Washington and Lee Law Review

Volume 46 | Issue 1 Article 2

Winter 1-1-1989

Market Failure and Regulatory Failure as Catalysts for Political Change: The Choice Between Imperfect Regulation and Imperfect Competition

Paul Stephen Dempsey

WASHINGTON AND LEE
LAW REVIEW

Volume 46 Winter 1989 Number 1

MARKET FAILURE AND REGULATORY FAILURE AS CATALYSTS FOR POLITICAL CHANGE: THE CHOICE BETWEEN IMPERFECT REGULATION AND IMPERFECT COMPETITION

PAUL STEPHEN DEMPSEY*

TABLE OF CONTENTS

* Hughes Research Professor, University of Denver College of Law. A.B.J. (1972), J.D. (1975), University of Georgia; LL.M. (1978), National Law Center, George Washington University; D.C.L. (1986), Institute of Air & Space Law, McGill University. The author formerly served as an attorney with the Interstate Commerce Commission (1975-77 and 1981-82) and the Civil Aeronautics Board (1977-79) and is a member of the bars of Colorado, Georgia, and the District of Columbia. The author would like to thank his colleagues, Professors David Barnes and Jan Laitos, for reviewing earlier drafts of this article, and providing useful insights and constructive criticism. The author would also like to thank Dean Henry Manne whose Law & Economics Institute (Pareto in the Pines of Dartmouth) inspired many of the ideas expressed herein. Any errors or omissions are solely those of the author, however.

I. INTRODUCTION

American legal, political, and economic history has come nearly full circle. We began our republic with a powerful thirst for individual liberty and economic *laissez faire*. After nearly a century of regulated competition, we are returning to the humble origins of the rugged individualist.

For nearly a century, the government has scrutinized and supervised America's infrastructure industries to a higher degree than the rest of the economy. Our federal government regulated various interstate activities of airlines, bus companies, motor carriers, railroads, freight forwarders, ocean vessels, pipelines, telecommunications, broadcasting, electricity, oil, and gas, while the state public utility commissions regulated the corresponding intrastate aspects. Whether regulated as "common carriers" or "public utilities," a normative decision was reached that the "public interest" in these activities should be protected by government oversight. Regulation subsequently was expanded to protect public health, safety, and the environment.

But during the Ford-Carter-Reagan era, the emergence of Chicago-school neo-classic economics as the dominant ideology of Washington, D.C., stimulated by the political backlash against gargantuan, obtrusive government and onerous taxation of the New Deal and Great Society, led to a comprehensive reassessment of the appropriate role of government vis-à-vis the market. Consequently, the contemporary balance tilts strongly in favor of private sector solutions to societal needs.

The choice between imperfect competition and imperfect regulation is never an easy one. Either system imposes significant costs and bestows significant benefits. This Article will identify the major philosophical schools, trace the evolution in public policy, and assess some of the principal costs and benefits of regulation and deregulation.[1]

II. Political Economics

The discipline of economics begins with the observation that we live in a world of scarce resources. Ours is a small, overpopulated planet (overpopulated by humans), and the insatiable demands of consumers will always exceed the available supply of resources. Economics analyzes the way in which societies allocate available goods and services. The law of scarcity compels every society to have some mechanism for rationing to distribute resources among consumers.

Government becomes a means of facilitating rationing by creating, defining, and protecting property rights. John Locke believed that when men were in a simple state of nature, they enjoyed private property and personal liberty unhindered. Locke further believed that as natural society became more complex, conflicts arose, many precipitated by scarcity.[2]

In part, government became a necessary shield for the weak against Darwinist predation by the strong in contests for real and personal property.

---

1. For other treatments of this general subject matter, see W. Jones, Cases and Materials on Regulated Industries (2d ed. 1976); R. Pierce, Jr., G. Allison & P. Martin, Economic Regulation: Energy, Transportation, and Utilities (1980); D. Boies & P. Verkuil, Public Control of Business (1977): C. Phillips, Jr., The Regulation of Public Utilities (1984); L. Schwartz, J. Flynn & H. First, Free Enterprise and Economic Organization: Government Regulation (6th ed. 1985); E. Gellhorn & R. Pierce, Jr., Regulated Industries (2d ed. 1987).

2. *See* J. Locke, Two Treatises of Government (P. Laslett ed. 1988).

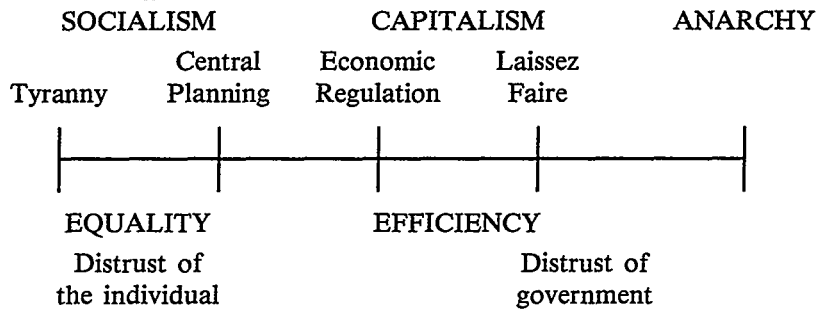
Collectively, the weak could subdue the strong. The "social contract" became possible because individuals were willing to exchange some freedom and liberty to gain the state's protection against oppression by the strong. The institution of government facilitates market exchanges by creating stability and order, and by providing currency as a medium of exchange. Government enforcement of property rights facilitates free, noncoercive exchanges of property, and thereby, economic growth.

I am willing to dedicate my labor to production of what you want if I can trade it to you for what I need. But if, through your superior force, you can take what you want from me and give me nothing but injury for my resistance, I will not produce long. Neither commerce nor civilization can long endure if bandits and thieves run riot, for by jeopardizing our right to enjoy private property they can destroy our incentive to produce.[3] Hence, the social contract.

There is a full spectrum of political and economic theories which economists advance and nations employ to determine how goods and services might best be allocated—what, how, and for whom goods shall be produced.[4] The theory a government embraces reflects a political conclusion that the mechanism selected will achieve optimum social ends.

Of course, not all societies embrace market organization as the optimal mechanism for distribution. Some societies, particularly small or primitive ones, distribute goods and services on the basis of tradition. In many families and some tribal societies, important property interests are owned communally. Moreover, in a Garden of Eden environment, where the available resources are so abundant that they exceed demand, there is little need for rationing. But these are the rare exceptions among contemporary nations.

Let us begin our examination of the world of economics with a chart, upon which we will rather crudely place the spectrum of major contemporary theories. We will assume, arbitrarily, that more government control over economic affairs is exercised on the left end of the spectrum, and that less is exercised at the right end:



The ensuing discussion proceeds from left to right across this spectrum.

---

3. Of course, excessive taxation or regulation by government also can have a debilitating impact upon market performance and productivity. Such is the essential thesis of the Laffer curve.

4. *U.S. Senate Comm. on Government Affairs, Study on Federal Regulation,* 96th Cong., 1st Sess. 7 (1978) [hereinafter *Study on Regulation].*

A. Communism

Among contemporary nations at the far left of the spectrum are those of the communist bloc, whose leaders profess faith in Marxist economic theory. Here, we have a socialist economy, or governmental ownership of the means of production, and central planning of the level of production, coupled with rather tight political control over individual liberty. Indeed, communist nations such as China and the Soviet Union have, until very recently, tended to exert stringent control over both the economic and political affairs of their citizens.

Communist nations, perhaps, achieve economic equality better than many capitalist countries. However, communist nations tend to keep the overall size of the pie smaller than do capitalist nations, and in so doing, sacrifice the aggregate standard of living. As Paul Samuelson might say, while central planning economies succeed in producing lots of guns, they fail to provide much butter. Tank production takes priority over consumer goods.

In the mid-nineteenth century, Karl Marx hypothesized that capitalism was doomed. In *Das Kapital,* Marx observed the excesses of *laissez faire* during the nascent industrial revolution—the tragedy of child labor, the absence of wage and hour limitations, and the growing number of industrial injuries. Marx concluded that these injustices were the seeds of destruction for capitalism. He felt that workers were enslaved in an economic system in which the rich became richer, and the poor became poorer.

On the surface, workers apparently bargained freely for the sale of their labor. But Marx saw capitalism as little different from feudalism or slavery, for the worker produced more than enough to sustain himself, giving the excess of his labor as profit to the master. The worker had little choice but to submit to this disguised form of slavery, for his alternative was starvation. Thus, according to Marx, capitalists exploited workers by paying them less than the fruits of their production. Capitalists shared the passion of the miser for wealth as wealth. But unlike the miser, whose passion is idiosyncratic, Marx saw the capitalist's greed, and his consequential exploitation of labor, as an inevitable product of capitalism. Marx found all this morally repugnant.

Marx also thought that the capitalist system was anarchical, resulting in tremendous inefficiency, overproduction, and much waste. Without rational planning, not only did the capitalist system produce waste, the system led inevitably to a boom and bust economic cycle, causing much social harm. Moreover, Marx saw the scale of organization in the capitalist system as leading inevitably to greater concentrations of wealth, with giant corporations dominating the market and conspiring among themselves to suppress competition.

Marx saw the abuses of capitalism—the exploitation of labor, the anarchical economic system, and the concentrations of wealth—as leading inevitably to a class struggle in which the proletariat would rise up and seize power from the bourgeois. But Marx proved to be a poor prophet. He failed to anticipate the growth of trade unions and universal suffrage,

both of which were powerful forces in alleviating the abuses of industrialism. Economic and social regulation tempered the political and economic power of the wealthy.

No industrial state has had a "workers' revolution." Nonetheless, Marx's egalitarian views are the rhetorical cornerstone of the fundamental communist doctrine: "from each, according to his ability; to each, according to his needs." Marx also believed that in a communist regime, eventually the state would wither away and economic goods would be distributed equally. But no government has been able to achieve a Marxist utopia (or any other utopia for that matter), perhaps because man is an imperfect beast.

Critics claim that the communist system is so flawed that it can only exist by employing totalitarian coercion, or tyranny, to suppress individual liberty. Thus has political freedom been sacrificed at the altar of economic theory.

B. Socialism

Also on the left of the spectrum is the socialist model, in which the state dictates all major economic decisions and owns the means of production. In the sense intended here, socialist governments (such as the Scandinavian nations) tend to interfere in their citizens' economic affairs, but leave them relatively free politically. Karl Marx saw socialism merely as a transitional stage of society between capitalism and communism, distinguished by unequal distribution of goods and pay according to work done.

In socialist nations, central planners dictate the level of production, distribution, and price. In theory, the planners avoid the chaos of anarchy, and the inefficiency and waste of duplication. A nation need not squander its resources on a dozen different colors of toilet paper when one will do the job nicely. In theory, costs will be lower, because not only will wasteful duplication be eliminated, but of the four components of production (*i.e.*, wages, rent, interest, and profit), profit can be returned to consumers in the form of lower prices.

