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The Trouble With Democracy

BY JOSEPH
SOBRAN

The sudden collapse of Communism in Eastern Europe has amazed and elated the West. But what does it mean? If Communism has lost, what has won?

The usual answer is "democracy." And this is assumed to be not only obvious and unambiguous, but unquestionably good.

True, free elections are finally being held in what used to be tyrannical one-party oligarchies. So far, so good. But we are entitled to doubt that this is the end of the matter, let alone "the end of history."

The mere possession of democracy does not guarantee freedom in every respect, because democracy is only one form of freedom, whose exercise may work to the detriment of other forms. This is recognized by those who fear that the end of Communism may mean the resumption of other evils of the past, long suppressed: violent na-

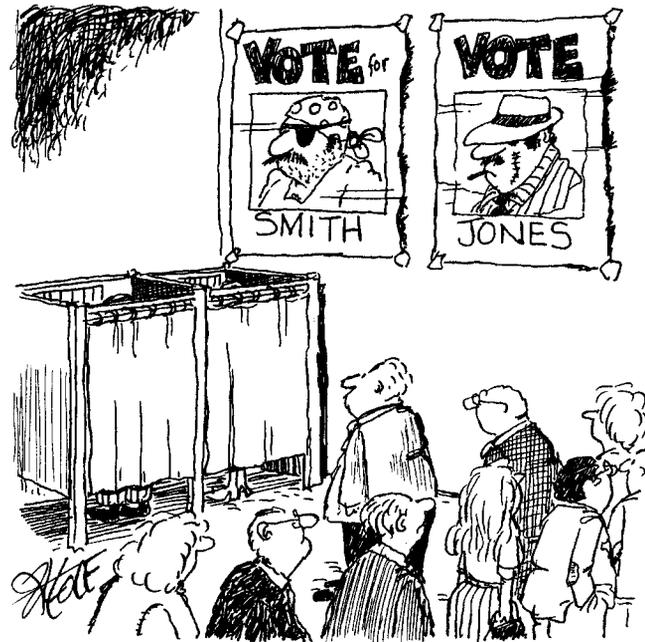
tionalism, the crushing of minorities, and so forth.

Most of us pay lip service to democracy, but we don't all agree as to why it is good. We merely agree that it is to be preferred over certain things in our historical memory: oppressive regimes that could be overthrown only with

difficulty and danger.

This, I submit, is the real virtue of democracy: it institutionalizes the peaceful overthrow of rulers. It is a principle of succession, and as such is opposed to hereditary succession, appointment within a closed oligarchy,

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In Defense of Child Labor

BY LLEWELLYN H.
ROCKWELL, JR.

Just the other day, hard-eyed federal cops descended on young lawbreakers all across America. Their crime wasn't drugs or gang warfare or even shoplifting. It was work.

Given the number of bums infesting our cities, one might assume a Republican administration would not attack work. One would be wrong.

Labor Secretary Elizabeth Dole—wife of Senator Bob (R-IRS)—is a pal of big labor, an institution which really ought to be called big *anti*-labor. Unions use violence and government-

granted privileges to get more money for less work. As part of this effort, they seek to outlaw the competition—newer people who might work harder or for market wages.

At the behest of Mrs. Dole and the unions, President Bush and Congress raised the minimum wage. This abolished entry-level jobs suitable for kids ill-educated in the government schools. Now Mrs. Dole, with White House support, is usurping parental rights with a union-inspired attack on "child labor." Like the minimum wage increase, it does

great harm.

After her Labor police investigated and fined a legion of businesses in Operation Child Watch, Mrs. Dole said: "I want to deliver a clear message to employers, parents, and youth. The cop is on the beat."

Some cop. These 14 and 15-year-old kids hold part-time jobs because they need the money, but it's illegal for them to work more than three hours a day, later than 7:00 pm, or more than 18 hours a week. Thus if a teenage busboy works three and a half

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or violence.

