PROPHETS
OF REGULATION

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CHAPTER 8

Regulation Reconsidered

If this were a book of pictures rather than words, it would contain three different types of photographs. The biographical sections on Adams, Brandeis, Landis, and Kahn would be detailed closeup portraits, each showing a single strategist who succeeded or failed in making regulation work. The short connecting chapters would appear as medium-range photographs depicting a regional or national landscape that was undergoing slow but significant change, such as the change through the seasons from spring to winter. Now, in this final section of the book, I want to add a third perspective: a satellite photograph of the broad regulatory scene, expressed in a few general conclusions about the history of regulation. Most of these have been foreshadowed earlier in the book; others make explicit what has so far been only implied. I bring them together here to form a brief panoramic commentary on the significance of the regulatory experience in America.

As the historical record shows, the regulatory tradition has been adapted to many different ends and purposes. Regulation has served as a versatile tool whose handle has been seized at different times by reformers, business managers, bureaucrats, and lawyers—and manipulated as often for the particular interests of one of these special groups as for the general interest of the American public.

Over time, regulation has performed not only economic tasks but political, legal, and cultural ones as well. Among the many particular functions that regulation has been used to serve are the functions of:

(a) disclosure and publicity (SEC, Adams' sunshine commission);
(b) protection and cartelization of industries (ICC, FCC, CAB before Kahn);
(c) containment of monopoly and oligopoly (FPC, FTC, Antitrust Division, state utility commissions);
(d) promotion of safety for consumers and workers (Consumer Product Safety Commission, Occupational Safety and Health Administration);
(e) legitimization of the capitalist order (SEC, Environmental Protection Agency).

Obviously such a list could be longer or differently stated. The general point is that regulation has served a variety of purposes, some of which (such as items b and c above) have been mutually inconsistent.

In view of these diverse and sometimes contradictory functions, all overarching theories and heroic generalizations about "Regulation" (with a capital R) run an extremely high risk of being in error. No single theory from any academic discipline can predict precisely which industries will be regulated and which will not. Some industries that in other market economies tend toward cartelization are, in America, regulated—but not all. Some regulated industries in America have social-overhead functions and are "affected with a public interest"—but not all. Some are "natural monopolies," with sharply declining costs to scale—but not all. Much of the American transportation industry is regulated—but not all of it.

Like the application of regulation to industries, the behavior of regulatory commissions, once they have been created, shows no clear single pattern. All agencies do not follow a standard "life cycle," for example, going from youthful exuberance to middle age, then finally to geriatric decrepitude. Instead, young agencies sometimes behave sluggishly (as did the early FTC) and old ones vigorously (the CAB under Alfred Kahn). No stage-by-stage evolution, nor any other assured expectation of agency behavior, can be predicted on the basis of actual regulatory history.

The single constant in the American experience with regulation has been controversy. Here the reason why is not hard to find. Many of the diverse functions assigned to regulatory commissions were regarded by legislatures as essential tasks, but very difficult for existing governmental institutions to perform. Because legisla-
tors did not wish to burden themselves with such duties, they passed the responsibility to specialized agencies. But whatever agency received the assignment was also forced to accept the intrinsic controversy that had created each task in the first place. Almost by definition, therefore, controversy became attached to regulation like a Siamese twin. For the same reason, issues common to regulatory agencies are unlikely ever to be settled, once and for all, so long as the United States remains an open, democratic society.

As in so many other aspects of American politics, the fundamental controversy underlying the history of regulation has been an ongoing need to work out the inevitable tradeoffs between the good of the whole society, on the one hand, and the rights of the individual, on the other. In regulation, these tradeoffs have appeared most clearly as ways of relieving the persistent tension between the forces seeking to implement economic efficiency for the broad benefit of American society, and those dedicated to guaranteeing the observance of legal due process for every individual member of that society. At different times in our history, each party to these fundamental tensions has established a clear advantage over the other. On balance, however, it seems clear that the concern about legal process has controlled the outcome of regulation more often than has the concern about the substance of economic efficiency. In lawyers' language, this means that the concern for equity has generally triumphed over the quest for efficiency. In lawyers' terms, it means that in regulation the judicial model has usually triumphed over the legislative and administrative model. In cultural terms, it means that the concern for fairness and for the protection of the diverse interests of all affected individuals has most often won out over the concern for overall growth in the national economy. More generally in political terms, it means that regulation is best understood as a political settlement, undertaken in an effort to keep peace within the polity.