In reality, central planners have the difficult if not impossible task of supervising a nation's economy. Inevitably, the central planners often underestimate or overestimate the type and quantity of products consumers want, resulting sometimes in shortages or excess supply, respectively. Central planning also tends not to produce the incentives of the market for managerial efficiency and worker productivity achieved by systems in which the producer enjoys a profit for his innovation and efficiency. Profit, it seems, is a powerful motivator. As we shall see below, this realization has led some nations to decentralize production and investment decisions, giving more autonomy to the local level, and creating economic incentives for superior performance.

C. Economic Regulation

On the spectrum, economic regulation is somewhere between *laissez faire* and anarchy, at one extreme, and socialism and communism at the

other. Economic regulation is a mix of private ownership of the means of production (capitalism), with government control of certain aspects of pricing and level of production, as well as protection of public interest values beyond allocative efficiency. Typically, a government agency is established to regulate entry into and exit from the industry (usually by issuing licenses, or certificates of "public convenience and necessity"), rates (which must ordinarily be "just and reasonable"), the level of service (which must be adequate), and various corporate activities, such as mergers and acquisitions (with antitrust scrutiny).

Private ownership creates a stimulant for efficiency and productivity. Regulation allows many business decisions to be made on the basis of market forces. Indeed, economic regulation often attempts to replicate the pricing and service levels that would exist in a competitive market, while ensuring the protection of public interest values which are not a high priority in a *laissez faire* environment. This Article will provide a detailed explanation of the economic and social rationales for regulation.

D. Capitalism

In a capitalist or market economy, the rationing decision is generally left to the impersonal functioning of the "price system." In the "price system" buyers bid for desired goods and services, and those items are distributed to individuals paying the highest price. Here, the means of production are privately owned: private decisions rather than state control determine individual or corporate investments in capital goods. In a competitive market, consumer demand determines the level of price, as well as quality and quantity of production. The price system ensures that resources are distributed to their highest valued use, as measured by the amount of capital buyers are willing to expend for their purchases. Economists describe such a distribution as "allocative efficiency." We will again examine these concepts below, when we discuss market theory.

E. Libertarian Theory

At the opposite end of the spectrum from communism and socialism is libertarian theory. In its purist essence, libertarian theory insists that men should be freed wholly from the reigns of government. At its logical extreme, libertarian theory suggests private ownership of the means of production, with entrepreneurs providing both public and private goods and services with little or no government oversight. To a true libertarian, even police protection and highways are candidates for privatization. Conservative leader William F. Buckley, Jr., has analogized libertarian ideology to poetry: both are pleasing to the ear, but neither has much to do with the world in which we live.

III. Islands in the Stream

The economic systems of nations appear to be in a state of flux. Each generation experiments, tinkers with, and fine tunes the system it inherited.

Ours is no different. Economic collapse may induce radical political change, even revolution, and economic restructuring. But in an environment of stable economic growth, change is usually gradual. Let us examine three examples of a metamorphosis to the right, which may reflect a contemporary global trend.

A. China and the Soviet Union: Retreat from Communism

Since the death of Chairman Mao, the leaders of the Peoples Republic of China have marched steadfastly toward freeing private enterprise to compete in the global economy. Having witnessed the economic miracles of Japan, South Korea, Hong Kong, and Singapore, which were accomplished on the foundations of capitalism, China's contemporary leaders appear to be willing to relinquish the reigns of economic power to individual entrepreneurs to stimulate national economic growth. Whether China's leaders will follow suit with correspondingly expanded political liberty remains to be seen.

In 1997, China annexes the British colony of Hong Kong, the crown jewel of Asian prosperity. If instead, Hong King annexed China, China's economy might eventually dwarf that of dominant Japan.

To the north, in a bold move away from the rigid bureaucratic socialism which has dominated the Soviet Union for seventy years, Mikhail Gorbachev is leading his nation away from central planning toward decentralization of economic planning and production. With new policies of glasnost (openness) and perestroika (political and economic restructuring), the U.S.S.R. seems to be heading West in its political and economic ideology. Here again, only time will tell whether such profound change will be sustained.

B. Britain: Retreat From Socialism

Most nations are somewhere in the middle of the above spectrum. The dynamics are such that all vibrant economies are moving across the plane, toward more or less government control over economic affairs. For example, Britain's Thatcher government is in the process of relinquishing state ownership of a number of industries (such as the airline, airport, telephone, aerospace, automobile, and coal industries) walking away from socialism, toward privatization.[5]

C. The United States: Retreat From Regulation

Note also that different sectors of a nation's economy can be represented at various points along the spectrum. For example, in the United States, grocery stores enjoy a relatively *laissez faire* environment, pipelines are regulated as natural monopolies, and our postal system is socialized.

---

5. Indeed, the entire European Economic Community appears to be moving in the direction of enhanced competition. *See* Dempsey, *Aerial Dogfights Over Europe: The Liberalization of EEC Air Transport,* 53 J. AIR L. & COM. 615 (1988).

But not even grocery stores are wholly free from regulation. For example, the U.S. Department of Agriculture inspects the food a grocery store sells; the store's relationships with labor in areas such as wages, hours, discrimination, and workers' compensation are regulated; and they pay taxes and contribute to their employees' social security.

In two centuries of existence, the United States has also wandered across the spectrum. We began this representative democracy with a thirst for man's freedom and a taste for *laissez faire,* particularly once our Constitution eliminated interstate barriers to trade in 1787. Nearly a century later, Congress established the nation's first independent regulatory agency, the Interstate Commerce Commission.

While moving away from pure *laissez faire,* the United States has remained among the freest of the world's nations. American citizens enjoy tremendous political, religious, and economic liberty. The Bill of Rights and the U.S. Constitution guarantee political and religious freedom. While the Fifth and Fourteenth Amendments provide some measure of protection against deprivation of property without due process,[6] individual economic liberty does not get the same measure of protection that the Constitution and Bill of Rights commend to political and religious freedom.

In *Nebbia v. New York,*[7] a case involving the regulation of milk prices, the United States Supreme Court articulated among its most generous views regarding the scope of legitimate government intervention in the market. Noting that the dairy industry was not a public utility, the Court nevertheless found the industry affected with a public interest:

> The phrase "affected with a public interest" can, in the nature of things, mean no more than that an industry, for adequate reason, is subject to control for the public good.
>
> So far as the requirement of due process is concerned, and in the absence of other constitutional restriction, a state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare, and to enforce that policy by legislation adapted to its purpose. The courts are without authority either to declare such policy, or, when it is declared by the legislature, to override it. If the laws passed are seen to have a reasonable relation to a proper legislative purpose, and are neither arbitrary or discriminatory, the requirements of due process are satisfied. . . .[8]

---

6. Generally, however, government enjoys wide latitude to regulate monopoly practices. *See, e.g.,* Federal Communications Comm'n. v Florida Power Corp., 480 U.S. 245 (1987); Federal Power Comm'n v. Texaco, Inc., 417 U.S. 380 (1974). However, pricing regulation may be deemed unconstitutional if "arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt." Nebbia v. New York, 291 U.S. 502, 539 (1934). *See also* Permian Basin Area Rate Cases, 390 U.S. 747 (1968). "[A] legitimate and rational goal of price or rate regulation is the protection of consumer welfare." Pennell v. City of San Jose, 108 S. Ct. 849, 858 (1960).

7. 291 U.S. 502 (1934).

8. Nebbia v. New York, 291 U.S. 502, 536-37 (1934).

Nevertheless, in the United States most decisions regarding consumption, production, and investment are made in largely unregulated markets by private entrepreneurs. In our domestic economic system, private ownership of the means of production has been the rule, and public ownership the exception. But notable exceptions to private ownership do exist—the postal system, the intercity rail system (*i.e.*, Amtrak), some of the electric utilities (*e.g.*, TVA), urban mass transit, highway construction, airports, public housing, much of education, and all of national defense. Also, we have a government monopoly in several of the "public goods," those things which are indivisible and nonexcludable. Publicly provided services, such as national defense, police protection, and fire protection, are enjoyed by all, except the enemies of the state. So a few governmental monopolies do exist in our economy (including, not so incidentally, the government monopoly on the use of deadly force). Some government monopolies are efficient and economical; others are wasteful and lethargic. As we shall see, in the 1970s the United States began to move away from the regime of economic regulation which had governed its major infrastructure industries for almost a century, and embraced deregulation.

IV. The Metamorphosis of Economic Theory in The United States

A. Mercantilism

Mercantilism was the dominant philosophy in England prior to the American Revolution. Born during the decline of feudalism, mercantilism was a doctrine which looked to government's use of its power to tax, subsidize, impose import and export duties and subsidies, and use other regulatory means to augment national wealth and power.[9] Policies designed to secure an accumulation of capital, particularly precious metals, a favorable balance of trade by importing raw materials and exporting finished products, the development of the manufacturing and agricultural sectors of the economy, and the establishment of foreign trading monopolies dominated mercantilist England.

Mercantilists generally embraced the ancient psychological views that man is a selfish animal. Unless such selfishness was controlled, a good society could not emerge. Mercantilists perceived government as the only force sufficiently strong to harness man's selfish energy to accomplish desirable social objectives.[10]

B. Market Theory

1776 was the year of two significant rebellions against mercantilism. America's founding fathers drafted the Declaration of Independence, and

9. Viner, *The Intellectual History of Laissez Faire*, 3 J. L. & Econ. 45, 56 (1960).
10. *Id.* at 56-57.

Adam Smith published the *Wealth of Nations.* In *The Wealth of Nations,* Smith suggested that the invisible hands of the market should be freed to provide the quality and quantity of goods and services demanded by consumers.

Capitalists, by investing in the means of production (labor, land, machinery, and operating capital), satiate consumer demands for goods and services. Consumers, acting as rational maximizers of their own personal interests, cast dollar votes of approval by the purchase of goods and services they desire most, thereby rewarding entrepreneurs who satisfy their wants. Profits provide a motivation for entrepreneurs to seek out and satisfy these consumer desires. The range of products and services offered are determined by consumer tastes and incomes. Under this theory, the community's interest is best served by allowing competitive market forces to determine prices, for in a fully competitive environment pricing approaches marginal costs, or the costs to society of the next additional unit of production.[11] Scarce resources are distributed by the "invisible hands" of the market system to their highest valued use. Classic economic theory embraces the premise that optimum efficiency is achieved when the world's resources are allocated in a way that maximizes the welfare of consumers, as measured by their preferences in the marketplace.

Smith believed that the division of labor stimulates productivity, and that free trade allows a producer to produce that in which he has a comparative advantage, thereby lowering consumer costs, and enhancing the overall standard of living. Smith provided the intellectual foundation for the notion that capitalist investment and profit were essential for optimal economic growth.

The theory of perfect competition, embraced by many contemporary neo-classic economists, is narrowly circumscribed by a set of assumptions. First, the model assumes that property rights are privately held, exclusive, and transferable. The model also assumes that individual actors in the market have perfect information, behave rationally, and that both transaction costs and externalities are insignificant. The model further assumes that no single producer has market power, and that all competitors are in a state of perfect competition; none has the ability to influence price with unilateral actions. Finally, the model assumes that the preexisting or resultant distribution of wealth is irrelevant. Given these assumptions, the market will clear at a price and level of output which reflects an optimum allocation of resources. Consumers purchase goods at prices closely approximating their marginal costs of production. Shortages are eliminated automatically through price increases which both curtail demand and stimulate new production.