To be sure, there have been thoughtful dissenters. Samuel Johnson preferred heredity, on grounds that it made for stability. Being in a sense "accidental," it aroused, he thought, less envy and rivalry than any attempt to establish rule according to merit. Johnson detested political agitation, and for that reason distrusted popular election. When Boswell suggested that the election of mayors of London might be better than the chancy custom of rotation by seniority, Johnson snapped that "the choice of a rabble" was no better than chance. We need not accept his belief fully—Johnson's Tory biases are notorious—but we ought to give his reservations some weight. Even good things have their attendant drawbacks.

On one point Johnson was eminently right. "The end of political liberty," he said, "is private liberty." He insisted that the freedoms now associated with democracy, such as freedom of the press, ought to be judged according to whether they tended to promote private liberty. His insistence on this principle sets him apart from those who identify certain specific freedoms with freedom itself.

A good deal of modern liberal opinion equates freedom more with the ballot-box and freedom of expression, say, than with the security of private property that was the great criterion for such diverse 18th-century thinkers as Johnson, Burke, Jefferson, and Madison. Modern liberalism, in fact, regards it as an advance for freedom if wealth is "democratized" by being claimed for "the public sector." And modern democracy has increasingly become a public competition for what was formerly private money.

The Founding Fathers would have been horrified by the change. Madison himself wrote in *The Federalist* that the "chief object" of government is "to pro-

tect the separate and unequal faculties of acquiring property." The nominal goal, at least, of modern democratic government is to equalize the possession of wealth. This, as we should have learned by now, can't be done. But even the attempt to do it renders *all* wealth insecure, by making it subject to political power.

Democracy in our time has become infected with a version of socialist or "progressive" ideology that is deeply at odds with the traditional ideal of an impersonal rule of law. According to its almost unquestioned idiom, the role of the state is not merely to provide a set of rules to create peaceful and stable conditions of social intercourse; it is to pursue "social justice," to remedy "historical inequities," to "eradicate prejudice," and the like.

The traditional rule of law doesn't pretend to make large moral and historical judgments. Its province is not merit or desert, let alone collective guilt, but simply legal entitlement. It decides which driver had the right of way, not which was on a more urgent mission or had the more worthy destination; which claimant possessed the deed, not which was more admirable or pathetic. It is the virtue of law, not its defect, that it is immune to the fluctuation of passion or sympathy and uninterested in the personal qualities of litigants.

To abandon this impersonality is to plug the state into controversies it is incompetent to decide, and to require it to intervene in a thousand areas of formerly private life. The attempt to create "racial justice" beyond merely treating race as an irrelevant category for legal purposes, leads to wholesale "compensation" to large categories of people, who may or may not personally suffer from the putative injustice, at the expense of other large categories of people, most of whom have committed no injustice.

Guilt is not proved but crudely

presumed, and a penalty is imposed without trial. What would be intolerable if done to the individual is somehow justified if done to the mass. And in classifying whole categories of citizens as accredited victims, the state renders gross historical verdicts that no serious historian would make.

"Historical" wrongs can't be atoned for. Only specific legal wrongs can be redressed. The federal government itself, in my judgment, illegally interned thousands of Japanese-Americans during World War II. If so, the government owes compensation, not to all Japanese-Americans, but to those people whose individual rights it violated, including any who were actually, say, Chinese or Korean.

Not all official victim categories are ethnic. The state now tries to remedy the alleged "wrongs" or meet the alleged "needs" of the poor, the handicapped, the elderly, the homosexuals, and other categories. Politically, there is a simple standard: power. You have to have a lot of clout to be a victim. And in a modern democracy, "rights" become privileges whose actual effect is to diminish, not enlarge, personal liberty.

Powerful and power-seeking constituencies illuminate a basic problem of modern democracy. It is a principle of the rule of law that no man is to be judge in his own cause. Yet democracy invites all citizens to assert their own interests. As long as people merely use the franchise to defend their interests against state encroachment, democracy is working as it should. But what if they use political power for the purpose of urging the state to encroach on the interests of others?

This is what Madison called the problem of "faction." But what Madison saw as a problem less scrupulous politicians have seen as opportunity. Whereas he hoped that factions, or special interests, would cancel each other

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out, more recent politicians, especially since the New Deal, have sought to surmount the checks and balances of federalism and to consolidate power by building coalitions of factions into a sort of ruling super-faction.

