free trade.

All of this, and subsequent actions by people in the profession, caused the leadership of the American Institute of Certified Public Accountants (AICPA) a great deal of concern. Bill Gregory, as he left the chairmanship of the AICPA in 1980, warned of the steady push toward commercialism by many firms. He warned that the competition between small firms and large, and from groups outside the profession, could cause us to lose our professional status and subsequently our franchise.

Also in recent times, the accounting profession has come under attack from Members of Congress for the quality of work being performed. The Board of Directors of the AICPA saw the necessity to look for some long-range solutions to that problem. It had become clear, as well, that commercialism within the profession was growing. Competition was increasing and professionalism was waning. Relationships were becoming strained with other professionals, among the members of our own profession, with clients, and with the public in general.

GEORGE D. ANDERSON, one of the founding partners of the accounting firm of Anderson, ZurMuehlen & Co., is a former Chairman of the AICPA. He chairs the Governors' Coordinating Committee, White House Conference on Small Business.

Perceptions were growing that business failures were really audit failures. This endangered the profession's public image. Hence the appointment in October 1983 of the Special Committee on Standards of Professional Conduct for CPAs. The Committee was charged with considering the changing economic, legal, social, and regulatory environment in evaluating the relevance of present ethical standards to professionalism, integrity, and commitment to both quality service and the public interest.

"THE CURRENT CODE OF PROFESSIONAL ETHICS . . . IS INADEQUATE TO CARRY THE PROFESSION INTO THE FUTURE."

The Committee was also asked to consider the AICPA's role in the process of establishing standards of professional conduct and to recommend a course of action.

Shortly after this charge was given to the Committee, five concerns identified by the Institute's Future Issues Committee were added. They were: (1) the expansion of services and products, (2) changes in the nature and extent of competition in the profession, (3) the role of self-regulation, (4) improving the quality of practice, and (5) independence and objectivity.

The result of the Committee's deliberations was the issuance of the report entitled *Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment.* The report was the result of much research and debate. Although there was a strong consensus within the Committee on its recommendations, there were, naturally, necessary compromises made.

The Committee decided very early that changes were needed in the current code of professional ethics, which is inadequate to carry the profession into the future. In light of the rise of competition and commercialism, it could, in fact, carry the seeds of our destruction. There is a need for a program that will result in educational and remedial actions for the members of this profession.

The Committee came to the conclusion that a new approach was needed to meet certain goals. That approach, the Committee felt, should enhance the quality of work done by CPAs. It should address the public interest as it relates to the CPA's work. It should emphasize compliance with broad, positively stated standards, as well as behavioral rules. It should establish a proactive monitoring program for firms to aid in finding and correcting substandard work. It should extend the application of standards to those not in public practice. Finally, it should provide guidance on responding to the changing practice environment.

The Committee decided that there was a need for a more positively stated code of ethics. The present code contains a concept section that provides positive guidance, but the section is not enforceable. Only the rules, the "Thou shalt nots," are enforceable. These rules constitute the minimum acceptable ethical behavior expected of a CPA. But these "Thou shalt nots" merely tell us how to stay out of trouble, not how to perform at our best.

The proposed code of ethics consists of two sections. The first, entitled

"Standards of Professional Conduct," is presented in a positive vein. It is based on the premise that members assume an ethical obligation when they join the AICPA. Therefore, the section includes the basic tenets of ethical and professional conduct; states the responsibility of AICPA members to the public, clients, and colleagues; and gives adequate guidance as to the performance of professional responsibilities. It gives guidance to all members: those in industry, education, and government, as well as those in public practice. The principles are enforceable through the second section, entitled "Rules of Performance and Behavior." It is still necessary to have the "Thou shalt nots," as positively stated rules are virtually impossible to enforce.

Enforcement is, of necessity, voluntary. The AICPA can rely only on moral persuasion to enforce its rules of conduct. They do not carry the force of law. That is why it is important that the AICPA be looked upon as a professional organization in which membership represents a level of professional achievement greater than the mere possession of a CPA certificate. The Institute should be a body that continually monitors and strives to improve the quality of its members' professional services.

The "Standards" section contains an article on the scope and nature of services. This is the first time, as far as we can tell, that this subject has been discussed in an official AICPA publication. This article caused some of the greatest controversy within the Committee. The content has been softened by subsequent actions of the Implementation Committee and the Board of Directors. It is, however, a start toward determining what the profession's ethical considerations must be toward nonattest engagements. Such engagements are important to the profession and will, in fact, become more important in the future. The profession must determine where this work fits within its ethical framework, taking care that the importance of this work does not completely overshadow the performance of the attest function, the service we are licensed to do.