America adopted *laissez faire* with some enthusiasm. Professors Louis Jaffe and Nathaniel Nathanson eloquently explained why:

---

11. *See id.* at 60-61; *Study on Regulation, supra* note 4, at xi-xii.

> It was believed that if men were free to make their own self-interested decisions whether to buy or sell there would be produced and exchanged the greatest amount of goods and services at the least price. In thus subjecting human destiny to the empire of the market, philosophers did not necessarily mean to deny social responsibility for the satisfaction of individual need. The market, it was thought, could create and exchange better than any conscious human agency the necessities for a good life.[12]

C. From Caveat Emptor to Strict Liability: The Common Law

The United States was born of a desire to cast off the dead hands of the British government, particularly its taxes and trade restrictions. At its inception, America was *laissez faire* to the point of permitting slavery. Only adult white male property owners had the franchise, a voting apparatus not terribly unlike that of the modern corporation.

Nineteenth century American courts embraced *laissez faire* and its doctrine of *caveat emptor* (let the buyer beware), refusing to intervene in market transactions except where actual fraud existed, or where the buyer had protected himself by insisting upon an explicit warranty. Indeed, American rejection of the dominant English standard of strict liability and adoption of the doctrine of negligence has been attributed to a policy of subsidizing infant industry.[13] The prevailing theory of the period was, perhaps, best summed up by Oliver Wendell Holmes, who insisted that the "cumbrous and expensive machinery [of the state] ought not to be set in motion unless some clear benefit is to be derived from disturbing the *status quo*. State interference is an evil, where it cannot be shown to be a good."[14] Thus, the Jeffersonian view that government is best which governs least dominated nineteenth century jurisprudence.

But twentieth century American courts have resurrected early common law doctrines such as strict liability, making a manufacturer liable for injuries even when he was not negligent in the production of the good which caused the harm.[15] Courts have thereby forced producers to internalize the cost of injury to consumers caused by defects in the products they manufacture. Courts also appear to have created a system of social welfare for the innocent who suffer injury, transferring wealth from those with deeper pockets (often insurance companies who spread risk more widely among those members of the public who pay insurance premiums), to those in need of economic assistance. Thus have courts intruded into the market to achieve social good.

---

12. L. JAFFE & N. NATHANSON, ADMINISTRATIVE LAW 6 (4th ed. 1976).

13. *See* Gregory, *Trespass to Negligence to Absolute Liability,* 37 VA. L. REV. 359 (1951).

14. O.W. HOLMES, THE COMMON LAW 96 (rev. ed. 1938).

15. The metamorphosis from caveat emptor to strict liability has been gradual. *See* H. JONES, J. KERNOCHAN & A. MURPHY, LEGAL METHOD 132-219 (1988).

The judiciary is by no means the only American legal institution which attempts to correct perceived imperfections in the market. Although the principle of private ownership has been largely unassailed in our domestic economy, during three major periods in our history Congress promulgated major regulatory programs to deal with market failure. During these periods Congress also exercised its constitutional power and created new regulatory agencies.

The Commerce Clause, article I, section 8, of the United States Constitution, vests in Congress the power to regulate interstate and foreign commerce. Except in the area of import duties, this power laid relatively dormant during the first century of our republic.

D. Market Failure and Economic Regulation

1. Origins of Economic and Antitrust Regulation

Government regulation is by no means a new phenomenon. In fact, government participation in the market dates from antiquity:

> [R]egulation to protect consumers is almost as old as civilization itself. Tourists to the ruins of Pompeii see an early version of the bureau of weights and measures, a place where the townsfolk could go to be sure they weren't cheated by the local tradesmen. Unfortunately a little larceny is too common in the human species.
>
> So regulation in some form or other is one of the prices we pay for our complex civilization. And the more complicated society becomes, the more need for some watching over its many parts. We shouldn't forget that a great deal of the regulation we encounter today in business or in our personal lives arose from a recognized need in the past.[16]

American economic regulation was born in an evironment of market failure. In 1887, Congress established the first independent regulatory agency, the Interstate Commerce Commission, to correct the monopoly abuses of the railroads.[17] Three years later, Congress promulgated the Sherman Antitrust Act to address concentrations of wealth and power across all sectors of the American economy. In 1914, Congress reinforced this policy by establishing the Federal Trade Commission.

2. The Great Depression and the New Deal

The second major era of governmental growth did not begin in earnest until the Great Depression, when again, market failure became the catalyst

---

16. Royster, *'Regulation' Isn't a Dirty Word,* Wall St. J., Sept. 9, 1987, at 32, col. 2.

17. The statute creating the ICC, the Act to Regulate Commerce of 1887, was modeled on the earlier British Railway Act of 1845. *See generally* Basedow, *Common Carriers — Continuity and Disintegration in United States Transportation Law — Part One,* 13 TRANSP. L. J. 1 (1983).

for increased regulation. Regulation of the infrastructure industries—communications, energy, and transportation—proliferated during this period. Congress created new agencies to regulate business, each modeled on the original Interstate Commerce Commission. These agencies included the Federal Power Commission (1930), the Federal Communications Commission (1934), the Securities and Exchange Commission (1934), the National Labor Relations Board (1935), and the Civil Aeronautics Board (1938). State regulation of interstate commerce enjoyed corresponding growth.

It was during this period that public utility regulation extended to such industries as airlines, motor carriers, natural gas companies, electric power production, telecommunications, banking, insurance, securities, and broadcasting. The stability and growth of these infrastructure industries was deemed essential to national economic recovery. Accordingly, the government regulated, in part, to shield those industries from the impact of excessive and destructive competition, and thereby provide them with the stability essential for sustained growth, upon which foundation the growth of the rest of the economy could begin again.

3. The New Frontier and Great Society: Environmental, and Safety Regulation

The 1960s saw the third era of proliferation of regulation, when environmental, safety, and health regulation expanded in nearly geometric proportions. Indeed, while there were forty-nine federal agencies in 1960, by 1976 there were eighty-three agencies. The number of civil servants employed by regulatory agencies grew from 28,000 in 1970, to 81,000 in 1979.[18] By 1985, more than 15 million local, state, and federal employees administered the regulatory welfare state.[19] Paul MacAvoy estimated that in 1965, regulated industries produced 8.5 percent of the gross national product; by 1975, that figure was 23.7 percent.[20]

Each of these several forms of regulation was a response to the perceived inability of the market to satisfy strong public policy imperatives. Thus, at several points in American history, it has been concluded that only government can achieve social objectives which fail to find a high priority in the marketplace.

E. Rationales for Regulation

Private enterprise dominates the United States economy. Most investment, production, and consumption decisions are made by private firms and individuals operating in relatively unregulated markets.[21]

---

18. S. BREYER, REGULATION AND ITS REFORM 1 (1982).

19. S. BREYER & R. STEWART, ADMINISTRATIVE LAW AND REGULATORY POLICY 1 (2d ed. 1985).

20. S. BREYER, *supra* note 17, at 1.

21. *Study on Regulation, supra* note 4, at 6-7.

On those occasions when the market works unsatisfactorily, government has stepped forward to assist the achievement of policy objectives that the body politic deemed to be in the public interest. One cluster of such motivations falls within the ambit of "market failure"—where the market results in inefficiency and waste in the consumption, use, or allocation of society's resources. In addressing the circumstances which led America to reject *laissez faire*, Professors Jaffe and Nathanson had these salient observations:

> [I]n a number of respects [the political economists] had miscalculated or had been overoptimistic, and, finally, they had believed that it was possible (despite the contrary feeling of the mass of humanity) to reduce certain human values to market values. The political economists had not reckoned sufficiently with the power of great owners to manage the markets. They had not dealt adequately with the tendencies and opportunities of entrepreneurs to control production and prices. They exaggerated the fluidity of capital, its willingness to seek new fields, its ability to leave old ones. They had envisaged the entrepreneur in terms of the isolated buyer and seller of a bushel of wheat trading in a vast impersonalized world market. They had grossly underestimated the inherent and manmade monopolist powers of banks, coal mines, railroads, great factories and large ship owners, the concretions of capital and custom which from their point of view acted like embolisms in the lifeblood of the system. In shore they had exaggerated the fluidity of the market and the sensitivity of the productive elements to forces working for the maximizing of production and the minimizing of price. . . . [I]n terms of government and administration [these results] added up for the legislatures to the proposition that neither the market mechanism nor business administration could adequately protect the social organism.[22]

The government has regulated various sectors of the American economy for a variety or reasons, not all of which are strictly economic in nature. Political and social rationales also have been advanced to justify regulation. But first, let us examine the economic rationales for regulation.

1. Natural Monopolies

Since the passage of the Sherman Act of 1890, monopolies generally have been disfavored in American law. Antitrust legislation tends to reflect the normative conclusion that large corporations, bastions of enormous concentrations of wealth and power, are undesirable.[23]

---

22. L. JAFFE & N. NATHANSON, *supra* note 12, at 7-8.

23. Hazlett, *The Curious Evolution of Natural Monopoly Theory*, in UNNATURAL MONOPOLIES 3 (R. Poole, Jr. ed. 1985).

But a number of industries in our economy are deemed to be natural monopolies. Here, the economies of scale are so pervasive that a single firm can offer the product or service most efficiently and economically. The fixed costs of operation may be so large that duplicative services are uneconomical. John Stuart Mill was among the first to recognize the problem, while reviewing the inefficiencies of competing gas and water systems in London:

> It is obvious, for example, how great an economy of labor would be obtained if London were supplied by a single gas or water company instead of the existing plurality. . . .
>
> Were there only one establishment, it could make lower charges consistently with obtaining the rate of profit now realized.[24]

By the late nineteenth century, Richard Ely had identified a number of industries as natural monopolies, including railroads, and express, telegraph, street-car, gas, and water companies.[25] Henry Carter Adams was the first to see natural monopolies in terms of economies of scale. Natural monopolies have marginal costs which are both lower than their average costs at the level of quantity demanded, and which decline over a long level of output. Where the cost per unit of output falls until a single producer can most efficiently satisfy market demand, competition may not be sustainable.[26]

The justification for regulating natural monopolies is both cost and price based. Once a single firm has sunk costs in providing sufficient capacity for all users, the cost per unit will be lower if that single firm satisfies all demand. The economies of scale are so significant that the unit costs of service would increase significantly if more than a single firm satisfies consumer needs in the region. Hence, a single firm providing the product or service will consume less of society's resources. For example, if one pipeline has unused capacity, to allow a competitor to lay a parallel line would be wasteful.[27] Moreover, economic regulation can ensure that the cost savings enjoyed as a result of economies of scale can be passed on to consumers in the form of lower prices.