The use of bribery, graft, and political spoils is as old as politics. All politicians realize that the surest way to amass power is to make as many people as possible dependent on themselves for jobs and favors. The traditional way has been to bestow appointments on political allies. But the number of government jobs is always limited.

It was the genius of Franklin Roosevelt to see that millions of voters could, in effect, be bought with the promise of income from the federal government—which meant, ultimately, with taxes levied on the income of other citizens. He privately boasted that “no damn politician” would ever be able to repeal “my Social Security system.” That system was fraudulent—the sort of scheme that businessmen go to jail for—but it was a tremendous success politically.

More recent federal programs have made tens of millions of Americans recipients of federal money. The money is collected by an agency that operates outside the restraints of the Constitution and the rule of law. The beneficiaries of the system are jealous of their benefits; the victims—the people who pay for it—are too intimidated and demoralized, and have little incentive, to resist. They face their annual tax inquisition with quietly bitter resignation. In relation to the federal government, the American citizen today is either a dependent or a defendant.

The new system, a virtual abrogation of the original constitutional plan, has destroyed economic privacy. At the same time, voting has come to be regarded as a purely private act. There is something askew in this arrange-

ment. A voter is a sort of public official. He should at least be held morally responsible to his fellow citizens in the use of his franchise. If he votes to enrich himself at their expense, he is no better than a politician who takes a bribe.

In fact, the sort of interest-group politics that prevails in the United States today amounts to a system of mass bribery. In the old days an occasional citizen bribed an occasional politician and, if caught, was punished. Nowadays nearly all politicians bribe as many voters as possible, and get elected. Our pundits and even our civics books celebrate this process as the fulfillment of the Framers' plan, when it is really the defeat of that plan.

Liberal opinion has lately been exercised about the “greed” allegedly unleashed during the Reagan years, meaning the transactions of a few fast operators on Wall Street (many of whom harmed nobody). But the most pervasive form of greed in America today is the greed that seeks to gain other people's money by electing politicians who will take it on your behalf. This form of greed, however, is now called “need.” The word “greed” is reserved for those who would protect their own earnings from the state and its clients.

The triumph of Roosevelt and his successors lay in implicating huge masses of voters in a gigantic conflict of interest. As citizens, we have a moral obligation to vote with strict regard for the public good. As prospective recipients of federal money, however, we are invited to urge the state to rob our fellow citizens on our behalf.

Democratic politics has become largely the manipulation of voting blocs; and as Benjamin Ginsberg has brilliantly explained in his book *The Captive Public*, the federal government keeps generating new constituencies for itself, new blocs demanding new benefits. The civic-

-minded individual voter gets lost in the gargantuan shuffle among the groups that really count, the powerful forces contending for victim status.

The word “minority” has a halo of pathos about it. But in modern politics, a “minority” is always a bloc to be reckoned with. It has translated its pathos into power, and it dwarfs the unaffiliated individual whose personal income is up for grabs.

George Will has praised Roosevelt for introducing into our national politics an “ethic of common provision.” But this would be a plausible description only if those who received benefits were debarred from voting—a stipulation that would now be denounced as heartless, inhuman, and (of course) undemocratic, though John Stuart Mill, among others, thought it axiomatically necessary to preserve the welfare state from corruption. Without such a stipulation, what we are likely to have is less an “ethic of common provision” than a politics of rapacity.

Democracy is morally legitimate only as long as citizens are delegating to the officers of state the powers that rightly belong to self-government. But democracy can't bestow on a state power that no government is entitled to. Democracy is powerless to sanctify robbery and bribery.

At the Nuremberg trials the civilized world was appalled to learn how the ostensible rule of law could be perverted into mass murder by bureaucratic delegation. Of course I am speaking of something infinitely less serious. But it is serious enough to notice, and the principle is the same. An enormous state apparatus is routinely committing, on our behalf, acts that would immediately be recognized as criminal if we performed them personally.

The arrogance of the modern state—democratic, Communist, Fascist—lies in its claim to alter

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even the moral principles that customarily guide human beings in their dealings with each other. Apart from being wrong, this is a futile and dangerous undertaking. It destroys the good faith and social trust on which any society, with any form of government, depends.