"THE 'THOU SHALT NOTS' MERELY TELL US HOW TO STAY OUT OF TROUBLE, NOT HOW TO PERFORM AT OUR BEST."

The Committee next addressed the need for self-regulation and recommended that the Institute have an effective practice-monitoring program for its members. Continuing membership in the Institute would be predicated upon compliance by the member firm with this quality-monitoring program.

When I came into practice some 37 years ago, it would have been considered completely unnecessary for one member of the profession to review another's work. The interpretation of the accounting literature was left to the professional. Much of this has changed, and there has been a narrowing of the latitude for interpretation by the advent of the Financial Accounting Standards Board and other bodies designated by AICPA's Council to interpret technical standards.

The Committee debated extensively the form practice monitoring should take. Desk reviews were considered; some combinations with State Boards were looked at; even the use of outside examiners was considered. It was finally decided that field

reviews comparable to those now performed by the Division for Firms best met the needs of the membership. I'm a great supporter of the quality-review process. Our firm has submitted to such reviews for nearly 20 years. We were first reviewed through an association of CPA firms, then through the AICPA, and now through the Division for Firms. To me, review is the stimulation that is needed to bolster the motivation we already have to keep our practice in line. I think we are all motivated to do good work, but I think that once in a while we need a little stimulation. I don't think you motivate people; instead, you stimulate their motivation.

"THE AICPA CAN RELY ONLY ON MORAL PERSUASION TO ENFORCE ITS RULES OF CONDUCT . . . [IT] SHOULD BE A BODY THAT CONTINUALLY MONITORS AND STRIVES TO IMPROVE THE QUALITY OF ITS MEMBERS' PROFESSIONAL SERVICES."

The Committee also recommended that all AICPA members comply with the requirement for 120 hours of continuing professional education (CPE) every 3 years. Also, to become a member of the AICPA after the year 2000, the candidate must have completed an additional 30 hours of postbaccalaureate work. The Committee also recommended changes in the enforcement of the rules of professional conduct, the handling of complaints, the composition of the National Trial Board, and the maintenance of public files.

The Committee's report was submitted to the AICPA's Council last year at its annual meeting in Kansas City. The Council agreed that the report should be implemented, and an Implementation Committee was appointed under the direction of Marvin Strait, the new Chairman of the Institute. The Implementation Committee reported to the Board of Directors with its recommendations; no fundamental changes were made in the content of the report by the Special Committee on Standards of Professional Conduct. Those changes that were made were debated at the Council's meeting in Phoenix last spring. The Council accepted the implementation package overwhelmingly. It was decided by the Council that six propositions would be forwarded to the AICPA membership for a vote; each would require a two-thirds majority of those voting in order to pass.

The first proposition involves the newly restructured code of ethics—both the "Standards" and the "Rules" sections—that will be voted on as one item. The second proposition covers the practice-monitoring program. The new CPE requirement has been split into two propositions. One is the CPE requirement for members in public practice, which will be 120 hours over a 3-year period; the other is the CPE requirement for nonpracticing CPAs: an initial 60-hour requirement, with 10 hours added during each of the following 3 years until the requirement reaches 90 hours.

The fifth proposition is that, after the year 2000, a candidate applying for membership in the AICPA must have completed 30 semester hours beyond the baccalaureate requirement. The final proposition involves the changes in the Trial Board and the new enforcement procedures.

Taken together, these propositions offer a tremendous opportunity for the accounting profession to demonstrate that it is responsible and that it is capable of guiding its own destiny without outside intervention. Members will be urged to follow positively stated principles of ethical conduct. The self-regulatory quality-assurance program will seek out substandard work and provide practice units with education and remedial procedures to correct it. The image of the CPA should be enhanced and the public interest advanced.

This is a unique profession; we are more interested in raising professional standards and standards of performance than in protecting our own turf. We worry about standards of professionalism and the degradation of those standards that too much commercialism can bring. We know we must compete because the economic strength of the world lies in competition. But our competition must be based on quality, not on economics.

In the fall of 1986, the Harris Poll conducted a study for the AICPA to determine the attitude of American business and the general public toward the CPA. The outcome of that study, although very gratifying, is to me a bit scary. CPAs fared exceedingly well in the attitudes they evoke, but to maintain that high standing will be difficult. It can and will be done only if we conduct ourselves according to high ethical standards.