But because private ownership encourages wealth maximization, a monopolist will have an incentive to restrict output below and raise prices

---

24. J. S. MILL, PRINCIPLES OF POLITICAL ECONOMY 13 (W.J. Ashley ed. 1926).

25. Ely, *The Future of Corporations,* HARPERS NEW MONTHLY MAGAZINE, July 1887, at 260.

26. *Study on Regulation, supra* note 4, at 9.

27. "[T]otal pipeline construction costs are roughly proportional to the circumference of the pipe and therefore to its radius, while the volume of gas or oil the pipeline can transmit is proportional to the pipeline's cross-sectional area and therefore to the square of its radius. Since the square of the radius increases more rapidly than the radius, it follows that cost per unit decreases continuously as the pipeline's capacity increases. Indeed, this understates the economies of large diameter pipe because friction in transmitting oil and gas is also reduced as capacity grows, and because the amount of right-of-way needed is practically the same regardless of pipe capacity." *Id.* at 10.

above competitive levels. Consumers receiving false price signals respond by consuming other goods and services, at a higher production cost to society. Thus, *laissez faire* can result in a misallocation of resources.

Regulation attempts to avoid a transfer of wealth from consumers to producers by forcing the natural monopolist to produce at a higher level of output and at a lower price than he would absent government intervention. Wealth transfers from users to investors tend to be regressive in character and, therefore, undesirable.[28] Regulation also avoids the problem of discrimination by the monopolist attempting to increase profits and suppress competition.[29]

But these are not the only reasons government constrains the monopolist. As Professors Stephen Breyer and Richard Stewart noted, "the rationale for regulation of monopoly power rests not only on economic claims, but also on other objectives such as fairer income distribution, avoiding discrimination in price or service among customers, and distrust of the social and political (as well as the economic) power of an unregulated monopolist."[30]

But note that emerging technology has created new competitive opportunities in those sectors of the economy which traditionally have been deemed natural monopolies. For example, while the early railroads may have been natural monopolies, the development of the gasoline engine and the pneumatic tire made motor carriage a viable competitor for the movement of most industrial products. Similarly, microwave and satellite communications provide an alternative to the long-line wire of Ma Bell, at least in long-distance service. Conversely, the new technology of fiber optics, which has almost infinite capacity for long distance telecommunications, may have the characteristics of a natural monopoly. If fiber optics does constitute a natural monopoly, the contemporary investment by AT&T, Sprint, and MCI in parallel fiber optics lines is wasteful.

Beyond long distance telecommunications, other examples of natural monopolies include gas and oil pipelines, electricity transmission, and local distribution utilities such as telephone service, gas, water, electricity, and cable television.[31] Some have insisted that a large amount of fixed and immovable plant is antoher essential characteristic of a natural monopoly. However, as we see from the local utility examples, the size and scope of the natural monopoly need not be large.

2. Externalities

An external effect of a transaction is a positive or negative impact upon a person not a party to it. Air and water pollution caused by the manufacture of a commodity is an example of a negative externality, one resulting from

---

28. S. BREYER, *supra* note 17, at 19.
29. *Study on Regulation, supra* note 4, at xiii.
30. S. BREYER & R. STEWART, *supra* note 18, at 16.
31. *Study on Regulation, supra* note 4, at xiii.

the consumption of the environment as if it were a free good, when it is in fact a scarce resource. So too are injuries to workers in an unsafe workplace, or injuries to depositors in failed banking institutions.

Because the maximization of wealth is the primordial economic imperative of the corporate body, it will have compelling incentives to externalize the full costs of production. These incentives will exist absent the coercive mechanism of government or fully specified, exclusive, and tradable property rights. If the firm succeeds, the price of the commodities the body produces will not reflect the marginal cost to society of the commodity's production. Purchasers will consume more of the goods whose "spillover" costs are absent from the purchase price, and, therefore, economic waste will occur.

In his powerful essay, "The Tragedy of the Commons," Garrett Hardin exposes the incentive to externalize costs:

> Picture a pasture open to all. It is to be expected that each herdsman will try to keep as many cattle as possible on the commons. Such an arrangement may work reasonably satisfactorily for centuries because tribal wars, poaching, and disease keep the numbers of both man and beast well below the carrying capacity of the land. Finally, however, comes the day of reckoning, that is, the day when the long-desired goal of social stability becomes a reality. At this point, the inherent logic of the commons remorselessly generates tragedy.
>
> As a rational being, each herdsman seeks to maximize his gain. Explicity or implicitly, more or less consciously, he asks, "What is the utility to me of adding one more animal to my herd?" This utility has one negative and one positive component.
>
> (1) The positive component is a function of the increment of one animal. Since the herdsman receives all the proceeds from the sale of the additional animal, the positive utility is nearly +1.
> (2) The negative component is a function of the additional overgrazing created by one more animal. Since, however, the effects of overgrazing are shared by all the herdsmen, the negative utility for any particular decision-making herdsman is only a fraction of 1.
>
> Adding together the component partial utilities, the rational herdsman concludes that the only sensible course for him to pursue is to add another animal to his herd. And another. . . . But this is the conclusion reached by each and every rational herdsman sharing a commons. Therein is the tragedy. Each man is locked into a system that compels him to increase his herd without limit—in a world that is limited. Ruin is the destination toward which all men rush, each pursuing his own best interest in a society that believes in the freedoms of the commons. Freedom in a commons brings ruin to all. . . .

In a reverse way, the tragedy of the commons reappears in problems of pollution. Here it is not a question of taking something

> out of the commons, but of putting something in. . . . The calculations of utility are much the same as before. The rational man finds that his share of the cost of the wastes he discharges into the commons is less than the cost of purifying his wastes before releasing them. Since this is true for everyone, we are locked into a system of 'fouling our own nests,' so long as we behave only as independent, rational, free-enterprisers.
>
> The tragedy of the commons as a food basket is averted by private property, or something formally like it. But the air and waters surrounding us cannot readily be fenced, and so the tragedy of the commons as a cesspool must be prevented by different means, by coercive laws or taxing devices that make it cheaper for the polluter to treat his pollutants than to discharge them untreated.[32]

The Tragedy of the Commons is manifested repeatedly in industrial production. It is coupled with the Tragedy of the Good Samaratin. Imagine two manufacturers producing widgets—one a ruthless, greedy, exploitive capitalist (call him Snidley Whiplash of "The Rocky & Bullwinkle Show" fame), and the other a moral, righteous, compassionate good samaratin (call him Farnsworth of "Heaven Can Wait" fame). Assume that widgets are essentially fungible products; a consumer would not prefer Whiplash's widgets to Farnsworth's, or vice versa, unless one was offered at a better price. Assume also that unless expensive pollution control devices are installed, the production of widgets creates carcinogenic air and water pollution. Further assume that both Farnsworth and Whiplash produce widgets at the same marginal cost of production (*e.g.*, wages, raw materials, and transportation costs are identical). They both sell their widgets in the market at the same price.

Farnsworth decides that he cannot sleep at night knowing that his production of widgets may create cancers in the downstream and downwind populations. He therefore invests in pollution abatement equipment, passing along the costs thereof as a few cents more in the purchase price of his widgets. Whiplash has no conscience at all, or at least prefers the wealth he can realize from increased sales to the emotional benefit to be realized from a clear conscience, and chooses not to invest in pollution abatement equipment. A few environmentally conscious consumers, knowing of the good work Farnsworth is doing to clean the environment, buy the Farnsworth widget. But the overwhelming number of consumers buy the product sold at the lowest price, and because the Whiplash widget is priced lower, Whiplash soon dominates the market. Before long, Farnsworth is out of business, the victim of the Tragedy of the Good Samaratin. Moreover, society's resources have been misallocated, for the Whiplash widget does not reflect its true costs of production, because its sale price fails to include

---

32. Hardin, *The Tragedy of the Commons,* SCIENCE, Dec. 13, 1968, at 1243.

the external costs of pollution, and the health care, pain, and suffering created by increased cancers.

Ronald Coase theorized that, assuming the absence of transaction costs and freely exchangeable private property rights, those with wealth, suffering the impact of the negative externality could bargain with those producing it, and reach a mutually agreeable price.[33] For example, home owners suffering the ill-effects of air pollution produced by Whiplash's nearby factory could band together and "bribe" him to abstain, or he could "bribe" them to accept poorer air quality. While an attractive conceptual theory, the problem remains that bargaining is not costless. Even if our home owners collectively had sufficient resources to fund the "bribe", and even if they could band together easily, some might refuse to contribute to it, becoming in essence "free riders," enjoying better quality air without paying the price.[34] Government regulation can significantly reduce transaction costs, and eliminate the "free rider" problem.

As we shall see below, the judiciary offers a forum to force producers to internalize the costs of production, including the cost of injury to third parties. However, evidentiary problems, transaction costs, and the inability of the available remedies to restore health or life may make the judicial solutions inferior to prophylactic regulation. Moreover, the overall costs to society of health care may far outweigh the cost for pollution abatement or enhanced safety.

Note how the regulatory mechanism can alleviate the inequitable disparity between the price of Whiplash's and Farnsworth's widgets, and enhance allocative efficiency. By forcing them both to clean their emissions, the price of their products rises to reflect the cost to society of avoiding the negative externalities of harmful pollution, and neither producer has an artificial advantage in the market. If one producer can develop more efficient and less expensive pollution abatement technology, the producer may have a deserved advantage in the sale of his product. Moreover, forcing the internalization of pollution costs sends consumers correct price signals that reflect fully the cost to society of producing widgets. Consumers might then choose to purchase something other than widgets, which costs society less to produce, rather than continuing their profligate consumption of widgets.

Many commodities sold in the market do not reflect the full cost to society or even the costs imposed upon parties to the transaction. This leads to overconsumption. Alcohol, tobacco, and firearms are prime examples, whose manufacturers escape the cost of health and life their products take.[35] Our legal system assumes free will, and absolves these manufacturers from liability. But for a moment assume a different legal regime. This regime

---

33. Coase, *The Problem of Social Cost,* 3 J. L. & ECON. 1 (1960).

34. A good example of free riders are those who enjoy public television or radio without contributing to it. In Denver, only fifteen percent of public radio's listeners contribute to it.

35. I know, I know, guns don't kill people; people kill people.

requires that tobacco companies fund cancer hospitals and mortuaries, that liquor manufacturers fund automobile insurance and mortuaries, and that gun manufacturers fund hospital emergency wards and mortuaries. Undoubtedly, this would have an inflationary impact on the price of alcohol, tobacco, and firearms. But the price would better reflect the costs incurred by society through the consumption of these products, and actually discourage marginal consumption.