The socialists have always spoken hopefully of "building a new society"; the Communists even claimed to have created a "new Soviet man." But what Mr. Gorbachev has painfully learned is that the real task of a ruler is to build an *old* society, not by switching all the rules and abolishing traditional understandings, but by preserving the essential components of concord. Building a society is slow work, like establishing a credit rating. The only assurance we have that a thing will last is that it has *already* lasted.

The euphoria of the moment shouldn't make us suppose that Communism and modern democracy are polar opposites between which lie all the pos-

sibilities of government. To a lesser degree, the democratic state in our time also invades and constricts the area of private life. Unlike the Communist state, it does so at the behest of powerful masses of voters who can't be overthrown and can hardly be restrained. We should be grateful that their rule is far less onerous than Communism. But this doesn't mean that their dominion is any sort of ideal.

Even under democracy, modern man has the unpleasant sensation that the state is closing in on him. "There is nothing left of which we can say to them, 'Mind your own business,'" C.S. Lewis lamented. "Our whole lives *are* their business." Politicians are seen, and see themselves, not merely as "rulers," Lewis noted, but as "leaders"—a change in terminology he thought deeply significant, implying as it does that the purpose of the state is not to stabilize but to *change*.

Even our inner lives are not immune, as public schools engage in "consciousness raising"—

monitoring and supposedly correcting children's attitudes on "social" issues; to liberal opinion, the Politically Correct Attitudes seem so self-evident that there is no reason not to instill them into every child.

Lewis was sensitive to the dangers posed by enlarging the public sector: "I believe a man is happier, and happy in a richer way, if he has 'the free-born mind.' But I doubt whether he can have this without economic independence, which the new society is abolishing. For economic independence allows an education not controlled by government; and in adult life it is the man who needs, and asks, nothing of government who can criticize its acts and snap his fingers at its ideology. Read Montaigne; that's the voice of a man with his legs under his own table, eating the mutton and turnips raised on his own land. Who will talk like that when the State is everyone's schoolmaster and employer?"

A good question. Modern democracy has yet to answer it. ◀

In Defense of Child Labor

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hours, or until 7:15pm, he's guilty, and his boss can be fined \$100,000 and sentenced to six months in prison.

What's wrong with hard work? And why should the federal government, not exactly an expert in hard work, stick its nose in? The Constitution doesn't appoint Mrs. Dole as Big Mother.

Can a youngster work too many hours? Sure, just as he can *play* too many hours. But in a free and decent society, decisions about these matters are for parents, not bureaucrats. Mrs. Dole not only violates the free market, she usurps the authority of fathers and mothers.

How dare she close off these kids' opportunities? A teenager's job is not only gainful, it's a school for life. And it is the most important school many kids attend. The government wants to

kick them out.

This is made easier by what Ludwig von Mises identified as the "anti-capitalistic mentality" of politicians and intellectuals, and the long history of socialist propaganda on this subject.

Youth labor is the "most widely misrepresented aspect of the history of capitalism," says Robert Hessen of the Hoover Institution.

We're told that capitalism put young people to work in the English factories of the 1700s and 1800s that were little better than concentration camps. As usual, the Left has got it exactly backwards.

In 1697, before the Industrial Revolution, John Locke urged families to put their children to work at age three. Otherwise, they would have only "bread and water, and that very scantily too."

And many would not have even that.

By 1830, the life expectancy of children had vastly increased, thanks to the most explosive growth in living standards in history. Before capitalism, "these children were destitute," said Mises. "Their only refuge was the factory," which "saved them from death by starvation."

The work was hard, as life was hard, but it was not abusive. The real maltreatment took place in the English welfare system. The government placed orphaned and deserted children in horrendous establishments.

When youth factory work was restricted by an unholy combination of upper-class bleeding hearts and socialists, it was the kids who suffered. Since they had to live, and since they would do anything to avoid the social

Inflation and the Spin Doctors



BY MURRAY N. ROTHBARD

We are all too familiar with the phenomenon of the “spin doctors,” those political agents who rush to provide the media with the proper “spin” after each campaign poll, speech, or debate. What we sometimes fail to realize is that the Establishment has its spin doctors in the economic realm as well. For every piece of bad economic news, there is a scramble to provide a pleasantly soothing interpretation.