The big difference between ethical reasoning and everyday reasoning is that a principled or ethical person places a very high priority on how his conduct affects others. It is important that CPAs have a positive attitude toward ethics, that we learn to live with the strong sense of doing what is right. If we always temper our behavior with that in mind, we will maintain our good reputation and cause it to grow.

"WE KNOW WE MUST COMPETE BECAUSE THE ECONOMIC STRENGTH OF THE WORLD LIES IN COMPETITION. BUT OUR COMPETITION MUST BE BASED ON QUALITY, NOT ECONOMICS."

Membership in the AICPA must be seen as a professional accomplishment. The goal of the Institute must be to enhance and ensure the quality of the work of its members. It should not be perceived as a trade association attempting to concentrate on the improvement of its members' economic status, but rather an organization that works in the public interest in financial reporting matters. The public's and the business community's need for confidence in the CPA is greater today than ever before, and that need will continue to grow. We must do everything possible to enhance and maintain that confidence. •

INSIGHT INTO POVERTY

William Julius Wilson

THE TRULY DISADVANTAGED: THE INNER CITY, THE UNDERCLASS AND PUBLIC POLICY

Chicago: University of Chicago Press, 1987. 254 pp.

By Lowell Dodge

America's inner city black neighborhoods have declined dramatically since the 1960's, despite civil rights gains and the War on Poverty. Strategies and programs addressing this decline, whether offered by liberals, conservatives, or civil rights advocates, have failed. This is the stark message of a landmark analysis of current urban problems offered by University of Chicago sociologist William Julius Wilson.

Wilson, the recipient of a MacArthur Foundation "genius grant," has culled through mountains of available data, reviewed voluminous literature, and assessed a wide range of past strategies and programs. His analysis leads him to reject each of these past approaches. Proceeding from his own carefully constructed empirical base, he proposes a different set of strategies. Wilson has taken on a task of Herculean proportions and has produced a highly useful, well-structured, and readable effort.

Wilson takes great care to identify the urban poor, to define their problems precisely, and to describe the forces responsible for their 30-year decline. Current-day racism, he concludes, is not a significant force. In fact, over the 1973–82 period, the number of blacks in professional, technical, managerial, and administrative positions increased by 57 percent, he points out.

The book uses many standard economic and sociological measures to convey the reality of the inner city:

- *Unemployment.* Only 58 percent of all black males aged 20–24, 34 percent of all black males aged 18 and 19, and 16 percent of those aged 16 and 17 were employed in 1984. In 1955, the corresponding percentages were 79, 66, and 41, respectively.
- *Education.* Of the 25,500 ninth-grade black and Hispanic students enrolled in the high schools of Chicago in 1980–81, 16,000 did not graduate. Of the 9,500 students who did graduate, 4,000 read at or below the junior high level and only 2,000 read at or above the national average.
- *Births Outside Marriage.* In 1980, 68 percent of births to black women ages 15–24 were outside of marriage, compared with 41 percent in 1955. According to 1981 figures, almost 30 percent of all young single black women become mothers before age 20.
- *Population in Poverty Areas.* Although the population of the five largest cities decreased by 9 percent between 1970 and 1980, the poverty population increased by 22 percent. The population of high poverty areas increased by 69 percent over the same period.

Wilson also uses a relatively novel yardstick, one that adds new insight into the problems he describes and leads him to define a key underlying factor. He terms his new measure the "male marriageable pool index" (for "marriageable," read "economically stable.") The index is the ratio of employed men per 100 women of the same age and race. It shows a long-term decline in the proportion of young black men in a position to support a family and suggests that the increasing rate of joblessness among black men, not the effects of the welfare system, is behind the rise in black single parents and female-headed households associated with extreme poverty. Over the same period, the male marriageable pool index for whites has increased.

Thus, front and center among the factors contributing to the creation and maintenance of an inner city underclass is black male joblessness. (Note Wilson's use of the term "joblessness," rather than unemployment, reflecting a permanence in the state of being without work. The term thus includes those not seeking employment.) Increased joblessness (exceeding 50 percent for younger black males) comes about as a result of several shifts in the economy: from goods production to services (requiring more education and/or training than the production jobs lost); interregional movement of production from north to south (leaving northern inner cities with especially low male marriageable pool index numbers); and most importantly, the movement of certain low education-requisite industries away from the older central cities to the suburbs. Paralleling these

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trends are two others: significant increases in minority residents in inner city poor neighborhoods cited above and an exodus of professional, stable middle-class two-parent black families to the suburbs.