Regulation also can encourage positive externalities. By insisting on a high level of service at a nondiscriminatory price, regulatory agencies can ensure that small towns and rural communities enjoy reasonable access to the transportation, communication, and energy networks. Without access, small town and rural community producers cannot compete in the broader market for the sale of goods and services.[36]

3. Protection of the Infrastructure Industries From Destructive Competition

During the economic collapse of the 1930s, faith in market forces fell to an unprecedented low. In the public debate as to whether the infrastructure industries (*i.e.*, transportation, communications, and energy) should be regulated, terms such as competition were saddled with pejorative adjectives, like "excessive," "wasteful," "destructive," "uneconomic," "unfair," and "ruinous."[37] For example, the high failure rate in industries like motor carriage and airlines was deemed injurious to the prospects for national economic recovery. Therefore, these industries were shielded from the deleterious effects of excessive competition by entry and rate regulation.[38]

The argument for economic regulation stems, in part, from the observation that the infrastructure industries provide an instantly perishable product which cannot be stored or warehoused. Hence, when capacity is excessive, the vicissitudes of the market cycle are particularly brutal for such industries. Producers might be able to cover only the marginal costs of production. Without a contribution to fixed costs over the long term, as the physical plant wears out, the producer will go out of business.[39]

Excess capacity can create a downward pricing spiral which will render many marginal firms bankrupt. In industries where the public will need the capacity when the slope of the demand curve turns upward, such as railroads and ocean shipping, a political determination has been made that the government shall shield these industries from the full effects of competition. This shielding assures the public adequate capacity to satisfy maximum

---

36. *See* Dempsey, *The Dark Side of Deregulation: Its Impact on Small Communities*, 39 ADMIN. L. REV. 445 (1987).

37. *See* Dempsey, *The Rise & Fall of the Civil Aeronautics Board — Opening Wide the Floodgates of Entry*, 11 TRANSP. L. J. 91, 91-108 (1979).

38. *See generally* P. DEMPSEY & W. THOMS, LAW & ECONOMIC REGULATION IN TRANSPORTATION 19-21, 26-29 (1986).

39. D. LOCKLIN, ECONOMICS OF TRANSPORTATION 138 (6th ed. 1966).

demand, without drastic swings in price. A healthy infrastructure, again, is the foundation upon which the rest of commerce is built. Thus, a number of key industries have been the subject of promotional favor by the federal government. As Richard Posner has noted:

> The regulated industries are part of the 'infrastructure' of economic growth. Adequate transportation, communications, and power (especially electrical) must be in place before the development of modern industry is possible, and most countries, including this one at various periods, have undertaken to subsidize these services or provide them directly in the hope thereby of attracting industrial developers.[40]

Some economists have observed that destructive competition can have several undesirable effects. These effects include long periods of inadequate investment and slow technological progress which would lead to poor service and periodic shortages. It might also lead to widespread bankruptcies of small firms, and ultimately, a highly concentrated industry structure. Large firms might engage in predatory practices against their smaller rivals, thus exacerbating the concentration problem.[41]

Some argue that a healthy infrastructure is essential not only for robust economic growth, but to satisfy the needs of the national defense. Hence, the congressional statements of policy in transportation and communications legislation often have included an explicit reference to the utility of the industries in enhancing the national defense.

In some instances, both labor and business may line up on the side of regulation and against "excessive" competition. Labor seeks to protect wages, while business seeks to protect investment. In these instances, it is argued that the economic and social costs of unconstrained market forces are simply too painful to bear.

4. Allocation of Scarce Resources

Some national resources are deemed owned by the public. Because the nature of these resources dictates that they can be utilized by only a single user, government selects which among several applicants will be granted the exclusive franchise. Examples include distribution of television and radio frequencies. Entry regulation is imposed so that multiple users do not create broadcast interference, thereby jamming each other's signals. Similar policies govern the decision of where a hydroelectric dam shall be constructed, and by whom, and the question of who shall be granted permission to lease or exploit the natural resources on federal land.

Unconstrained individual use of a scarce common resource also may result in waste. Thus, several property owners' uncontrolled extraction of

---

40. Posner, *Taxation By Regulation*, 2 BELL J. ECON. & MGMT. SCI. 22, 39 (1971).
41. *Study on Regulation, supra* note 4, at 13.

oil from a petroleum reservoir may deplete the pool so that maximum efficiency can never be achieved, leaving some of the oil unrecoverable. Many oil producing states have enacted conservation statutes which regulate spacing of wells and rates of extraction to maximize the long-term productivity of the field.

5. Furtherance of Other Social Policies

(a) Paternalism: Protecting the Public From Erroneous Decisionmaking

Several additional reasons beyond allocative efficiency have been advanced for the use of regulation to accomplish social goals. Usually, these forms of regulation are justified on grounds of protecting the "public interest." In essence, this public interest regulation results in government's paternalistic protection of the citizens who lack sufficient information to perceive risk and make a rational choice. It also shields citizens from erroneous decisionmaking, or protects citizens from negative externalities before they occur.

The costs of acquiring information can be large, and any one consumer may be unable to obtain sufficient information at a reasonable cost. Government regulation can reduce these transaction costs by forcing producers to provide accurate information regarding the products they produce, licensing certain industries, providing oversight to ensure that industries meet minimum standards, or outright prohibition. Examples of such preinjury protection include health and safety regulation (of food and drugs, and means of transport, for example), and the licensing of industries and professions (such as banks, insurance companies, doctors, and lawyers).

The philosophy of P.T. ("there's a sucker born every minute") Barnum rested on a premise of ruthless human greed that compels producers to deceive consumers as to the quality or characteristics of the products they are selling. Regulation over "unfair and deceptive competitive practices" is designed to keep the market honest, so that a rational consumer can make informed judgments as to how to spend his wealth.

The free market will provide the goods and services that individual consumers (who have money) want most. But if broader societal objectives should be promoted irrespective of satiating consumer tastes, the market will be an imperfect means of promoting them. As Nobel laureate George Stigler has noted, "When the society forbids children to be chimney sweeps or forbids the public sale of heroin, it is not countering market failure but seeking to thwart the market's fulfillment of undesirable desires."[42]

(b) Distribution of Wealth

Another social policy which regulation sometimes advances is the redistribution of wealth and power between regulated industries and their cus-

---

42. Stigler, *The Economists' Traditional Theory of the Economic Functions of the State,* in THE CITIZEN AND THE STATE 103, 110 (1975).

tomers, and between classes of customers. The unregulated market, in contrast, tends to favor those with more wealth, because they have more votes of dollar approval to cast in the market than those without.

The government established several regulatory agencies to provide some measure of balance between the needs of consumers and the needs of the regulated enterprise. For example, a railroad cannot unilaterally abandon rail service to a community. The railroad must wait until those members of the shipping public who the move will adversely affect have an opportunity to express their objections to a governmental body, the Interstate Commerce Commission. Regulatory agencies sometimes insist that industries use their supracompetitive profits from lucrative markets to cross-subsidize losses in less remunerative markets. Consequently, regulation can redistribute wealth without utilizing the taxing and spending mechanism.

Examples of the government's redistribution of wealth through regulation are abundant. Before 1970, rail freight profits cross-subsidized rail passenger service. Prior to 1978, airline ticket prices in major markets cross-subsidized small community service.[43] Before the break-up of AT&T, profits from long distance cross-subsidized losses in local and residential service. Posner notes that

> an important purpose in fact of public utility and common carrier regulation is to compel, by the device of the internal subsidy, the provision of certain services in quantities and at prices that a free market would not offer, much as the conventional taxing-spending power is used to the same end.[44]

Regulation also strengthens the position of those without equality of bargaining power, and thereby protects the competitive process against distortions based on wealth and power. Individuals and small businesses are more subject to pricing discrimination than large businesses. Individuals and small businesses, therefore, have employed the regulatory mechanism as a shield against such discrimination. Because such services as telecommunications and transportation, and such products as electricity and natural gas cannot easily be resold to other purchasers, a producer can maximize wealth by raising prices to those least likely to leave the system, and lowering prices to prevent abandonment by those who have a reasonably priced competitive alternative.[45] Pricing discrimination can increase unduly the producer's profits and have a deleterious effect upon competition.[46] Most traditional forms of regulation prohibit such discrimination.

Another form of wealth distribution that both regulation and taxation encourage is the elimination of "windfall profits." Thus, if a producer of

---

43. Dempsey, *supra* note 35, at 454-59.

44. Posner, *supra* note 39, at 41. Nevertheless, Posner objects to such a policy on grounds that it tends to be arbitrary and inequitable, and distorts the efficient allocation of resources. *Id.* at 41-43.

45. S. BREYER, *supra* note 17, at 17.

46. *Study on Regulation, supra* note 4, at xvi.

products particularly important to consumers is suddenly able, through no creative enterprise of his own, to raise prices, a regressive transfer of wealth from consumers to producers occurs. Because the producer has done nothing to increase the value of his product, the profits are unearned. Government intervenes to ensure that the "windfall" rents benefit the consumer rather than the producer.[47] Thus, after the Arab Oil Embargo of 1973, the government imposed oil price regulations upon the petroleum industry. During both World War II and the Nixon Administration, the government administered price controls to reduce inflation.

6. Legal Rationales for Expansion of Federal Regulation

(a) Judicial Emasculation of State Regulation

On a number of occasions judicial decisions have been the catalyst for expansion of federal economic regulation. In transportation, the states were the first to regulate the railroads. The 1886 decision of the U.S. Supreme Court in *Wabash v. Illinois,*[48] however, limited the states' jurisdiction over intrastate commerce. The Supreme Court interpreted article 1, section 8 of the U.S. Constitution as precluding states' regulation of interstate rail activities. Because most of the freight moved in interstate commerce, Congress filled the regulatory void the following year by establishing federal regulation over the industry and creating the Interstate Commerce Commission to administer the regulations.

In 1926, the U.S. Supreme Court handed down a similar decision in *Buck v. Kuykendahl.*[49] In *Buck,* the Supreme Court limited the states' jurisdiction over interstate motor carriers. Less than a decade later, Congress gave the ICC jurisdiction over interstate motor carriers.[50] Similarly, in 1927, in *Public Utilities Commission v. Attleboro Steam & Electric Co.,*[51] the Supreme Court struck down state regulation of interstate electric rates. Largely to fill the gap the *Attleboro* decision created, Congress established the Federal Power Commission in 1930.

(b) Administrative Efficiency: The "Tar Baby Effect"

Sometimes it becomes impossible to regulate one aspect of an industry without regulating all facets of the industry. Once again, let us look at transportation. In 1887, Congress vested the ICC with jurisdiction over rail rates. By 1920, it was apparent that for the ICC to regulate the industry effectively the ICC would need authority over rail entry and abandonments. Accordingly, Congress so expanded the agency's jurisdiction. By 1935, motor

---

47. S. BREYER, *supra* note 17, at 22.
48. 118 U.S. 557 (1886).
49. 267 U.S. 307 (1925).
50. *See* P. DEMPSEY & W. THOMS, *supra* note 37, at 10-21.
51. Public Util. Comm'n v. Attleboro Steam & Elec. Co., 173 U.S. 83 (1927).

carriers had become a viable alternative mode for the movement of freight. Again, Congress extended the ICC's jurisdiction to cover motor carriers. Equality of treatment became a policy objective of some importance. Either both railroads and motor carriers should be unregulated, or both should be regulated. Congress, fearing that the superior market position of the railroads would curtail the growth of the infant trucking industry, chose regulation.

In 1938, with the creation of the Civil Aeronautics Board, Congress committed the burgeoning airline industry to economic regulation. In the 1940s, freight forwarders and inland water carriers were placed under the ICC's regulatory umbrella. Similarly, the Federal Communications Commission extended its jurisdiction to cable television services more effectively to regulate broadcasting.