One perennial favorite is our permanent state of inflation. During the halcyon days of the 1950s and 1960s, the Fed and the other monetary authorities believed that inflation was out of control if it went above 2% a year. But such is the narcotizing effect of habit and desensitization that nowadays our standard 4.5% rate is held to be equivalent to inflation having disappeared. In fact, the implication is that we have no need to worry so long as inflation stays below the dread “double digit,” reached for the first time in peacetime during the inflationary recessions of the early and

late 1970s.

Well, in January 1990, the cost of living index at last reached well over double-digit proportions. During that month, the cost of living shot up by 1.1%, which amounts to more than 13% per year, reaching the disturbing inflationary peaks of the 1970s. Was there any grave concern? Did the Fed and the Administration, at long last, reach for the panic button?

Certainly not, for the economic spin doctors were quick to leap to their tasks. You see, if you take out the fastest rising price categories—food and energy—things don’t look so bad. Food went up by 1.8% in January—an annual rise of almost 22%; while energy prices went up by no less than 5.1%—an annual increase of over 61%. But that’s OK, because the culprit was the record cold snap in December, which drove food and vegetable prices up by 10.2% the following month (an annual rise of over 122%), and pushed up heating oil prices by 26.3% (an annual increase of over 316%).

Take out those volatile (though concededly important) categories of food and energy, then, and we get a far more satisfactory “core rate” (defined as consumer price movements minus food and energy) of “only” 0.6% for January, an annual rise of 7.5%. This, the Establishment admitted, is definitely cause for concern, but it is, after all, well under the baleful levels of double-digit.

But, we must remember, there are often cold snaps during the winter, and the always allegedly random effects of the weather always seem to work more strongly in the inflationary than in the deflationary direction.

The concoction of the “core rate” is a plausible-seeming example of a racketeering general principle: if you want to make inflation go away, simply take out the price categories that are rising most rapidly. Lop off enough prices, and you can make it seem that there is no inflation at all, ever. Find some excuse for taking out all the rising categories, call whatever is left the “base rate,”

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Instead of harassing small businesses, I have a better idea. Let’s raid the Department of Labor and toss the slothocracy out on the street.

workers, the youngsters were forced to look for usually lower-paying and more dangerous work in the countryside. Many ended up, says Mises, “vagabonds, beggars, tramps, robbers, and prostitutes.”

Youth labor was not abolished by Parliament, says Hessen, any more than it could be legislatively eliminated today in Bangladesh or Ghana. Only when “the income of the parents became sufficient to support them” did it cease. The “emancipators and benefactors for these children” were “manufacturers and financiers,” not politicians.

Twice during the Progressive Era (the *regressive* era that gave us the Federal Reserve, the income tax, and World War I), Congress tried to restrict youth work, but both times it was stymied by a

Supreme Court that followed the Constitution.

Liberals and unions proposed a constitutional amendment to ban child labor, but it too failed. Only Franklin D. Roosevelt’s New Deal, which subverted the Supreme Court and exalted unions, could have enacted the union-inspired Walsh-Healey Act of 1936, ordering government contractors to fire young people, cut working hours, and pay above-market union wages. The so-called Fair Labor Standards Act of 1938 extended these principles to the whole economy, and gave us the first minimum wage.

Northeastern Congressmen saw the legislation as a way to attack the lower-cost, non-union Southern states. A conservative Republican-Southern Democrat alliance tried to stop the laws, but

unfortunately to no avail. Anti-market legislation is always harmful, but these laws threw people out of work during the Great Depression.

The power of labor unions has faded since those dark days, and few people (outside of university economics departments) believe in Marxist exploitation theories anymore, but we are still saddled with anti-work laws that stunt young peoples’ lives.

Instead of harassing small businesses, I have a better idea. Let’s raid the Department of Labor and toss the slothocracy out on the street. Maybe they can get some real jobs in fast-food restaurants...as long as they’re willing to compete with America’s young people newly enfranchised by the repeal of all child-labor laws.

Food Fascism

BY SHELDON L. RICHMAN

To the bureaucrat, the market is chaos. Order comes from the design of a powerful planner, from the government. That's why Louis W. Sullivan, Secretary of Health and Human Services (HHS), will impose new nutritional labeling regulations on about 20,000 food items next year.