The result of these trends is a concentration of the most disadvantaged segments of the black urban population—what Wilson calls the "underclass"—in today's inner cities, particularly those in the North and East. It is significant that almost none of today's northern city black youth are migrants from the rural South, most of whom had some skills and could find employment. Most of today's inner city black youth were born into the underclass. The inner cities continue to experience a weakening of their basic institutions, churches, schools, recreation facilities, and shopping districts as the more affluent leave for the suburbs. Role models are lost; job-finding network systems nonexistent; and the underground economy flourishes, becoming the only alternative for those caught in the isolation of poverty areas.

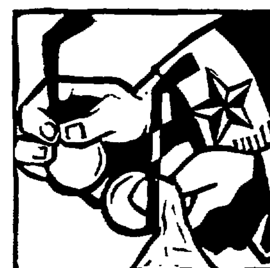
What is Wilson's prescription? Here he limits himself to general statements of strategies and programs, breaking little new ground. He urges

- economic policies generating full employment and economic growth;
- increased competitiveness of U.S. goods in international markets;
- programs to increase the adaptability of the labor force to changing economic opportunities; and
- targeted programs, such as family allowances and child care, in the short term.

One almost wishes Wilson had left the development of these proposals for his next book. They fall short of the expectations for incisiveness and innovation he establishes in the rest of the study. However, he does effectively set forth the ground rules for their development. First, programs must be developed that are conceived in terms of the actual disadvantages suffered by the underclass and the individuals in it, rather than on the basis of membership in racial or ethnic groups. Problems of the black underclass, Wilson maintains, are not problems of blacks as blacks, and will not be solved by race-specific programs. Second, to garner political support, programs must be designed to provide universal benefits, rather than to benefit only those most in need. It is perhaps the strain between these two ground rules, never finally resolved by the author, that impedes his final development of detailed strategies and programs.

But while his final proposals are limited, Wilson's thinking more than adequately lays the foundation for others, in the political arena as well as in academia. His book could not have been better timed for impact on the shaping of issues for 1988 presidential race. Though Wilson never states it explicitly, he has perhaps intentionally left the details of his proposals open-ended, as an invitation to the candidates to hammer them out and debate them during the 1988 campaigns.

BLURRY VISION



Oxford Analytica

AMERICA IN PERSPECTIVE

Boston: Houghton Mifflin, 1986. 333 pp.

By Kathy Karlson

America in Perspective is a lengthy assemblage of facts about American society. The question its authors try to answer is about American "exceptionalism": Is America still special, and what can changes in such things as life-styles, religious adherence, social institutions, ideologies, and employment and productivity say about the nation's future? It's an odd book for three reasons: First, the audience for the book is unclear; second, the authors' argument is undefined; and third, their biases make for quirky conclusions.

Audience is a big problem here. Who will read this book? Six years go, three U.S. companies (American Express, Bristol-Myers, and Sun Oil) asked the British consulting firm and think tank, Oxford Analytica, to take a look at trends in American society. Presumably, the authors would analyze such things as developing markets, population patterns, and the economy in general as they affect business. One would expect the business community to be the book's audience. But there is no analysis aimed specifically at this community; the book is unfocused. On every page, there is a bit of information—whether about America's falling Gross National Prod-

KATHY KARLSON, an instructional systems specialist in GAO's Office of Organization and Human Development, holds a doctorate in American Studies.

uct or its rising teenage pregnancy rate—but how should the reader use these facts or think about them?

A corollary to the problem of audience is that the theme and argument are undefined. The authors assert an American "exceptionalism" that they suggest is threatened by the changing economy, immigration, the new roles and expectations of women, and other social and political forces. But the theme is never clearly stated; the authors use exceptionalism as a kind of envelope for ideas, surrounding them without touching them.

This lack of definition brings me to a third problem: the authors' blurry argument lets their biases leak through. Here are two examples, one about women, the other about Hispanics: "As employers see the advantage of what is at present a more docile female workforce... a degree of feudalism may emerge" and "[Immigrants] tend to be superloyal and super-patriotic. This is likely to persist, but in the Latin case, loyalties may very well be uncertain."

