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Peter O. Steiner
University of Michigan

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THE LEGALIZATION OF AMERICAN SOCIETY: ECONOMIC REGULATION

*Peter O. Steiner**

I

Markets regulate, and so do despots. I focus, in this Comment, on neither of these, but rather on regulation via rule making and legal enforcement. I intend no pejorative content to the phrases "regulation" and "legalization" for they can be colored green as well as black. But the positive (as distinct from normative) fact is that the change in the economic institutional climate in the last hundred years is little short of revolutionary. It is barely a century since the first state railroad and utility regulation, and the centennial celebrations of the Sherman Act and the Interstate Commerce Act are still ahead.

Consider, initially, a working definition of economic regulation.¹ I include the vast array of ways in which governments (state and local as well as federal) interfere *via rulemaking* with the activities of economic actors. I mean to include such conventional examples as regulation of railroad and public utility rates and service, and drug and mine safety. I also include regulation of emissions, strip mining, mergers, price discrimination, permissible rents, and importation of steel or autos or textiles at prices judged to be too low. Some of the rules that I call regulations are formulated by identifiable regulatory agencies or departments, from the ICC and SEC to EEOC; others have their origin directly in legislation, and are merely administered by agencies; still others are non-governmentally initiated under the umbrella of enabling legislation permitting private action.

There is no very neat line between such rulemaking and (on the one hand) the whole range of tax and subsidy provisions that also impinge on economic behavior, nor (on the other hand) the range of governmental expenditures that replace, displace, or supplement private market behavior. Indeed these are characteristically alterna-

* Dean of the College of Literature, Science, and the Arts; Professor of Economics and Law, University of Michigan. A.B. 1943, Oberlin College; M.A. 1949; Ph.D. 1950, Harvard University. — Ed.

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1. Definitions are meant to be useful, and there are other definitions for other purposes. Some have argued that any set of social institutions constitute a regulatory framework for social intercourse. In that sense, even *laissez faire* is a form of regulation. For present purposes, I want a narrower concept.

tives (along with *laissez faire*) to regulation for achieving particular ends. But some limitation is essential, and my conclusions are, I think, robust with respect to the definition of regulation.

There have been a number of taxonomies of regulation proposed recently,² and I shall add yet another. My central thesis is that regulation may be insightfully classified into *three* broad types of response to perceived market failure, and I will merely touch examples of each. The first is *protection of competitive results*. I shall focus on natural monopoly regulation, although anti-trust would do as well. The second is *protection from competitive results*, such as entry control and setting of minimum prices. The third is *regulation of externalities* such as pollution and accidents arising as byproducts of more usual production.

My central points are

(1) These regulations, and the legalization that accompanies them, result both in substantial costs to our society, and in substantial benefits. The nature of the costs and benefits are qualitatively different in the three kinds of regulation.

(2) The benefits and the costs are to a substantial (but not complete) extent inseparable, because some costs inhere in each type of regulation.

(3) The current mood, in which the aggregate costs of regulation are perceived to be intolerably high, provides a political opportunity for significant reform of the regulatory process that will improve the benefit-cost balance. But this mood carries also the danger of zealous but simplistic reform.

II

Regulations — rules — interfere with private action. Further, rules require administration and policing by the regulators and compliance efforts by the regulatees. Such uses of resources compete with others that can satisfy consumption and investment desires, and ultimately get reflected in higher costs, higher prices, and higher taxes. Rules, and their enforcement, inevitably occasion dispute, and dispute involves lengthy and frequently expensive efforts at mediation or adjudication. All of these are among the costs of regulatory regimes, and involve the legalization that is our focus today.

The *symptoms* of dissatisfaction with the current regulatory climate are not hard to identify. The familiar litany includes:

(1) *Red tape, delays, licenses, compliance reports*. Everything requires approval, approval takes too long and requires too much

2. See, e.g., Wilson, *The Politics of Regulation*, in *THE POLITICS OF REGULATION* 357, 366-82 (J. Wilson ed. 1981); Schuck, Book Review, 90 *YALE L.J.* 702, 708-09 (1981). See also S. BREYER, *REGULATION AND ITS REFORM* (1982); Gellhorn, Book Review, 81 *MICH. L. REV.* — (1983).

manpower. One can't introduce a deodorant, build a factory, hire a secretary, market a product, or even close down without the endless oversight of several regulatory agencies, and the maintenance of a large cohort of managerial, clerical, and even legal personnel to chart the way.

(2) *Litigation*. Even best faith efforts in all of the above will not avoid the morass of ever widening litigation with one's rivals, one's customers, one's employees, and with self-appointed private, as well as public, watchdogs of the public weal who have been given standing to intervene.

(3) *Stultification*. It is necessary to divert major fractions of available R&D and new capital funds into compliance rather than into new product or process innovation. This causes us to fall ever farther behind Germans, Japanese, and others who have usurped our traditional role of industrial leadership.

(4) *Rigidity*. Rules once made, and agencies once formed, live (if not forever) at least far beyond the problems that spawned them. Rules become perverse or senseless, but tend to survive.

(5) *Avoidance and evasion*. Intricate and arbitrary rules make it economically sensible for individuals and business firms to devote efforts to avoidance and evasion rather than to product ventures themselves.

(6) *Inflation*. Regulation inhibits, even where it does not actually prohibit, competition, experimentation, and price cutting. It thus denies the relief from inflation that competition and freedom would produce.

There is merit as well as caricature in each of these. It makes one wonder why we ever did accept (indeed *seek*) regulation. Some of the answer may be that we traditionally underestimated these costs, but far more has been the recognition that unrestrained markets can and do malfunction, and that regulation is a beneficial response to the multiple set of phenomena that it is fashionable to label "market failure." *Regulation was a response to real needs, many of which remain cogent today.*

However valid was the emergence of a substantial regulatory apparatus, it is hardly debatable that the current mood, in academic circles no less than in the body politic, is one of at least partial disenchantment with regulation. How much of this is a temporary political phenomenon and how much a long-term shift is not clear. But it is plain that, at the very least, some of the past faith in government regulation is lost for good. A central question is, why? Not, why is regulation excessive? But, why is it *now* newly perceived so to be?