"The grocery store has become a Tower of Babel," Sullivan said, "and consumers need to be linguists, scientists, and mind readers to understand the many labels they see." The bureaucrat, like some Australian bushman newly arrived in New York City, stares at the market and is dumbfounded.

Besides the mandatory labels,

which will list in specified form the amounts of fat, fiber, and cholesterol and the percentage of calories that come from fat, the new regulations will define "low fat" and "high fiber." Fresh fruit and produce are included in the new regulations, but, mercifully, labels will not be attached to apples and potatoes; rather, the store will have to make the information available to shoppers.

The New York Times said "the proposal was greeted with a variety of cheers and boos from the industry and consumer groups." But the only boo it reported came from the Food Processors Association, which wants a single nationwide labeling system instead of "hodge-podge of conflicting

state requirements." This is opposition?

The *Times* explained that the food industry has changed its position on mandatory labeling because consumers like labels. In fact, for reasons that should surprise no one, the companies using labels want the companies that don't to be forced to use them. "We'd love mandatory labeling," said David J. McDonald, CEO of Curtice-Burns Food Co. "It's a level playing field."

Under current law, adopted 17 years ago, nutritional labels are required only for foods that have vitamins added or which make health claims.

The first thing to notice is that, once again, the market is way ahead of the regulators. Seventeen years ago few people cared about fat and fiber. Yet when consumers began to get interested, business did not wait for the government to act. Private individuals wrote books, which consumers eagerly read, and this heightened interest led to product labeling. The feds are playing catch-up.

But they can't play it well. Instead, they will lumber, bull-like, into the china shop and upset the market process, which would otherwise, in countless unforeseeable ways, educate and satisfy consumers. The government will deny American consumers the right to demand and get precisely the kind of labeling that they, and not some bureaucrats, want.

If we know one thing for certain about this area of science, it is that we don't know much for certain. One day we're told that everyone should avoid salt; next day, the warning is restricted to people with high blood pressure. One day a study demonstrates that oat bran can lower cholesterol; next day, another study shows the opposite. Researchers now dispute whether diet can affect cholesterol levels at all!

The New York Times reported

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and presto-changeo! inflation is gone forever.

Thus, during the early years of the Reagan Administration, housing prices were going up by an embarrassing degree, and so they were simply taken out of the index, on the excuse that consumers pay annual rents, actual or imputed, and at that point rents had not yet caught up to the increases in the prices of housing. During the infamous German hyperinflation of 1923, for another example, there were respected Establishment economists who maintained that there was no inflation in Germany at all, but rather deflation, since prices in terms of gold (which was no longer redeemable for marks) were going down!

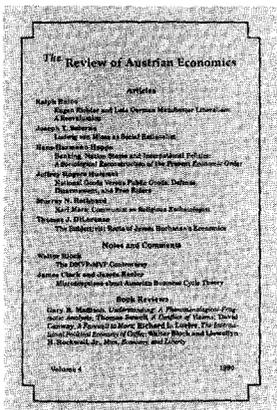
Unfortunately, the poor benighted consumers are paying through the nose in higher prices for all the goods on the index (and even more for goods that never get on the index, such as brand-name products and books), even including houses, food, and energy. We consumers don't have the privilege of paying only for "core" goods; nor, unfortunately, do we enjoy the luxury of paying in gold.

Since even the core rate is get-

ting disturbingly high, the Establishment economists are beginning to look around for explanations. One old candidate for blame has therefore resurfaced, with several economists pointing out that wage rates went up by a disquietingly high 5.0% last year; but since prices went up by the now traditional 4.5%, this hardly seems a major point of worry.

Wage rates have been lagging behind price increases for years. The real culprit for the accelerating inflation is the one candidate that the Establishment always tries its best to avoid fingering: the money supply created by the federal government itself.

After years of the government's creating new money and pouring it into the economy, the people are now spending that money, and hence driving prices upward. But the last group the federal government wants to blame is itself; besides, money creation is too pleasant for the creator and his beneficiaries to give up without a struggle. And only when the power to create money, that is, to counterfeit, is taken totally out of the hands of government will the curse of inflation truly disappear forever. ◀



In all the world, only one scholarly journal is dedicated to the Austrian school: *The Review of Austrian Economics*. Volume 4, containing Murray N. Rothbard's pathbreaking analysis of Karl Marx and many other articles and reviews, is \$20, which includes U.S. postage and handling.