Hence, it can be difficult to regulate one aspect of an industry without regulating them all. Professor Thomas Morgan describes this phenomenon as the "tar baby effect."[52] Comprehensive regulation becomes the ultimate result of the inability of government to extricate itself once it has become immersed in regulating significant aspects of an industry's operations.

F. Regulatory Failure and Deregulation

Paradoxically, just as economic regulation was born of market failure, the contemporary wave of deregulation was born of regulatory failure. After the dust settled from the Great Society, there was a widely held perception that government was inefficient, costly, and ineffective. Much of the momentum for deregulation was born of the exasperation of businesses and individuals over what was perceived to be an unwieldy and expensive Washington bureaucracy that tied them in red tape.[53] People viewed the direct and indirect costs of regulation as expensive and inflationary. The direct costs were felt in the tax dollars directly needed to support the agencies and their large staffs. But the indirect costs were also large—the armies of lawyers, lobbyists, accountants, and expert witnesses needed to satiate the agencies' enormous appetite for paper and endless hearings. "Regulatory lag" was costly not only in terms of the impact of market inflation upon obsolete pricing, but also made business decisionmaking difficult, for the regulatory future was uncertain and unpredictable.

Economist Robert DeFina predicted that for each dollar spent by government directly to regulate, industry suffered an economic burden for compliance of twenty times as much. Under this hypothesis, taxpayers spent $3 billion in 1976 to run the regulatory agencies, while industry presumably spent an additional $60 billion to comply with the regulations the agencies

---

52. T. MORGAN, J. HARRISON, & P. VERKUIL, ECONOMIC REGULATION OF BUSINESS 22 (2d ed. 1985).

53. Dempsey, *Erosion of the Regulatory Process — The Winds of Change,* 47 I.C.C. PRAC. J. 303, 319 (1980).

imposed.[54] Regulatory agencies are often headed by individuals who are products of a system of political patronage. Furthermore, like academic institutions, regulatory agencies are staffed by individuals with excessive job security. Neither of these factors are conducive to productivity or efficiency.[55]

Professor Bernard Schwartz noted this political patronage and excessive job security as one of the two major causes of contemporary disillusionment with administrative agencies. Schwartz stated:

> The goal of cheap and inexpensive justice by experts, one of the chief reasons for setting up agencies, has proven illusory. The administrative process has too often proved even more expensive and time-consuming than the judicial process. Even more important has been the increasing failure of agencies to protect the very public interest they were created to serve. The administrative process, which had once been vigorous in fighting for the public interest, has become an established part of the economic status quo. It has come to terms with those it is ostensibly regulating; the "public interest" is equated more and more with the interest of those being regulated.[56]

Professor William Jones gave as an example the inability (or unwillingness) of regulatory agencies to protect the public against monopoly abuses. Jones said, "In most multi-firm regulated industries . . . the principal focus of price regulation is not on protecting consumers from monopolistic exploitation, but on protecting rivals from vigorous pricing competition."[57] Thus, over time many agencies have lost sight of their responsibility to protect the "public" or consumer interest. Instead, these agencies have embraced the policy of facilitating the optimal economic interests of the industry they regulate.

According to George Stigler, regulatory agencies became subject to "capture." The agencies fell prey to the interests of the industries they regulated. The regulators began to protect the regulated industries from competitive market forces, instead of achieving their original social objectives.

The direct and indirect costs of regulation were inflationary, and created distortions in the marketplace which resulted in a misallocation of society's

---

54. *Deregulation — A Fast Start for the Reagan Strategy,* BUS. WEEK, Mar. 9, 1981, at 62, 66.

55. Like civil service protection of government employees, tenure of college professors seems to have a debilitating effect upon all but the self-motivated. Post-tenure, too many of our colleagues crawl into a fetal position in semi-retirement, making little contribution to legal education beyond the classroom. *See* Swygert & Gozansky, *Senior Law Faculty Publication Study: Comparisons of Law School Productivity,* 35 J. LEGAL EDUC. 373 (1985).

56. B. SCHWARTZ, ADMINISTRATIVE LAW (2d ed. 1984).

57. Jones, *Government Price Controls and Inflation: A Prognosis Based on the Impact of Controls In the Regulated Industries,* 65 CORNELL L. REV. 303, 323 (1980).

resources. The distortions were perverse. In transportation, regulation created excessive service and insufficient pricing competition (vis-à-vis that which might have existed in the absence of regulation). Railroads earned an inadequate return on investment, leading to several carrier failures during the 1970s (Penn Central, Milwaukee, and Rock Island "mighty fine" Line principal among them).[58] In natural gas, regulation imposed low prices, but created massive shortages. In telecommunications, regulation underpriced local service, but overpriced long distance.[59]

As a consequence, there began in the 1970s a strong bipartisan political movement to free industry from the shackles of regulation. The blind antagonism against government inspired a barrage of deregulatory initiatives. The major deregulatory efforts of the contemporary era have included the following:

1968—U.S. Supreme Court allows non-AT&T equipment to be hooked up to Bell system
1969—Federal courts allow MCI long distance access to residential telephones
1970—Interest rates on deposits of more than $100,000 deregulated
1972—FCC adopts open skies satellite policy
1975—SEC abolished fixed brokerage fees; ICC prohibits rate bureau protests for independent rate filings
1976—Railroad Revitalization and Regulatory Reform Act
1977—Air Cargo Deregulation Act
1978—Airline Deregulation Act; Natural Gas Policy Act; OSHA revokes 928 rules
1979—FCC deregulation of earth satellite stations
1980—Motor Carrier Act; Staggers Rail Act; Depository Institutions Deregulation and Monetary Control Act; International Air Transportation Competition Act; Household Goods Transportation Act; FCC deregulation of cable television
1981—Executive Order decontrol of crude oil and refined petroleum prices; FCC deregulation of non-entertainment programming for radio
1982—Bus Regulatory Refort Act; Garn-St. Germain Depository Institution Act; Modified Final Judgment in *U.S. v. AT&T*
1984—The Shipping Act; Civil Aeronautics Board Sunset Act; Cable Communications Policy Act; FCC deregulates non-entertainment TV programming
1986—Freight Forwarder Deregulation Act
1987—FCC abolishes Fairness Doctrine

Congress' legislative initiatives have been coupled with the Presidential appointment of a large number of free market economists and deregulation

58. For criticism of railroad regulation and praise of deregulation, see Wilner, *Railroads and the Marketplace,* 16 TRANSP. L.J. 291 (1988).

59. *See* S. BREYER, *supra* note 17.

ideologues to the federal agencies.[60] The result has been the most radical and comprehensive change in government policy since the New Deal. Not surprisingly, this change has been profoundly in the opposite direction.

G. *Public Choice Theory*

Proponents of the public choice theory embrace the normative conclusion that we would be better off with less regulation and less government. Because politicians respond to pressure groups and the desire to be reelected, politicians often employ the wheels of government to magnify rather than eliminate market imperfections. Blending schools of market economics and political science, public choice theorists adhere to a policy hostile to government and friendly to unconstrained competition.

Public choice theory was the prevailing wisdom in the Reagan Administration. Consistent with public choice theory, Interior Secretary James Watt and Environmental Protection Agency Administrator Ann Gorsuch reduced enforcement of environmental regulation. It was the theory under which Federal Trade Commission Chairman James Miller III gutted the agency's antitrust regulatory staff. Pursuant to public choice theory Federal Communications Commission Chairman Mark Fowler repealed radio and TV programming and advertising regulations.[61] It was the theory under which ICC Chairman Heather Gradison refused to regulate rail rates in monopoly markets.[62] Adhering to the tenets of public choice theory the Department of Transportation under Secretary Elizabeth Dole approved every airline merger proposal submitted to the agency.[63]

V. A Cost/Benefit Analysis

A. *Benefits of Deregulation*

Only the market can create the combination of price and service options that consumer demand dictates. The law of supply and demand eliminates shortages. In a competitive industry, if a good or service is earning its producer excessive profits, new competitors are attracted to the market like sharks to the smell of blood. Thus, under the "theory of contestable markets," new entry, or its threat, constrains the exertion of market power for any appreciable length of time, at least where the barriers to entry are

---

60. *See* Dempsey, *The Interstate Commerce Commission: Disintegration of An American Legal Institution,* 34 Am. U. L. Rev. 1 (1984). Former ICC Chairman Joseph Eastman argued that "[Z]ealots, evangelists, and crusaders have their value *before* an administrative tribunal, but not *on* it." Eastman, *Twelve Point Primer,* 16 Transp. L.J. 175, 177 (1987) [emphasis in original]. He was right.

61. *See Broadcast Deregulation: The Reagan Years and Beyond,* 40 Admin. L. Rev. 345 (1988).

62. *See* Dempsey, *Antitrust Law and Policy in Transportation: Monopoly I$ the Name of the Game,* 21 Ga. L. Rev. 505, 577-88 (1987).

63. *Id.* at 510-47.

low.[64] In a competitive market, prices are set at marginal costs. Inefficient competitors are driven out of the market by their lower-cost rivals. Ultimately, the most efficient producers survive.

Deregulation has tended to make the deregulated industries more competitive, particularly as to price. Inefficient and smaller enterprises have been driven into bankruptcy. The disciplines of social Darwinism have forced existing enterprises to become more efficient, curtail costs, and improve productivity. The Darwinistic disciplines have inspired technological development in many industries. The squeeze on profits engendered by competition has encouraged technological and managerial innovations, and thereby higher levels of productivity. Productivity increases result in expanded economic wealth and, hence, higher living standards.

America's capitalist system has produced a cornucopia of goods and services for the common man. It does this by tapping man's innate greed, and rewarding those who satisfy the wants of the masses. While the capitalist system has been less than perfect at achieving equality of wealth distribution, it has worked well in expanding the overall size of the economic pie. The prevailing wisdom in the contemporary political environment is that the unconstrained market is a superior mechanism to government regulation for the distribution of the earth's scarce resources among consumers. In no small sense, the Reagan Administration's approach transcended the notion that efficiency in the allocation of resources is the optimum social objective, for it embraces deregulation even where competition is imperfect (*e.g.*, unconstrained rail monopoly pricing, dilution of antitrust standards). Deregulation has become an end in itself, not a means to the end of enhanced competition.

B. The Costs of Deregulation

While deregulation has had significant benefits, it has not been without its costs. The free market only satisfies man's interest in economic efficiency, and it sometimes fails to do that. The free market also fails to satisfy society's social needs which do not find a high priority in the marketplace.

Although deregulation offers the economy significant benefits in facilitating achievement of allocative efficiency, the empirical results of the experiment reveal that, nevertheless, major costs have been incurred. For example, while the Fortune 500 companies tend to enjoy relatively lower transportation and communication rates, small businesses do not.[65] Although large communities seem to enjoy enhanced competition in transportation and communications, small communities pay higher prices for decidedly poorer service.[66] Thus, the benefits of deregulation have been unevenly

---

64. *See* W. BAUMOL, J. PANZAR & R. WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE (1982).