The distinguished economist F.M. Scherer recently offered a two-

part explanation.³ First, in his view, is the growing awareness by economists that optimal regulation is exceedingly difficult and the new perception that undesired side effects of seemingly sensible rules lead regulation to fall far short of replacing or restoring efficient markets. As a result, while regulation solves some problems, it creates, Hydra-like, new inefficiencies that greatly reduce, and perhaps wholly offset, its benefits. (I shall return to this line of criticism shortly.) Second, he argues, is the spreading realization that the regulatory commissions have been captured by the regulatees, a realization for which he gives approximately equal credit to revisionist historians of the left, the Naderites, and the Chicago School of economic free marketeers.

While each of these explanations may be persuasive, I think they are too parochial: they perhaps explain why industrial organization economists have backed away from advocating regulation, but they say relatively little about why the public has become (at least partially, at least momentarily) disenchanted. Let me suggest two other reasons. The first of these has almost nothing to do with regulation itself. I suggest that much of the force for deregulation comes from our inability to understand and cope with inflation. Inflation has proved to be a great instrument of reform of things that did not cause it: things such as the Fair Trade Laws and macroeconomics. Much of the deregulatory pressure, it seems to me, comes from people, in government and out, who are frustrated about their government's inability to cope with inflation in other ways. Regulation makes a nice scapegoat, and deregulation is a form of doing something.⁴

More subtle and more important is my second alternative. I think the loss of faith in regulation arises not from the fact that there is too subtle a theory of how to regulate effectively, but from the fact that we now recognize — indeed even expect — that governments as well as markets can fail. This may be the longest lasting impact of Vietnam and Watergate.

But the notion of government failure that I wish to explore goes far beyond the failures that may be caused by stupid or venal politicians or regulators. I suggest that we are coming to recognize that many of the most visible and annoying costs of regulation are *inevitable* byproducts of the regulation. It is not, as I think Scherer suggests, that regulators are too ham-handed to be efficient regulators. Rather, regulation in a society that values law and due process has

3. Scherer, *Public Regulation Economics Then and Now*, in ECONOMICS CENTENNIAL CELEBRATION SYMPOSIUM (forthcoming from the University of Michigan Press).

4. There is, of course, some reason to believe that *some* of the costs and some of the rigidities that entrench inflation are regulatory in origin. But the bulk of the regulations were in place long before the inflationary trend set in.

within it the seeds of its own costliness. To understand why, I find it helpful to look at the growth and spread of regulation as well as at its current impact.

III

The regulatory landscape we know today would seem as unfamiliar to the nineteenth century American pioneers as the massive mountains they encountered on their journeys west. Like those mountains, I shall argue, the regulatory edifices are neither unmixed blessings nor useless impediments, although there is no shortage of advocates of each of those views. The regulatory mountains (like the real ones) have not been built by gradual accretion but in a series of epochs of cataclysmic mountain building. I identify three regulatory epochs, widely separated, and each different from the others.

The first was the late nineteenth century spurt that attempted to cure the "classical" form of private market failure: monopoly, both natural and unnatural. *Prescriptive* regulation of railroad, gas, electric, and water rates by independent commissioners was designed to yield the results that would be produced by competitive markets, if only the underlying economic realities did not preclude both competition and efficiency. Commissioners insulated from both economic and political pressures could simulate the invisible hand. *Proscriptive* regulation of monopoly, conspiracy, and predatory behavior was different in form but not in purpose. The targets were the "unnatural" ways that also prevented the market from achieving the glories of the competitive world that Adam Smith had sketched and that Alfred Marshall (in English) and Leon Walras (in French) were codifying.⁵

The second wave of regulatory mountain building occurred in the 1930's in the grasp and terror of the Great Depression. It was totally different in motivation and form: it was concerned with the *failure of competition*, not with its absence, with the collapse of the economy and with excess competition. Protection of workers from low wages, and of business (large *and* small) from low prices were the hallmarks of the NRA, and its more lasting successors. Antitrust laws were amended to be protective of competitors, not of competition. The Fair Trade Laws, the Robinson-Patman Act and others were designed to limit competition and prevent price cutting. The ICC turned from protecting farmers from the railroads to protecting railroads from the truckers. The Federal Communication Commission and the Federal Power Commission made regulation of entry and limitation of competition their major foci.

5. A. MARSHALL, *PRINCIPLES OF ECONOMICS* (1890); L. WALRAS, *ELEMENTS D'ECONOMIE POLITIQUE PURE* (1877).

The third period of regulatory expansion was in the 1960's and 1970's when more new regulatory agencies and activities were started than during any comparable period of our history. Regulation arising out of the civil rights movement and out of EPA and OSHA are the prominent examples of this period, and they are revealing because they reflect the dominant concern of the regulations of the period: market or societal failure due to what economists call adverse externalities. Adverse externalities are costs imposed on others — or, if you will on society — by actors who do not need to pay for the costs they cause society to incur. Pollution is a most obvious example of such an adverse externality, but any impingement on social goals — such as causing accidents or discriminating against minorities — is similar. Producers who do not have to pay the cost of the pollution (or accidents or discrimination) they impose on others are not motivated to engage in expensive activities to avoid imposing such costs. Thus markets fail to take full account of social values. Peter Schuck among others insightfully recognizes the distinct character of these regulations.⁶ He and others describe this as “social regulation” in contrast to economic regulation, a designation that I find less helpful than the distinction, for such regulation is assuredly economic in motivation.

The three epochs of regulatory mountain building are separated not only in time, but in scope, and in the kinds of costs they have inevitably imposed on our society. Moreover, they have proved additive, and it is partly a cumulative clogging of the pores of the market economy that has led to the present sense of malaise. Although most of the research on regulation has concerned the first epoch, it is, I will suggest, the third that has proved most decisive politically. But all this requires a closer look.