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recently that scientists are still arguing, after decades, over whether fluoridated water causes cancer in rats. It is precisely in an area where scientific research frequently contradicts itself that the inflexibility of bureaucracy is most dangerous. That is where we need the competitive market process: here the marketplace of ideas and the marketplace of products intersect—to the benefit of consumers. Limiting either market harms their health.

Another problem with government-mandated labeling is that it gives people a false sense of security. With mandated labeling, many will understandably feel that they are being told everything they need to know. Everyone must economize on knowledge. No one has enough time or money to learn everything about even the subjects most important to them.

The daily challenge is to use one's resources intelligently in acquiring information. One tries to avoid squandering resources on useless or bad information and missing opportunities for good information. If the government decides what information should be provided and requires that it be placed on products, the information will appear to consumers as a free good.

Many will respond to this "free" information by using resources that would have otherwise gone to acquiring nutritional information on other uses. Their interest in reading and thinking about nutrition will erode. They will be less informed consumers, contrary to the stated purpose of the labeling program. What is billed as a consumer education program is in fact an anti-education program.

Another problem with mandatory labeling is that people tend to grant undeserved credit to the government's imprimatur. Most consumers discount to some extent the information they get from the manufacturer of a product because its interest is readily understood. But these same consumers take information from government regulators, "consumer" groups, and university research institutions as if their only interest were consumer welfare.

It doesn't occur to most people that bureaucrats, "consumer advocates," and government-funded scientists have career interests not unlike those of business executives. They want to succeed, see their bureaus or organizations grow, and command bigger budgets. Many of them also have a busy-body complex:

they think they know how people should live and eat, and intend to harass, if not force, them into living and eating that way.

The information they provide is no more likely to be "objective" than that provided by, say, Quaker Oats—and probably less so because Quaker Oats has to face fickle consumers in the marketplace every day. Consumers don't have to turn one nickel over to Quaker Oats if they choose not to. But they have no such power with regard to HHS or research institutions that live off government grants.

Without government requirements, a wealth of information about nutrition would be available in a variety of forms, from package labeling to *Consumer Reports*. Ironically, when the American Heart Association proposed a private labeling program, the government opposed it.

The very contention that Sullivan condemns (government is always uneasy about processes it doesn't control), the contention over what information to present and how to present it, is what yields benefits to consumers. We don't know everything and, more important, we don't know what we don't know. Competition in the free market is the best way to learn. ◀

The Government War on Drexel

BY MATTHEW
HOFFMAN

The demise of Drexel Burnham Lambert, the maverick investment banking house, was applauded in elite business and banking circles. But it was one of the tragedies in U.S. financial history.

Drexel had made many enemies since 1983, when it single-handedly created a new industry by financing the first high-yield bond takeover of a corporation. Through the work of its star financier Michael Milken, it engineered a new way to wrest poorly-run corporations from their managers.

For the next seven years, Drexel helped entrepreneurs

raise capital through low-rated bonds that rewarded investors for their risk with high rates of return. The "corporate raiders" used the bonds to purchase controlling fractions of stock in target companies, ousting long-established executives who had often mismanaged the firms. The media, following Establishment practice, called the high-yield instruments "junk bonds," but they ushered in a new era in finance.

By 1986, Drexel had risen to become the most profitable investment bank in the country, while disapproving competitors, frightened corporate managers, and the media watched in horror.

Their influence in Washington brought about the SEC prosecution of Drexel client Ivan Boesky for insider trading. In November 1986, the SEC launched an investigation of Milken and Drexel based on information supplied by Boesky.

Almost immediately, "sources" within the agency began leaking Boesky's allegations to *The Wall Street Journal*. According to the reports, Boesky had revealed a variety of insider schemes and other trading violations.

Not to be outdone, the Federal Reserve aided the ongoing ha-

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rassment of Drexel by using its margin rules to restrict the use of low-rated bonds in financing corporate takeovers, after influential corporations such as Unocal, a takeover target of T. Boone Pickens, requested they do so.