65. *See* Dempsey, *The Empirical Results of Deregulation: A Decade Later, and the Band Played On*, 17 TRANSP. L.J. 31 (1988).

66. *See* Dempsey, *The Dark Side of Deregulation: Its Impact on Small Communities*, 39 ADMIN. L. REV. 445 (1987).

distributed. With the elimination of the cross-subsidies that regulation mandated, there are winners and losers under deregulation. And while the downward squeeze on profits engendered by enhanced competition has forced many deregulated companies to become more efficient, labor-management relations have deteriorated.

In a nutshell, these are some of the major costs which have been incurred in deregulating the following industries:

Airlines

Service deterioration
Erosion of the margin of safety
High number of failures (more than 150 bankruptcies)
Industry concentration (8 airlines have 94% of the passenger market)
Consumer abuses (misleading advertising, deliberate overbooking, unrealistic scheduling)
Deterioration of labor/management relations

Banking

Service deterioration
High number of failures
Federal insurance companies nearing bankruptcy

Buses

4,500 small communities abandoned
Industry duopoly becomes monopoly with merger of Greyhound and Trailways
Deterioration of labor/management relations

Railroads

Industry concentration (7 railroads account for more than 86% of freight and 93% of profits)
Monopoly rents extracted from grain and coal shippers

Telecommunications

Deterioration of service
Concentration in long-distance (AT&T has 82% market share)
Local and residential rate increases outpace declining toll rates (local rates have increased between 38-52% since divestiture)

Trucking

Deterioration of safety
High number of failures
Concentration in the less-than-truckload [LTL] sector of the industry (with the top 10 firms responsible for 60% of freight and 90% of profits)
Deterioration of labor/management relations

C. *Externalities*

Free market theorists argue that the market provides an optimum and efficient allocation of the world's scarce resources. It is a cold theory devoid of morality. Thus, if men believe that the horn of a rhinoceros contains an aphrodisiac, they will hunt the beasts to extinction to obtain that scarce resource. If the soft fur of a baby seal fetches a good price in the market, trappers will club the seals unconscious, and strip them of their fur, leaving them to freeze to death in the cold arctic winds. Only regulation, backed by the coercive enforcement mechanism of the state, will save the rhino from extinction, and the baby seal from an agonizing death. Only government can protect the rich history of archaeological sites from pillage by looters.

The primordial imperative of economic man is the accumulation of wealth. To the extent that he can shed himself of the costs of production by externalizing them, he will gladly do so. He will spew his toxic waste into the "commons" of our streams and atmosphere. As we shall see, the judiciary is a poor mechanism for resolving such injuries, for the chain of causation is difficult to prove. For example, if one suffers the ill effects of "acid rain," how does one identify the culprit(s)?

Not since the passing of the great dinosaurs some sixty-five million years ago have so many species of life on this planet met their fate in extinction, as man, pursuing the imperatives of the free market, hunts them down, clears their forests, and pollutes their habitats. This is a rational man pursuing wealth, distributing the world's scarce resources among homo sapien consumers. Because other species of life have no dollars, they get no vote in the human economic system. Other earthlings, thus, become consumables in an inhumane system which places little value on the preservation of the genetic codes of exotic forms of life.

The externalities of unregulated industrial production are also producing global environmental hazards. Consumption of fossil fuels has released massive volumes of carbon dioxide into the atmosphere, creating a greenhouse effect. Some scientists predict that, if present trends continue, the mean temperature of the planet will rise between 2.5 and 7.5 degrees Fahrenheit by the middle of the next century. That would make the earth warmer than it has been in 100,000 years. It would thaw water locked in the polar ice caps, raising sea level by fifteen to twenty feet, enough to flood many cities.[67]

Chlorofluorocarbons are used as a refrigerant and, in most nations, as an aerosol propellant. Their release into the atmosphere contributes to the greenhouse effect, and also destroys ozone, which protects the earth's inhabitants from the sun's ultraviolet rays. A sharp increase in ultraviolet exposure would cause increased melanomas and other malignant skin cancers, and reduce agricultural yield. In recent years, melanomas have doubled

---

67. *A Global Greenhouse,* NAT'L GEOGRAPHIC, April 1987, at 514-15.

worldwide.[68] The forests of Europe are being destroyed by "acid rain," a phenomenon common to all nations downwind of the burning of high sulfur coal.[69] As Garrett Hardin noted, only the government's coercive mechanisms of taxation or regulation can force producers to internalize the environmental spillovers of production.

D. Paternalism: The Prophylactic of Injury

I use the term paternalism to mean little more than a prescriptive solution to the problem of externalities. To the extent that potential negative externalities are perceived to exist, government may regulate in a manner which protects those who might be injured before they suffer injury. Although the courts were created to provide economic compensation after an injury has been sustained, thus making the injured party "whole," there are instances where economic compensation, no matter how generous, is not enough. Wealth, for all the pleasure it may command, cannot resurrect life, and too often, cannot restore health.

Market theory rests on the foundation that men will behave rationally. If survival is a rational behavioral characteristic of mammals, then conduct which jeopardizes survival is irrational. If men behaved rationally, the tobacco industry would be bankrupt. The unregulated market encourages hedonistic satisfaction of human desires. Government can attempt to regulate the market to achieve paternalistic objectives that are deemed socially best for its citizens, but if the market imperatives are sufficiently strong, men will avoid the regulatory impediments. Thus, illicit drugs are consumed in vast quantities, despite government's efforts to regulate their consumption, because the market so strongly satiates man's thirst for pleasure. Would a rational man submit his body to drug addiction? But pimps and drug dealers are some of the more unsavory products of too free a market. Other examples of government's protection of its citizens by promulgating regulations designed to shield them from injury include the following:

> —During the first four years of federal safety packing requirements, ingestion of poisons by children dropped by forty percent. Child resistant bottle caps reduced the number of poisonings treated by hospital emergency rooms by 230,000 between 1973 and 1979.
>
> —Since safety standards for cribs were promulgated in 1974, crib strangulations have fallen by fifty percent.
>
> —Prior to the promulgation of children's sleepwear regulations, thirty-four percent of flame-burn injuries involved sleepwear; today, the figure is nearly zero.
>
> —The benefit of eliminating dangerous drugs from the market, *e.g,* Thalidomide and Panalbas, has been estimated to be $300 million annually.

---

68. *Air, An Atmosphere of Uncertainty,* NAT'L GEOGRAPHIC, April 1987, at 502, 518.
69. *Id.* at 530.

—Between 1966 and 1981 federal automobile safety regulations saved approximately 100,000 lives, and averted millions of injuries.

—Federal clean air standards for sulphur dioxide and suspended particulates are projected to reduce the mortality rate by seven percent, saving 125,000 lives per year.[70]

Of course, such benefits are not without their costs. For example, many important and useful drugs are available in Europe years before they are sold in the United States. Accordingly, many Americans are deprived of the benefits of these drugs while the U.S. Food and Drug Administration performs its tests. Of course, that means that Europeans serve as America's guinea pigs. If vast European populations should suddenly die, we would know not to introduce *that* drug into our nation.

E. Distribution of Wealth

Professor/jurist Richard Posner admits that market "economics yields no answer to the question whether the existing distribution of income and wealth is good or bad, just or unjust . . . neither does it yield an answer to the ultimate question whether an efficient allocation of resources would be good, just, or otherwise socially or ethically desirable. Nor can the economist tell us whether, assuming the existing distribution of income and wealth is just, consumer satisfaction should be the dominant value of society."[71]

1. Transportation

In fact, much of economic regulation initially was premised on the achievement of an allocation of goods and services more just than the market allocation. For example, one of the principal rationales for economic regulation of transportation was to eliminate carrier discrimination in levels of price and service based upon the size or location of the shipper. In part, this was a response to John D. Rockefeller's competitive advantages in shipping his oil to market via railroad, advantages attributable to size and market power over his smaller competitors.[72] Congress deemed itself ill-equipped to deal with the complex problems posed by the rail monopolies, and created the Interstate Commerce Commission, giving the ICC jurisdiction to devise a solution.[73]

The ICC enforced statutory prohibitions against discrimination between shippers. This allowed the small shipper to enjoy essentially the same rates

---

70. *See* Green, *Cost of NOT Regulating,* WASHINGTON POST, Nov. 24, 1981, at A17, col. 4; Lee, *The Good Regulations,* N.Y. TIMES, Jan 31, 1979, at A22, Col. 3.

71. *See* Posner, *supra* note 39.

72. Dempsey, *Transportation Deregulation—On a Collision Course?,* 13 TRANSP. L.J. 329 (1984).

73. Dempsey, *Rate Regulation and Antitrust Immunity in Transportation: The Genesis and Evolution of this Endangered Species,* 32 AM. U. L. REV. 335, 336 (1983).

for equivalent shipments as the large shipper. The ICC also ensured that common carriers served small and remote shippers on a nondiscriminatory basis by holding them to a "common carrier obligation"—a responsibility to serve all shippers within the perimeters of their operating certificates.[74] If carriers were not earning sufficient returns on less attractive markets, the ICC forced them to cross-subsidize these losses with profits earned on more highly remunerative markets. Through "rate averaging," the regulation of telecommunications and electric utilities has embraced essentially the same principle.

Economic regulation imposed both a benefit and a burden upon regulated enterprises. The burden was the common carrier obligation to serve all geographic regions in their operating certificates in a nondiscriminatory fashion. Ceilings were imposed on rates to prohibit carriers from taking advantage of situations in which they held market power. The benefit to carriers was freedom from destructive levels of competition; entry into the industry was regulated. One of the results of this system was a transfer of wealth, from urban shippers to rural shippers, from large shippers to small shippers, and from rail freight traffic to rail passenger service.

Deregulation has largely eliminated those cross-subsidies. Today, large shippers enjoy a significantly lower price for transportation services than do small shippers. Urban areas have advantages in terms of lower prices and higher levels of service than do rural areas. For example, since promulgation of the Bus Regulatory Reform Act of 1982, more than 4,500 communities have lost intercity bus service, while only 896 have gained it.[75] The winners under deregulation are the large shippers and large communities; the losers are small businessmen and rural America.

2. Communications

Regulation frequently was imposed to accomplish social objectives unrelated to economic efficiency. For example, one of the major objectives of the Communications Act of 1934 was the promotion of universal service.[76] Universal service meant that every village and hamlet in the country would have reasonably priced telephone service. It was believed that every home should have access to this important communications system.

As technology improved, the cost of providing long distance telecommunications fell, while inflation drove up the cost of providing local service. Yet, to keep local and residential rates down, regulators refused to allow telephone companies to raise them, forcing the companies to make up the difference by internally cross-subsidizing the revenue shortfall with growing

74. Dempsey, *Congressional Intent and Agency Discretion—Never the Twain Shall Meet: The Motor Carrier Act of 1980,* 58 CHI.-KENT L. REV. 1 (1982).