IV

The nineteenth century origins of modern economic regulation were responses to the hardly avoidable conclusion that the invisible hand of Adam Smith had been replaced in some sectors by the visible paw. Whether Congress jumped or was pushed into regulating those sometimes designated as robber barons, is not material to my thesis.⁷ The regulations of this period were intended to be relatively limited in scope. This first epoch — that of the battle both against natural monopoly and unnatural clogs on competition — was largely

6. Schuck, *supra* note 2 at 708.

7. *But compare* I. SHARFMAN, *THE INTERSTATE COMMERCE COMMISSION: A STUDY IN ADMINISTRATIVE LAW AND PROCEDURE, PART FOUR* (1937), with such revisionists as G. KOLKO, *RAILROADS AND REGULATION, 1877-1916* (1965); P. MACAVOY, *THE ECONOMIC EFFECTS OF REGULATION: THE TRUNK-LINE RAILROAD CARTELS AND THE INTERSTATE COMMERCE COMMISSION BEFORE 1900* (1965); Hilton, *The Consistency of the Interstate Commerce Act*, 9 J. LAW & ECON. 87 (1966).

concerned with rulemaking about *limited* aspects of activities that affected a *limited number* of well-identified firms and industries. The antitrust proscriptions, though generally stated, were likewise intended to be (and were perceived to be) imposed against very few — the *trusts*.

Focusing on the natural monopoly rather than the antitrust aspects, the jurisdiction of a regulatory commission was usually statutorily circumscribed and the identity of regulatees was well defined. This limitation should not be underestimated. While railroads, gas, electric, and water utilities were subject to scrutiny and constrained in what they did, the vast sectors of manufacturing, mining, trade and finance were left virtually unfettered. Moreover, the regulatees knew with whom they had to deal, and about what, and on which occasions.

The first part of the story of the spreading ambit of regulation arose because, although the targets of regulation were few in number, the activities regulated were not effectively confined to a limited and well-defined set of problems. This was truly unexpected. It arose not because of legislative indecision as to objectives, but because of the difficulty of achieving well-defined objectives. A dominant objective was to achieve by regulation the efficiencies, the resource allocations, and the distribution of income that a free market would produce, if only the free market could exist. James McKie describes the gradual expansion of the regulatory ambit in the natural monopoly area as the “tar baby” problem, after the mythical creature that disabled its enemies by enveloping them.⁸ The anatomy of the process, and indeed its inevitability and irreversibility, is an important part of my thesis. It is, however, the familiar part, and the one on which most research has been done.

Consider a regulatory commission that is motivated to achieve the price and output results of a competitive market. These may be represented by the set of lowest prices and largest outputs that will cover out-of-pocket costs, provide for the replacement of capital, and provide the normal competitive rate of return necessary to induce owners to invest in the industry. Unfortunately, neither the regulators nor anyone else knows what this price-output constellation is. (It is the genius of successful market processes iteratively to converge on equilibrium solutions without prior knowledge of their nature.) Given a clear objective, but imperfect knowledge, regulators were forced to settle on a disequilibrium indicium: they would know price was too high (and output too low) if profits were too high. From that realization, it was but a small step to adopt a “fair return” yardstick as the criterion for allowing price increases, or demanding

8. McKie, *Regulation and the Free Market: The Problem of Boundaries*, 1 BELL J. ECON. & MGMT. SCI. 6, 9 (1970).

price decreases. But fair return on what? On fair value of invested capital, of course. I pass over the elephantine economic, accounting, and ultimately legal problems of defining "fair return on fair value," although in so doing I neglect an enormous body of theory as well as administrative law (and lore). Suppose all this to be settled. McKie argues that is only the beginning. Because a firm can no longer retain the (excess) profits earnable by efficient use of hired factors, its incentives to let costs rise instead of bringing prices down are substantial, both because it makes for an easier managerial life and because many of these costs may be hidden managerial prerequisites. Thus, regulatory commissions must become cost supervisors, attempting to devise and scrutinize the legitimacy of expenditures and cost imputations. Similarly (but more subtly), given return on *capital* as the guide to profits, it became profitable to overcapitalize so as to have a bigger base on which to earn one's permitted six or eight percent.⁹ Since one could not trust regulatees to limit capital expenditures to those that were directly productive, it became important for commissions to review the *necessity* of particular investments, and to hear evidence as to whether to authorize particular investments.¹⁰

Another complexity arises because a profitable utility is typically a multi-product one, and has many classes of customers. While there is only one unique profit-maximizing set of prices, there are likely to be dozens of alternative ways to limit profits to the "fair return" allowed. The necessity to choose among price structures thus exists. Which commodity freight rates, which hauls — long or short — shall share in rate reductions, and in what degree? Regulators treated this necessity for choice as an irresistible opportunity to satisfy secondary objectives. In doing so they created pitfalls, as we shall see.¹¹

Complicating all of this is the need for regulators to depend heavily on data and assertions generated by regulatees. This requires them to devise accounting rules and other procedures to protect against regulatees' self-serving statements and procedures.

Rather than extend this list (or do a similar listing of the ex-

9. This is the so-called Averch-Johnson effect, and reflects the nonoptimality to which Scherer adverted. Averch & Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 AM. ECON. REV. 1052 (1962).

10. The possibility that the electrical utilities profitably let themselves be overcharged by the electric-equipment conspiracies is explored in Westfield, *Regulation and Conspiracy*, 55 AM. ECON. REV. 424 (1965).

11. The list can be expanded. Consider the question of service. It is frequently possible to achieve the same amount of profits at different levels of output. Should break-even activities be provided? While the company is indifferent, the putative customers are likely to say yes. But how is a break-even activity identified, and by what rules of costing? Is passenger service really a money loser, or just a nuisance? Should activities that cover out-of-pocket costs, but less than their share of overhead costs be dropped? The interests of the customers, the public, and regulated utility may well diverge.

panding complexity of proscriptive rules with respect to, say, price fixing), let me suggest five *sources* of the tar baby phenomenon that inhere in this kind of regulation. Many of them apply to later regulatory regimes as well.