Finally, in September of 1988, the SEC filed sweeping civil charges against Drexel in a staggering 184-page civil complaint. The beleaguered company had already spent more than \$140 million to defend itself, including \$40 million to copy, collate, and cross-reference 1.5 million pages of documents.

After its two-year investigation, however, the SEC's case turned out to be surprisingly weak. Most of the allegations were based on the word of Ivan Boesky, a convicted felon whom columnist Robert Samuelson called "a practiced, even enthusiastic liar." Although the SEC claimed to have collaborating witnesses, it neglected to name them in the complaint. Then, U.S. Attorney Rudolph Giuliani informed Milken that criminal indictments would also be brought.

The dubious strength of the government's case was a far cry from the "systematic corruption" and "rampant criminal conduct" claimed by U.S. attorneys before the charges were filed, and questions were raised in the media about the potency of the evidence. Almost all of the Drexel clients named in the SEC complaint continued to do business with the firm, including Maxxam Corp., a firm the SEC claimed Drexel defrauded. Drexel appeared ready to do battle, but the government had not yet begun to fight. It would later be revealed that it was desperate not to.

In late December, federal prosec-

utor Giuliani approached Drexel with an ultimatum: settle or suffer criminal indictment. Giuliani's threat was backed by the awesome power of the Racketeer Influenced and Corrupt Organizations Act (RICO), which one federal judge has called a "monster." RICO allows the government to seize a defendant's assets before a case is brought to trial, let alone before anyone is convicted. Although the law was created as a weapon against organized crime, Giuliani had made a name for himself by applying RICO to a wide variety of white-collar infractions.

Drexel executives realized that if criminal charges were filed against them under RICO, the company would probably not survive the pre-trial asset forfeiture. In late December, Drexel reluctantly announced that it had struck a deal with prosecutors in which it would plead guilty to six felony counts of mail, wire, and securities fraud which "the company is not in a position to dispute," fire Milken, and pay \$650 million in penalties. Giuliani agreed in return to cancel his plans to prosecute Drexel under RICO. Thus, more than two years and hundreds of millions of dollars after the government began its campaign against Drexel, the world would never know if the company had committed a single crime.

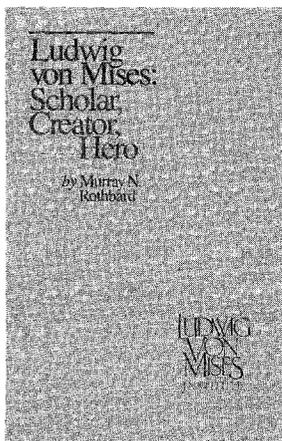
During the early months of 1989, Milken attempted to prevent his firing, but three months after his indictment in March, he resigned. In April, the SEC settled the civil charges with Drexel, in a deal that amounted to an SEC takeover of the company. Drexel was forced to accept John Shad, the former SEC

chairman who had launched the current wave of insider-trading investigations, as its new non-executive chairman. Two "outside directors" were appointed, as well as an "ombudsman" who would be available to Drexel employees who wanted to report trading irregularities. Although the new situation imposed a stranglehold on a company that had lost its key employee, Drexel's troubles seemed largely to be over.

But the government vendetta against Drexel was far from complete. In 1989, the federal government forced all savings and loans to dispose of their high-yield bonds, sending prices in the market plummeting. Then, in September, Drexel paid \$500 million of its colossal \$650 million fine. The massive fine combined with the government-induced slump in the high-yield bond market caused Drexel's net worth, largely held in low-rated bonds, to decline sharply. Because the liquidity of high-yield bonds was largely dependent upon Drexel's well-being, the company's problems further depressed the market.

In February 1990, Drexel's holding company began to transfer money from its subsidiary to pay off short-term loans coming due. The SEC struck its final blow, ordering Drexel to stop. The holding company defaulted on more than \$100 million in loans, and was forced to file for chapter 11 bankruptcy. The government, after three years of concerted effort, had finally managed to destroy Drexel Burnham Lambert.

The company, and Milken, had made the mistake of doing what every great American innovator has done: threatening the status quo. ◀



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