European thinkers have been writing about America for more than 300 years. Samuel Johnson called America traitorous; Alexis de Tocqueville called it the most democratic country in the world. But more powerful perhaps than political judgments has been the belief in American specialness; from the days of Columbus, many Europeans have viewed America as another Eden, perhaps the harbinger of a golden age. The reader who has looked forward to new perspectives from Europe on American specialness will be disappointed in this book. The authors of *America in Perspective* employ the term "exceptionalism" as the vehicle for their argument, but they don't take us anywhere.

LIFE-AND-DEATH DILEMMAS

Daniel Callahan

SETTING LIMITS: MEDICAL GOALS IN AN AGING SOCIETY

New York: Simon and Schuster, 1987. 256 pp.

By Eleanor Liebman Johnson

Daniel Callahan has created a rare policy book: a clearly written, personally gripping, tightly reasoned exploration of a highly sensitive area. For many people, the outcome of the debate over health care for the elderly will quite literally mean the difference between life and death. With publication of this book, Callahan is likely to become a lightning rod, attracting in full force the elements that are at odds over the key issues. Advocates for the elderly who have eschewed "age" as a criterion for any type of health policy will not be pleased at its reinstatement by the author. Prolife groups will not take kindly to any policy that allows a death to occur when it is technologically avoidable.

Callahan, Director and cofounder of The Hastings Center, a leading medical ethics institute, points out that "national programs for the elderly have always rested upon somewhat shaky moral and legal premises; the elderly have been granted neither a natural nor a constitutional right to assistance." Further, the subject has been avoided because it forces us—a nation that identifies with youth, limitless possibilities, and the credo that technology holds the answer to everything—to confront not only death and dying but the limits on the application of technology and the finite nature of our resources.

It is a subject we can no longer avoid. The medical advances that allow the indefinite prolongation of biological life have led to the rapid increase in the portion of our population over 65, just at the point when the relative size of our working-age population is dwindling. Concerns about health costs (Callahan notes that in constant 1980 dollars, health-care expenditures for the elderly will expand from $80 billion in 1981 to $200 billion in 2000) and who will pay for them are linked to concerns about the quality of life of the elderly. The trend encouraging individual independence is at odds with the enduring need for the generations to be interdependent with one another. Our youth orientation conflicts with the need to find a legitimate role for the elders—as elders—in our society, and with the need to accept death and dying as part of the natural life cycle. Whether we like it or not, intensely private issues have been forced into the public arena because of the collision of these medical, economic, and societal forces.

Callahan maintains that we cannot make rational decisions about public policy until we confront and

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explore the fundamental values surrounding these issues. Four general questions act as foci for his exploration: How might we best think of the mutual obligations and equitable relationships of the generations to each other? What is the place of the pursuit of health among the other goods and needs of society? How does the care of the elderly relate to the future of the Medicare Program? How might we best characterize the agendas of aging-advocacy groups (who "pretend that aging does not occur, or with sufficient energy can be brought to heel") and those of prolife groups with regard to health care and the elderly? The specific questions Callahan frames become intensely personal for us as we filter the issues through our feelings about our own health and mortality, as well as those of our parents and other loved ones.

Callahan takes us on a quest for answers. He concludes that medicine should have two specific goals: averting premature death (understood to mean death before fulfillment of a natural life span) and the relief of suffering. Medicine should pursue those goals so that the elderly can finish out their years in the conviction that their lives have meaning and significance, enduring as little suffering as possible, and with as much vigor as they can bring to bear in contributing to the welfare of the young and the community of which they are a part. Callahan also maintains the following:

> ". . . government has a duty, based on our collective social obligations, to help people live out a natural life span, but not actively to help extend life medically beyond that point. . . Government is obligated to develop, employ, and pay for only that kind and degree of life-extending technology necessary for medicine to achieve and serve the end of a natural life span . . . Beyond the point of a natural life span, government should provide only the means necessary for the relief of suffering, not life-extending technology . . . The question is not whether a technology is available that can save a life, but whether there is an obligation to use that technology."

This book begins the process of defining critical terms, such as "acceptable span of life" and "tolerable death," and of mapping out such fundamental arguments as the legitimacy of using age as a criterion for decision-making or generalizing about as heterogeneous a group as the "elderly." He offers a set of principles for the use of age and other criteria for terminating treatment. These criteria include seven classifications of physical and mental status, as well as criteria for assessing the quality of life (i.e., capacity to think, feel, and interact with others). Callahan then links these criteria with the four levels of care that could be provided by means of a carefully designed decision-making process. In following his arguments, the reader can join in—and judge the merits of—the process of trying to define those lives that are not worth living, or at least not worth the expenditure of public funds. These criteria also can be used to identify what research areas are worthy of public funding.