(1) *Adaptive behavior*. Rules to regulate human behavior are subject to adaptive responses by those regulated, whose interests are not the same as the interests the regulation is designed to protect. Limiting profits was intended to be a proxy for avoiding low output and high prices. But once the proxy becomes the rule, the regulatee rationally chooses to maximize its welfare subject to the rule, and indeed finds it profitable to invest resources in doing so. Whence further rules are required to prevent the avoidance of the underlying purpose of the first rule. Even with perfect foresight, the design of a rule that avoids perverse responses would be extraordinarily complex. Obviously, with less than perfect foresight, a rule is likely to be faulted as well as complex. Nor is it a question of regulators needing to be only as clever as the regulatees. Once a rule is in place, there is an endless opportunity for *trying* to evade it. As with other innovative processes, the unsuccessful attempts are abandoned while the successful become endemic. All sets of rules eventually need shoring up, by additional rulemaking.

(2) *Iterative rulemaking, with imperfect reversibility*. A reasonable sounding approach to a complex regulatory problem is to approach it iteratively, solving problems one by one as they arise. If prior rules are not easily reversed, there are inherent deficiencies in such a procedure. It may well be for example that, after experience, the "best solution" would be to scrap an original rule and replace it by one that better serves the basic goals. But administrative processes need the equivalent of *stare decisis*. Regulators find it more congenial to *add* rather than to change. This is not merely a matter of saving face; it is probably required to protect the vested rights of those who have in good faith complied with the original rule. When the FCC started, it faced chaos in use of the broadcast spectrum and took as its first priority allocation of the radio spectrum so as to avoid interference yet provide national coverage. It did so by establishing certain high power clear channels, supplemented by lots of limited local outlets of limited power. The allocation, unfortunately, proved within a few years ill suited to fostering competition among national networks. Given the enormous investments in existing clear-channel allocations in reliance on the announced allocation scheme, it was unthinkable to start over from scratch. To use a non-regulatory analogy, one can ask engineers on a given budget to design an optimal system of dams for a river basin in order to most nearly achieve a set of desired results. Suppose their best solution is a two-dam constellation. If more funds become available, a better scheme is for a three-dam system, which can also be described. It is

typically the case that none of the dam locations for the three-dam system prove to be the same as either of the locations in the best two-dam configuration. Yet if the original two dam system has been built, it is unthinkable to start over. Instead, the least costly solution is to add the best possible third dam *given* the existence of the other two. (Nature, via evolution, works more cruelly than that with its evolving mutations. But then nature is not politically or legally to be held accountable for its processes.)

(3) *Unforeseen changes*. Even an optimal set of rules is likely to become imperfect as the world changes. Yet in our world, society, technology, and the economy inevitably evolve in unforeseen ways. When population and industry leave New England, the optimal nature of a railroad network changes, even if the technology is unchanged. Telephone was a natural monopoly when long cables offered the only means of interconnection; first, the microwave relay, and later, satellite communication eliminated the essentiality of a monopoly in long-distance communication. But regulations and investments made pursuant to the original situations are not easily liquidated. The half life of a legal or regulatory regime is likely to be too long in a dynamic technology or society. Economic changes are similar. Sharply rising wages increase the appropriate capital/labor mix: rapid inflation changes the balance of advantages between original and replacement cost depreciation, and explosively rising oil prices change the appropriate pollution rates with respect to non-oil fuels. Yet, it is surely too much to have expected regulators to have anticipated all such developments and unrealistic for them to have formulated conditional rules. Lack of foresight becomes expensive, however, when decisions become difficult to reverse.

(4) *Institutional obligations to do the impossible*. A frequent, but highly consequential, source of regulatory complexity is the existence of boundary problems between the regulated and unregulated activities of regulated firms. Every multi-product enterprise has certain important costs that must be covered, but are unallocatable as among classes of customers or units of product. In an unregulated world, the seller is simply concerned that the contributions to such collective costs from all activities are each positive, and aggregatively sufficient. If activity *A* contributes 95% and *B*, 20%, the seller has covered them all and has 15% to boot. But now suppose that activity *A* is regulated and *B* is not (say because it involves sales to customers who fall outside the jurisdiction of the regulator). If the regulator is going to base permitted price in the regulated sector on *cost* in that sector, he has to allocate a fraction of the common costs to it. *But there is no uniquely correct fraction*. Any allocation to *A* between 80% and 95% will permit the common costs to be covered. Customers in class *A* want the lower figure; the firm the higher one. Any allocation is wholly arbitrary. But our institutions make it im-

perative for administrative agencies to avoid the appearance of being "arbitrary and capricious." Regulators, rather than *appear* merely arbitrary, adopt wholly arbitrary criteria for allocating unallocatable costs. Such rules have the not inconsiderable virtue of assuring a consistent set of arbitrary solutions. But such rules are not robust with respect to changes in the underlying circumstances. Let the nonjurisdictional sector (say, formerly charged with 15% of common costs) shrink in profitability (with no change in the relative quantity of service) to the point where it is able to contribute only 10% to common costs. If the regulatory commission allows the regulator to recover only 85% from the jurisdictional sector, the utility will discontinue service.

Precisely this sort of dilemma arose in natural gas pricing, under what became known as the Atlantic Seaboard formula.¹² There the Federal Power Commission was faced with allocating costs of pipeline transmission to peak and noninterruptible demand (which was subject to regulation) and to off-peak, interruptible demand (largely not subject to its regulations). The first group included most consumers, the second many industrial firms. The theoretically correct answer is to assign capacity costs only to peak users.¹³ But this seemed arbitrary and unfair as well as politically unpopular. (Said the FPC: "If fixed expenses are assigned wholly to the demand or capacity function, then gas service which is interrupted on peak days will not share in any of the fixed costs [T]he failure to allocate any of the fixed expenses to that service would result in very high profits (return) therefrom")¹⁴ With Solomonic wisdom the Commission decided that fixed costs should be assigned 50% to demand costs and 50% to commodity costs. As a result peak users would pay a higher share, but not *all* of the costs of providing capacity to meet the peak demands.