75. Dempsey, *supra* note 35, at 460-62.

76. Federal Communications Act of 1934, 47 U.S.C. §§ 151-661 (1982).

profits in the long distance field.[77] In effect, this was the route of least political friction. The result was some wealth redistribution, away from businesses and higher income groups, whose members place a larger number of toll calls, in favor of users of basic local service.

When the AT&T monopoly was broken up, the cross-subsidy totaled some $7 billion annually. Because AT&T has suffered the diaspora of divestiture, and because the evolving technology allows bypass of local telephone service, further deregulation is inevitable. The inevitable consequence of further deregulation will be elimination of the cross-subsidy. In Colorado, for example, this will mean that the basic local telephone rate must be increased from its present $9 to $10 per month, to approximately $21 per month if it is to cover incremental costs, $32 per month if it is to cover fully allocated costs, and whatever the market will bear if the monopoly is deregulated.[78] Local residents will have no option but to pay the higher costs or terminate their service because, under existing technology, it is a natural monopoly. However, in competitive telecommunications markets (such as some local business service, or long distance), rates will fall. The winners in the deregulation of telecommunications will be businesses and higher toll users—or generally, the higher income groups. The losers will be members of lower income groups and residents of rural communities and, consequently, the statutory policy of universal service.[79]

VI. Alternatives To Regulation: Taxing & Spending, the Judiciary, and Artificial Markets

There are three major alternatives to regulation to accomplish ends which society views as desirable[80] and to allocate resources. These alternatives are the power of taxing and spending, the relief which the judiciary may provide, and the creation of artificial markets.

A. Taxing & Spending

If indeed there is some social benefit to be realized by transferring wealth from large to small and from urban to rural, many economists argue that the taxing and spending mechanism is the preferable vehicle for accomplishing that objective. The Airline Deregulation Act of 1978 chose

---

77. *See* MacAvoy & Robinson, *Winning By Losing: The AT&T Settlement and Its Impact on Telecommunications,* 1 YALE J. ON REG. 1 (1983); W.B. TURNSTALL, DISCONNECTING PARTIES: MANAGING THE BELL SYSTEM BREAK-UP (1985); S. COLL, THE DEAL OF THE CENTURY, THE BREAKUP OF AT&T (1986).

78. Glesne, *Status of Deregulation (Regulatory),* in MOUNTAIN BELL ACADEMIC SEMINAR 81, 83 (1986).

79. *See* Dempsey, *Adam Smith Assaults Ma Bell With His Invisible Hands: Divestiture, Deregualtion, and the Need for a New National Telecommunications Policy,* 11 HASTINGS COMMUNICATIONS & ENTERTAINMENT L.J. (forthcoming 1989).

80. That is not to say that society always agrees as to what ends it should achieve. Indeed, the public policy debate is to both ends and means.

this approach to ensure continued essential air service to airports serving smaller communities. That type of tax subsidization is jeopardized for the same reasons that no new mechanism of tax subsidies has been implemented for bus transportation. With a $2 trillion federal debt, and an annual deficit in recent years of around $200 billion, the pragmatic political reality is that the cost of additional subsidies cannot now be imposed on taxpayers.

But taxing might be a preferable means of forcing producers to internalize the costs of production. For example, rather than having government regulators specify the precise technology to be employed in ridding the environment of pollution, a tax imposed at a progressively higher rate for higher levels of pollution might be a more efficient means of encouraging producers to develop the technology best able to arrest pollution.[81] Conversely, tax incentives may be employed to encourage producers to invest in pollution abatement technology.[82]

B. The Judiciary As Regulator

Others argue that the courts are a superior mechanism to the regulatory agencies for the accomplishment of social objectives. For example, some argue that the antitrust laws are a superior mechanism for correcting anticompetitive conduct in the market. However, civil antitrust litigation is expensive and time consuming, and the evidentiary hurdles are often formidable. A private litigant stands a better chance of winning when the U.S. Department of Justice precedes the private action with a criminal enforcement judgment. In such a situation, the Justice Department has already undertaken the expensive burden of discovery, and thereby alleviated some of the cost to the private plaintiff.

But in the Reagan Administration criminal antitrust actions against companies engaging in anticompetitive conduct were relatively rare in areas other than price fixing. Moreover, even if a private plaintiff prevails in litigation, his recovery ordinarily is limited to monetary damages. If he has been driven out of business, even trebled damages do not serve to restore his presence in the marketplace. For example, when Sir Freddie Laker's Skytrain was driven out of the transatlantic market, his creditors in bankruptcy brought an antitrust action against a number of U.S. and foreign airlines. The out-of-court settlement was generous. It put dollars in the pockets of Sir Freddie and his creditors, but it did not resurrect Skytrain. The net result was the loss of a vigorous price competitor on the North Atlantic.[83] Thus, the consumer interest in preserving a competitive marketplace is rarely vindicated by antitrust remedies.

The problem of externalities, or spillover costs, discussed above, also poses a difficult problem for the judiciary. Professors Breyer and Stewart summed it up this way:

---

81. J. LAITOS, NATURAL RESOURCES LAW 116-17 (1985).

82. *See* Heinz, *Tax Incentives for Pollution Control,* 8 J. CORP. TAX. 83 (1981).

83. Dempsey, *The International Rate and Route Revolution in North Atlantic Passenger Transportation,* 17 COLUM. J. TRANSNAT'L L. 393 (1978).

> [C]ourt litigation is plagued with imperfections and limitations that are especially pronounced in dealing with the problems of market failure that arise in an urban, industrialized society. Certain forms of market failure, such as air pollution, result in harms that are widespread but too small in the case of any individual to justify the expenses of a lawsuit to redress the harm. In some cases it may be thought necessary to prevent the occurrences of serious harms, such as those caused by unsafe drugs, through prophylactic measures imposed in advance and continually policed; court damage awards are imposed after harm has occurred and the capacity of courts to devise comprehensive prophylactic injunctions and engage in on-going monitoring and supervision is limited. Many forms of market failure—for example, the 'spillover' problems generated by nuclear power generation and the disposal of nuclear wastes—call for centralized, specialized, technically knowledgeable administration of controls.[84]

In the absence of regulation, the unevenness of access to the judicial forum (because not all members of society can afford a good lawyer) and the uncertainty of result would likely cause producers to take less reasonable and prudent care to avoid injury to workers or consumers. Producers' absolute exposure would be less than the total injuries suffered, unless of course, punitive damages ran wild. Moreover, society pays for injuries indirectly in, for example, subsidies to hospitals, and risk pooling insurance cross-subsidies. Cancer hospitals are full of patients who have no contribution from, or actual knowledge of, the producers who injured them.

C. Artificial Markets

Among the more imaginative modern approaches which the government has adopted to arrest the problem of externalities is the creation of artificial markets. For example, giving polluters freely transferable discharge permits allows the creation of a market for such permits so that pollution opportunities flow, so to speak, to their highest valued use. Similarly, under the 1977 Clean Air Amendments, new sources are required to "offset" existing emissions in the area before they are allowed to produce new pollution. Polluters, therefore, have an incentive to purchase existing polluting facilities, and shut them down, or to donate pollution abatement equipment to such facilities.[85] Similarly, the "bubble" concept treats an area as a single pollution source, requiring that aggregate pollution from multiple sources within the "bubble" not rise above designated ceilings.[86]

---

84. S. BREYER & R. STEWART, ADMINISTRATIVE LAW & REGULATORY POLICY 15 n.11 (1985).

85. *See* Comment, *Emission-Offset Banking: Accommodating Industrial Growth with Air-Quality Standards,* 128 U. PA. L. REV. 937 (1980).

86. *See* Stathos and Treitman, *Using Private Market Incentives for Air Cleanup,* PUB. UTIL. FORT., July 30, 1981, at 13. *See also* J. LAITOS, *supra* note 80, at 117.

In 1987, the Department of Transportation created an artificial market in "landing slots" at our nation's four slot constrained airports—Chicago O'Hare, Washington National, New York Laguardia, and New York Kennedy. Today, airlines may freely buy and sell landing and takeoff slots at these airports.[87] Thus, while establishing overall ceilings on congestion for purposes of safety and environmental regulation, the DOT has turned over to the market the decision of which airline shall serve the airport.

VII. CONCLUSION

This is an era of crisis for the regulatory agencies. During the past decade, federal deregulation and preemption have significantly changed the legal environment. Similarly, techological change has had a profound impact on the economic environment. As a consequence, we must reassess the social and economic goals we wish regulation to accomplish, and here we begin nearly from a clean slate. We must also devise the least obtrusive means to accomplish those newly identified goals.

The national direction during the past decade has been away from regulation. But it was not always so. During the 1930s and 1940s, the economic collapse of the Great Depression followed by a foreign military attack at Pearl Harbor and World War II, caused Americans to turn to government to save the economy and save freedom. That generation viewed government as a great friend whose vast power could be put to public good.

But during the 1960s and 1970s, disillusionment with government swept across the nation. The left was appalled by the war in Viet Nam and Watergate. The right was dissatisfied with the Great Society, the tremendous growth in social spending, bureaucratic red tape, and high taxes. The national mass psychology became one of hostility to government. Government had become the enemy.

Just as 18th century mercantilism gave birth to *laissez faire,* and 19th century *laissez faire* gave birth to economic regulation, and 20th century regulation gave birth to deregulation, undoubtedly deregulation will lead to 21st century reregulation. As surely as the pendulum of American public policy swings, a nation which fails to learn from its history is doomed to repeat it.[88] Our nation has a terribly short memory.

It seems that idealistic faith in *laissez faire* as the perfect solution for a complex society's problems runs the risk of jeopardizing its success in creating the economies and efficiencies which flow from healthy competition. By zealously taking the nation down the path of no government, deregulation's proponents have created enormous dislocations, and a perception

---

87. *See* Hardaway, *The FAA "Buy-Sell" Slot Rule: Airline Deregulation at the Crossroads,* 52 J. AIR L. & COM. 1 (1986).

88. *See* Dempsey, *The Rise and Fall of the Civil Aeronautics Board—Opening Wide the Floodgates of Entry,* 11 TRANSP. L.J. 91, 173 (1979); Dempsey, *Transportation Deregulation—On a Collision Course?,* 13 TRANSP. L.J. 329, 331 (1984).

that the wealthy are its principal beneficiaries. The people will demand more protection from their government than they are now getting, and they will pull the pendulum away from full scale *laissez faire* toward a populist sharing of economic opportunity.

The real choice is not between no government and all government. It is simply a question of how much, and of what kind. In its darkest days, regulation's heavy hand had a debilitating impact on the economy. If instead of the heavy hand of regulation, we could achieve a delicate touch of enlightened public policy, we might have the best of both worlds: the economies and efficiencies of competitive capitalism, and the protection of public interest values beyond allocative efficiency. Can we find a prudent middle ground between excessive regulation and excessive *laissez faire?*

It is this careful adjustment of the appropriate level of government vis-à-vis the market that poses the most challenging opportunity for creative minds during the next decade. We must decide what we want government to do, and devise carefully tailored mechanisms to accomplish those public policy objectives. Government need not be the enemy. If properly harnessed, government can be a great friend, one who inspires us to do more for the common good.