Callahan sets before us the beginnings of a painful and difficult process: exploring the values that ultimately will determine public policy on health care and the elderly. The comprehensiveness, specificity, and cogency of his exploration makes *Setting Limits* required reading for anyone with a stake in the issue.

WORLD OF CHANGES

Tom Forester

HIGH-TECH SOCIETY: THE STORY OF THE INFORMATION TECHNOLOGY REVOLUTION

Cambridge, Massachusetts: The MIT Press, 1987. 311 pp.

By Timothy P. Bowling

When the microchip first became commercially available in the 1970's, it was viewed by many as having the potential to radically reshape society. Visionaries sketched a world where electronically stored and manipulated data would completely replace paper in the office environment; where education would be conducted by computers instead of teachers; where factories staffed by robots and controlled by computers would replace traditional manufacturing techniques; where, in short, the microchip would fundamentally alter the way we work and live.

In Tom Forester's *High-Tech Society: The Story of the Information Technology Revolution*, the reader is treated to a panoramic view of the societal landscape that has resulted from the development of the microchip and related advances in microelectronics. The book provides a useful, engagingly written guide to this new terrain. Since Forester carefully avoids embracing wild predictions while still celebrating the enormous

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promise of the new technology, his point of view is particularly valuable.

Forester charts the course of the revolution in microelectronics from the creation of the first electronic digital computer in Britain during the Second World War to the brink of tomorrow's "fifth generation" computer and "artificial intelligence." As Forester notes, the pace of development in this field has been extraordinary. One of the earliest computers, the 1946 ENIAD (Electronic Numerical Integrator and Calculator), cost over $2 million in today's terms and filled an area the size of a small gymnasium. Today, the same computing power can be found in $200 home computers. As Forester puts it, "If the automobile [business] had developed like the computer business, a Rolls Royce would cost $2.75 and run for 3 million miles on one gallon of gas."

At the heart of these advances is the trend toward miniaturization. Forester illustrates this with a street-map analogy: "Roughly speaking, in the 1950's information about just one street could be placed on a chip or board; in the 1960's the street map of a small town could be placed on the same size of device; in the 1970's a chip could contain the street map of a smallish city, and in the mid-1980's the street map of the entire Greater Los Angeles area could be placed on a chip. Sometime in the late 1980's it will be possible to put a street map of the entire North American continent on just one tiny chip. In the 1990's it could be the whole world."

While citing the effects of the high-tech revolution in areas such as manufacturing, service industries, banking, construction, and education, Forester's generally positive assessment is tempered by the realization that in some cases, technical advances have not been effectively integrated into the workplace. Discussing the office of the future, he notes that "many of the predictions made in the late 1970's about the pace of developments in office automation were wide of the mark. Some of the more improbable scenarios about totally automated paperless offices becoming the norm by 1985 never came to pass." When the dust from the stampede to office automation in the early 1980's settled, many executives found to their dismay that they had purchased the wrong equipment or software for their needs.

This issue is particularly intriguing when viewed from the vantage point of GAO's work in the computer and telecommunications area. What Forester has observed in certain areas of the private sector, GAO has noted in many cases in the public sector. All too often, the lure of the electronic office has led agencies to launch expensive automation programs without adequately defining what characteristics the automated system should have, which alternative approaches for achieving automation are most efficient and effective, or even how best to use computer and telecommunications equipment once it is acquired.

In other words, while the high-tech revolution holds bright promise for improving productivity, spending large sums on computer and telecommunications equipment and software is not a panacea. Any plan for automation should contain steps such as (1) defining the critical tasks the system should be able to perform, (2) analyzing the cost and benefits of the technological alternatives available, (3) testing the system to ensure that it can work in the environment for which it is intended, and (4) objectively assessing the risks of acquiring or developing the system. In addition, special considerations, such as the need for a system that can safeguard classified or sensitive information, should be identified early so they can be integrated into the initial design.

What is needed, then, is greater emphasis on understanding the current state of information technology and learning to apply it effectively in solving problems. Tom Forester underscores this need in his wide-ranging discussion of the microelectronic revolution and its impact on society. •

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