Both the rationale for the original rule, and its subsequent inconvenience in cases where off-peak users were unable to bear this fraction of capacity costs are wholly understandable. But they illustrate a nasty administrative dilemma, which demands a solution. Courts and commissions faced with the subsequent untenability of previously viable but arbitrary rules tend to engage in a series of ad hoc definitional tricks. They redefine the new problem to meet the old solution. Outside observers wonder at their capacity for illogic, rather than admire their ingenuity. All this leads to patterns of regulatory holdings that are reminiscent of those pre-Keplerian epicyclical explanations of the patterns of rotation of planets, moons, and stars that were invented to keep alive the theory that the earth was

12. Atlantic Seaboard Corp., 11 F.P.C. 43 (1952).

13. Cf. Steiner, *Peak Loads and Efficient Pricing*, 81 Q. J. ECON. 585 (1957).

14. Atlantic Seaboard Corp., 11 F.P.C. at 55.

the center of the solar system, by modifying it so it was not inconsistent with new rounds of emerging astronomical observations.

(5) *Adapting to emerging competition.* A second kind of boundary problem concerns the consequences of emerging competition between a regulated utility (say railroads) and its unregulated competition (say trucking). It will usually be essential to *do something* to permit the regulated utility to adapt. But any adaptation is likely to be inconsistent with some of the criteria (or rationalizations) previously used, reduce the number of price structures that are possible, and may easily conflict with past choices among price structures. For an example, the enormous profit potential of a monopoly telephone company gave the FCC (and AT&T) a great variety of long-distance rate structures among which to choose. The regulators, given these degrees of freedom, found it irresistible to satisfy other objectives, *e.g.*, providing a virtually *national* interconnection system by subsidizing rural phone service and extending low cost service to remote areas of the country. As a result, heavy density intercity toll charges were allowed to make major contributions to fixed costs, and (very possibly) also to subsidize some unprofitable forms of service. The high profits in the high density traffic areas, however, provided precisely the incentive for others wishing to develop and offer alternative, cheaper service.¹⁵ One possible response would be to allow AT&T to lower its rates to compete. But, if it did, it would have to be allowed to raise its rates elsewhere and/or to discontinue unprofitable subsidized service. The political and possibly legal bars to this are formidable.

I have tarried on the reasons why what seemed to be a straightforward regulation of the sort required to protect consumers from the anti-competitive tendencies of natural monopolies instead generated adverse side effects, and expanded regulations. An important conclusion is that neither stupidity nor corruption on the part of regulators is *necessary* to the complexity and ever growing scope of regulation. Imperfect anticipation is sufficient. In the real and ever changing world, imperfect anticipation is sure to occur. Since it is sensible — indeed essential — to avoid abrupt reversals in administrative rule making, adaptation takes the form of increasing intricacy of the rules themselves. To this one may of course *add* venality and stupidity, but those attributes, albeit in abundant supply, are neither necessary to the problem nor would their elimination be sufficient to resolve it.

15. This is precisely the scenario that developed in microwave radio communications. See *Microwave Communications, Inc.*, 18 F.C.C. 2d 953 (1969).

V

I have characterized the second great regulatory epoch as protectionist — as anti- rather than pro-competitive. Labor, farmers, and businesses were all to be protected by a supportive government from the rigors of a competitive world. There were good reasons for this, for the competitive world of the 1930's was hardly the benign world envisaged by the classical economists. But protectionism was not merely a depression phenomenon and it has had several lasting consequences in terms of the spread of regulation.

It is a popular thesis that nineteenth century regulation failed because of the capture of the regulatory commissions by the regulatees, and there is surely some evidence that such pressures existed and were not always resisted. But much more basic, in my view, was the loss of faith in free market results that the Great Depression engendered. Regulators that had been installed to simulate the free market could be used to replace it, not merely because regulatees wanted it, but because the government wanted it. Setting minimum prices is not procedurally very different from setting maximum prices, but philosophically it is *wholly different*.

This is not the place to evaluate critically the capture thesis, but I believe it suffers from some internal difficulties. Its logic would suggest that the probability of capture should be greater the fewer the regulatees and the more readily they could be identified. Such targets have the incentive and the means of influencing the regulators. Thus one might have anticipated capture of the ICC by railroads, the FTC by networks, and the utility commissions by private utilities. One would not as likely have expected capture of the anti-trust enforcement agencies or the Congress by the scattered targets of the antitrust laws. But the wave of protectionism that engulfed the regulatory apparatus was not selective in that way; for example, it embraced antitrust enforcement fully as much as railroads.

The protectionism of the 1930's, in my view, exhibited a new ambivalence: competition was still good, but only up to a point. The incoherence of economic regulatory policy of this decade is reflected in the contrast between the NRA and the TNEC. The former used government influence to form industry-wide agreements to prevent price cutting, while the latter discovered with alarm the propensities for oligopolistic industries to do precisely the same thing. The legal treatment of price fixing shown in the shift from per se condemnation in 1927 (*United States v. Trenton Potteries Co.*)¹⁶ to acceptance in 1933 (*Appalachian Coals, Inc. v. United States*),¹⁷ and back to per

16. 273 U.S. 392 (1927).

17. 288 U.S. 344 (1933).

se illegality in 1940 (*United States v. Socony Vacuum Co.*)¹⁸ is another case in point. Indeed the behavior in *Appalachian Coals* and *Socony Vacuum* was essentially the same: in each, private producers were seeking to stabilize chaotic conditions along lines Congress had specifically endorsed.¹⁹

It is possible to argue that protectionism was but a transient phase, that a second New Deal reversed the first during Roosevelt's second term. The facts do not support this. Protectionism, once entrenched, has proven hardy. Most of the protectionist regulatory accretions of the thirties survived well into the 1970's and 1980's. Robinson-Patman cases still clog the courts, and Fair Trade laws fell victim, in 1974, not to a post-depression renewed faith in competition but to a latter-day frustration with inflation. Removal of entry control and re-emergence of price competition is only slowly, only gradually, and only partially occurring in transportation, in communications, and in security dealing.

The most lasting legacy of the regulatory efforts of the 1930's is what my colleague Gardner Ackley terms the "politics of redress": firms such as Lockheed and Chrysler, industries such as steel, textiles, and even high technology, expect insulation from the rigors of competition and the market. Indeed the notion of regulation to provide redress has become extended to individuals claiming redress from economic handicaps that had previously been accepted as facts of life. Physical disabilities, the competing demands of childbearing and employment, and the lower level of education and skill acquisition of some members of minority groups are each cases in point. I would not like to be misunderstood here: these sources of disadvantage in unregulated markets may be wholly worthy objects of regulatory interference with market determination. My point is only that they were a new form of regulatory involvement, protective in form and in effect.

Consumer protection (in the old sense) and efficiency were, of course, not wholly absent from the regulatory regime of the Depression, and there are many counter examples including the regulation by the SEC of security manipulation. But the dominant theme of pre-World War I regulation — protection *of* the competitive market — was surely changed to protection *from* the competitive market. The notion of "fair return" designed to limit price gouging, was replaced by the entitlement to a fair return. The seeds of the "new property" were surely planted, and many have become robust survi-

18. 310 U.S. 150 (1940).

19. The explanation of the different legal treatment is that wonderful legal device: delay. By 1940, when *Socony Vacuum* was decided, the crisis was past the heroic efforts at price stabilization could be stigmatized as unthinkable tampering with the central nervous system of that finely tuned instrument (newly reelevated to virtue) — the economy.

vors.²⁰ So, too, were the seeds of the yet-to-come third phase.

This elevation of protectionism to a prominent role in regulation has had major additional consequences for the present regulatory environment. Consider three:

(1) *Increasing Scope*

Once protection against economic hardship becomes a legitimate basis for regulatory intervention, there is no logical basis for limiting it. Indeed it is complementary to the first kind of regulation. Protection of industries, firms, and individuals that are likely to be losers in competitive struggles combines with restraining those who are likely to be big winners, to embrace — at least potentially — most of the economic scene. Further, a protectionist philosophy invites expansion of regulation at every boundary of existing regulation. I earlier spoke of emerging competition to the regulated activity of a natural monopolist as mandating some adaptation of the regulatory scheme to the new competition. In a protectionist environment, an appealing alternative is to expand the regulatory sector to embrace the new competitors, and thus to protect the new and the old from competition with each other. The extension of regulation of transportation from railroads to trucks and barges is only the most visible example. Minimum wage legislation complements union security legislation. Cable and community antenna TV competition have none of the inherent needs for allocation that made essential licensing of over-the-air broadcasting, but protection of the latter provided the more recent reason to regulate the former. Protecting grocers from chain stores was but a first step to protecting every seller from price cutters. In an interdependent, interlocking economy, this kind of expansion of the locus of regulation invites pressure for next regulating the group of unregulated sellers at the new boundary. Indeed, as we have seen in recent years, demand for regulation readily spreads to asking our government to use its political power to regulate foreign competition with domestic industries.

(2) *Loss of Resistance to Expanding Regulation*

When regulator and regulatee are in an adversary stance, the rising scope of what is regulated must contend with a well articulated, reasonably cohesive resistance. Networks and TV stations could and did resist attempts by the FCC to control what they broadcast and how they allocated their resources, even given their dependence on the FCC for licenses to operate. When regulatory commissions start protecting firms and limiting competition, they come under well ar-

20. The phrase "new property," of course, traces to Reich, *The New Property*, 73 YALE L.J. 733 (1964). My intellectual debt to that article is tremendous.

ticated and cohesive pressure to expand and perfect their protectionist policies. This is the essence of Professor Stigler's critique.²¹ Industries subject to foreign competition may first claim the right to be protected against "predatory" price cutting by foreign competitors, and gradually extend the notion to protection against non-predatory dumping, to protection against unreasonable prices, etc. Both regulator and regulatee want expanded regulation, albeit perhaps for different reasons. The potential victims of all this are likely to be too dispersed to be an effective force in resistance.

While one may characterize this process as "capture," I find that misleading. For it is not in any sense necessarily caused by the subversion of the regulators by the regulatees. It reflects, rather, a governmentally mandated change in the regulator's goals.

(3) *Bureaucratization of Regulation*

As "protectionist" regulation spreads, matters of equitable treatment and procedural due process become increasingly important. One aspect of this is that, while protectionism may have begun in response to periodic crises, it may well turn to establishing standards for market division. If banks are limited in interest they can pay, there is an appropriate limit on S&L's that will be fair to both groups.

A more important aspect of fairness, in my view, is that once protectionism is the objective, much of the regulatory process turns to deciding not only *what* will happen, but *to whom*. As soon as entry is licensed, and restricted, valuable entitlements are granted to some *and withheld from others*. Here a critical difference between market and governmental allocations emerges. One can be a winner or a loser in a market economy for a good reason, or as a result of random bad luck, but there is no general tribunal in which one can claim one ought to have succeeded. The regulatory environment is quite the reverse, an insight first articulated by Professor Cramton in 1964.²² If there are to be winners and losers in the regulatory process, it is essential that there be criteria, comparative hearings, and both substantive and procedural due process. Much of the bureaucratization of regulatory proceedings, much of the delay, and much of the adversarial character arises from the allocation of valuable entitlements to some but not to all. Moreover, political choices must be judged by political goals; market choices need not be. Reg-

21. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); see also Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 35 (1974); Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

22. See Cramton, *The Effectiveness of Economic Regulation: A Legal View*, AM. ECON. REV., May 1964, at 182 (Papers & proceedings of the 76th Annual Meeting of the American Economic Association).

ulatory decisions are inherently political. However much one may regret the relative scarcity of black professional golfers (or grocers), there is no claim of entitlement. Contrast, however, the political concern with the relative scarcity of black broadcasters or judges.

Further, regulatory entitlements, however they are initially granted, are not lightly taken away, if not as a matter of law,²³ then as a matter of reasonable treatment. The moral or legal vesting of the new property adds to the rigidity of regulatory schemes, and to the need for regulators to resist technological and other changes that threaten those who have complied with regulatory requirements and relied upon them.

VI

The third and most recent epoch of regulatory expansion rests both on the recognition of adverse externalities such as discrimination, pollution, and threats to personal safety, and on the sense of affluence that makes avoiding these social evils affordable. The double condition is vitally important. It is not true that externalities are more common now than they were fifty or one hundred years ago. Economists recognized market failure due to externalities at least as early as the publication by Pigou of his treatise on welfare economics in 1905. The policy responses to possibilities of egregious harm caused by private neglect of costs not borne by firms are equally venerable. They are seen in the agitation for child labor legislation, and for imposed standards of mine safety. But the threshold of egregious harm was formerly quite high, and acceptance of "normal" hazards a part of the ethic. A retired Pittsburgh steelworker recently put the point elegantly: "I remember that when I was young, we never thought about pollution. Everybody was working, and everybody had money, and the smokestacks were smoking, and the air was dirty, and we were all happy. I think the best air we ever had in Pittsburgh was during the Depression. That's when nobody was working."²⁴

The amenities of life, and a greater degree of protection of individuals from avoidable injury are "goods" that have (in the economists' phrase) high income elasticity. As the society gets richer, we want to consume such goods in disproportionately rising quantities. By the 1960's we felt we could afford not only guns and butter, but cleaner air and more safety, too. Not merely egregious hazards, but any threats to safety and all pollution became subject to scrutiny.

23. See Reich, *supra* note 20; cf. Van Alstyne, *Cracks in "The New Property": Adjudicative Due Process in the Administrative State*, 62 CORNELL L. REV. 445 (1977) (arguing that the notion of the "new property" was not needed to deal with the right-privilege distinction and that it threatens to undermine the doctrinal foundations of due process).

24. R. LIPSEY & P. STEINER, *ECONOMICS* 442 (6th ed. 1981).

Since externality control is *inherently* a function that must be provided by nonmarket action it has led to expanded regulation. New regulatory agencies were spawned and additional requirements emanated from existing agencies.

The effect of this on the actual scope of regulation and its perceived success has proved enormous. Some activities of *all* actors came under scrutiny, and the newly scrutinized dimensions are largely additional to previous ones. The first significant difference between externality generated market failure, and the earlier forms of regulation, is that such externalities are truly pervasive, both in time and in scope. As a result, efforts to prevent, mitigate, or control them became potentially limitless. The monopoly problem is, after all, relatively confined. So, too, is the extreme economic distress that triggered the protectionist regulation. But possibilities of occupational injuries and pollution (as well as such other worthy targets of externality regulation as sex or race discrimination) are absolutely ubiquitous. The implication of moving from preventing specific harms (*e.g.*, collapsing mine tunnels) to achieving absolute goals (*e.g.*, eliminating industrial accidents) is formidable. There is no such thing as perfect safety or nonpolluting activities. Thus, regulation is sure to "fail" to achieve them. These are, of course, matters of degree, and one of the problems of the new regulation is to define the threshold level that triggers regulation. The rhetoric of the externality-reformers neglects the threshold question. Freedom from pollution and safety become attributes, not variables. Once the notion of a threshold is abandoned, the regulatory apparatus required becomes potentially vast, and the probability of perceived failure very high.

Moreover, this very vastness leads to an expansion of regulatory impact. Because of constraints on public regulatory budgets, a substitute must be found for the potentially unlimited public enforcement expenditures that would be required. The solution is to shift onto the regulated the burdens of enforcement. This substitutes policing for direct public control. To make policing a manageable public activity, the natural sequel is to impose extensive compliance-reporting requirements on all. This conserves public budgets, but greatly expands private expenditures.

Simultaneously, such things as the rapid growth of private suits, the private class action, and the granting of standing for private citizens in regulatory matters expanded the set of regulators. This has obvious advantages in preventing (or compensating for) capture, corruption, or neglect of the problem by a small cohort of governmental regulators, but it has vastly added to the regulatory apparatus and to the perception of the ubiquity of regulation. Many firm managers believe that any action will trigger *some* legal or administrative

action; and that this will cause delay, and surely add to the costs and hazards of doing business.

An important political feature of this newest wave of regulation is the consequence of the shift of many of the costs of policy and compliance onto the private sector and indeed on to individuals as well as firms. It has had the important effect of making regulation a fairly direct annoyance to a very large number of individuals who had previously regarded public regulation as something remote. More people perceive pollution devices on cars, and expensive safety features, as hurting them than as serving them. EPA, busing, EEOC, OSHA, and the like, have put government "on the back" of the ordinary person as never before. Combined with high taxes, these provide a climate in which politicians can promise sweeping and welcome relief.

I have here stressed the effect of the new wave of externality regulation on the *costs* of intervention, and more particularly on the perception by a large part of the population of these as costs. It would be a mistake to neglect the benefits — the needs that led to a demand for regulation. Thalidomide, Love Canal, Three-Mile Island, and LA smog are genuine horrors, not public relations constructs. But the *needs* for regulation have been long perceived; it is the costs and failures that are newly felt, because the beneficiaries are paying the costs directly rather than indirectly.

VII

The historical growth of regulation was a response to the perception of new and more pervasive forms of market failure. The more recent mood favoring deregulation is a widening response to the perception of regulatory failure. This statement is less portentous than it may sound, for "failure" is a term of art. It need mean no more than that anticipated benefits have been achieved at higher than anticipated costs, or that some of the anticipated benefits have not been realized. In good part what we today regard as failure in the regulatory sphere is the product of early overoptimism, even naivete, about the ability of government to solve problems without burdening individuals, and underestimation of the innovative (but not necessarily socially optimal) responses of economic actors to attempts to constrain their private profit-maximizing behavior.

If then, in 1980, we were less naive than in 1890 or 1935 and there is a political climate receptive to rethinking regulation, what is the proper consequence for our behavior? Is it, as some now urge, that we go back to what I will call the status of "unregulation"? The answer is no, for the complex world in which we live is one in which markets often work imperfectly (*i.e.*, fail) and so does remedial intervention. In such a world we seek not maximum regulation or no

regulation, but instead the appropriate mix of regulation and *laissez faire*. For the mix selected there is the possibility of having erred in either direction.

Let me state the problem formally, in economic terms. I will consider some activity, say the construction of a power plant to service Pittsburgh. One can imagine, at one extreme, a regime of *laissez faire* — of letting the private sector do what it pleases. Next, one can imagine a variety of rules restricting the form of the plant (nuclear, coal, oil, gas), or its location, or its size. At the other extreme, one can imagine a rule prohibiting construction at all. Which of these many “rule sets” is best? The formal answer is: the set that *maximizes the difference* between “benefits,” appropriately defined, and “costs” likewise defined. This apparently trivial (and empty) statement has some virtues: (1) It emphasizes that we are *not* seeking to find a costless rule, even if there is one, nor to minimize the costs, nor to maximize the benefits. Instead, we seek the best balance between benefits and costs; (2) it invites the distinction between a suboptimal rule and a perverse rule. A suboptimal rule may be defined as one where benefits exceed costs, but not by as much as possible; a perverse rule is one where costs exceed benefits. A suboptimal rule is better than nothing, a perverse rule is not; (3) it emphasizes that suboptimality is itself a variable concept, not an attribute: there may be better or worse imperfect rules; (4) it suggests that benefits and costs are concepts that must be defined and measured before we can have any consensus about whether a rule is perverse, suboptimal, or optimal.

Returning to real situations, an illustration may be helpful. Three-Mile Island surely reflects serious regulatory failure, but it hardly leads to a demand for no regulatory concern with nuclear safety. The successful deregulation of airline rates does not lead to a sense that we should leave to the free market the question of whether DC-10 engines are attached in a proper way. Analysts are today comparing, at long last, imperfect regulation (which we now *know* to be imperfect) with imperfect markets. Regulation and the market failure it is designed to correct are not a unitary phenomenon. Neither is the adequacy or inadequacy of particular regulatory regimes, or the legislation that creates them. The choice among solutions — more regulation, less regulation, different regulation, and unregulation — may each be appropriate some of the time. There is need for serious analysis and diagnosis. We need to reconsider the alternatives, regulatory regime by regulatory regime, market failure by market failure, regulatory failure by regulatory failure, and see if we cannot come closer to a better mix of the free market and regulation.

Here lies the promise in the present zeal for reconsidering each

regulation. The disenchantment with governmental infallibility, albeit belated, can be a major constructive force in the economy, and in the society. It may help to increase growth potential, to decrease inflationary forces, and even to decrease the unnecessary legalization of American society.

But there is also reason for concern. For much of the zeal is that of a simplistic ideology, rather than of analysis of trade-offs. The easy cases for decisionmaking are first those where markets fail abysmally and intervention works virtually perfectly, and second those where markets work virtually perfectly and intervention fails abysmally. While there may be such cases (and the policies implicit are consequently not controversial), they are assuredly not the *general* case. If once we erred in accepting too readily the first case, today the danger is reversed. The modern regulatory reformers see government failure and neglect the market failure that originally caused government to intervene. They regard most regulation as perverse rather than merely suboptimal. Some reformers are willing — even eager — to sacrifice the benefits along with the costs. The public goes along because it sees the costs, but neglects the link of those costs to the unmistakable benefits of the regulations we have installed over a century. The most zealous of the reformers are not naive — their actions reflect placing a much lower value than most of the public on the underlying needs which motivated regulation in the first place, and typically remains. They are in truth, the radical right. They have capitalized on the popular disenchantment and on a confusion between the need for changes in the extent and form of regulation, and the desirability of some regulation. The political day of reckoning in deregulation, as well as in budget cutting, will come when the uncommitted public sees what it has given up.

I have neglected “legalization” since the opening paragraphs of this Comment; it is time to relate the level and nature of regulation to the question of legalization. The latter term includes first the increased use of legal and administrative processes and second the increased bureaucratization of society. The higher the level of regulatory activity, other things being equal, the greater the legalization in both senses. For a given level of regulatory activity, different forms of legalization may be more or less bureaucratizing. For example, sale of licenses may be less legalistic (in this second sense) than comparative hearings; effluent charges may be less legalistic than direct specification and policing of permitted effluent discharges.

Is legalization a “good” or a “bad”? There is no doubt that so far as it represents unnecessary interference with freedom of individual action, or unproductive bureaucratization, it is undesirable. But much of the legalization (in both senses) of modern economic regu-

lation arises from the need to observe substantive and/or procedural due process, in areas where regulation meets real needs. Optimal regulation would lead to an optimal degree of legalization: suboptimal regulation may well lead to excessive legalization.

A most dangerous symptom of the deregulatory fervor of the moment is the "anti-legalistic" bias it reveals. It is not too much legalization, but any legalization that is scorned. There seems almost no appreciation that while due process may be costly — sometimes unnecessarily costly — it is ultimately a necessary condition of outcomes that can command public confidence. Legalization is sadly not sufficient, but it is surely necessary. Let us dedicate ourselves to reaffirming the benefits to society of the legalization of human affairs, as well as to avoiding excessive or unnecessary legalization.