Overall, the conclusion appears inescapable that regulation in America has more often functioned as a protective device rather than as a promotional or developmental one. Of course, protection was not always inappropriate. By holding in check socially destructive forms of behavior, protective regulation often cushioned the impact of rapid industrial change. In America, in contrast to older societies, so many other forces consistently acted to promote pell-mell economic growth that regulation can hardly be condemned for not always doing so.

Because the appropriate balance between economic efficiency and legal due process has seldom been self-evident, individual persons and particular ideas have mattered a great deal in regulatory history. Thus, most of this book has explored the roles of particular persons, and I rest that part of my case on the biographies of Adams, Brandeis, Landis, and Kahn. The more general role of ideas in the history of regulation, however, deserves some additional comment. As the political scientist James Q. Wilson has written, "We must be struck at every turn by the importance of ideas. Regulation itself is such an idea; deregulation is another . . . To the extent [that] an agency can choose, its choices will be importantly shaped by what its executives learned in college a decade or two earlier."

Ideas about regulation, as Wilson implies, vary with time. During the 1930s, national policymakers generally held the powerful conviction that market mechanisms left to themselves would produce widespread injustice and even inefficiency. Hence they believed that an active federal government was essential for the protection of the public interest. So these political activists created a broad portfolio of new, independent agencies: the SEC, the FCC, the CAB, and so on. A few decades later, during the 1960s and 1970s, a new generation of policymakers embraced a very different idea. Rather than applauding the old activism, they became convinced that many of the independent commissions created during the 1930s had since been captured by the very interests that these agencies had been set up to regulate.

Partly as a result of the capture idea, there arose during the 1960s a curious two-pronged reform movement: pointing, on the one hand, toward deregulation and, on the other, toward a new wave of large-scale social and environmental regulation. These new rules were to be enforced not by independent commissions of the 1930s variety, which usually administered brief general statutes designed to give broad discretion to a group of commissioners acting collegially; but rather by an entirely different type of agency, with a single executive at its head (who could be held individually responsible for success or failure) and an agenda set in advance by the explicit provisions of extremely detailed legislation. New laws such as the Clean Air Act and the Occupational Safety
and Health Act, often running to scores of pages in length, were calculated to minimize administrative discretion and to close all possible loopholes. Meanwhile, on the other prong, the deregulation movement—whose basic intellectual premise was that economic markets do work well—also advanced, simultaneously but contradictorily, gaining momentum alongside the companion movement toward growth of regulation in the areas of social and environmental policy.

The result, by the 1980s, presented a most peculiar spectacle. In an ironic historical example of the ways in which ideas can move policymakers in opposite directions, significant deregulation had been instituted for such industries as airlines, trucking, railroads, financial markets, and telecommunications. At the same time, additional social and environmental regulation had become firmly embedded in the structure of state and federal government in such a form as to make any capture by regulated interests very difficult, if not impossible.

The movement of ideas alone, of course, had not produced this ironic result. Despite the power of thought in the history of regulation, ideas in themselves could not determine concrete outcomes. Instead, ideas had to interact with particular economic and political circumstances to form a reciprocal relationship in which one or both might be altered. Nor, in any absolute sense, did the ideas themselves have to be demonstrably true in order to exert strong influence. We have seen, for instance, how Louis Brandeis’ flawed idea of competition moved the hearts of his contemporaries. To cite a second example, the disparate sets of ideas underlying the initial imposition of regulation in airlines and trucking during the 1930s, and the later deregulation of these same industries in the 1970s and 1980s, could not both have been correct, in the absolute sense. Yet both sets of ideas became institutionalized. What had changed was the historical context in which opposing ideas about the legitimacy and actual performance of economic markets were defined.

During the 1930s, a period not only of depression but also of economic deflation, policymakers searched for some way to stabilize prices, as a means of preventing further economic decline. By the 1970s, however, deflation no longer provided the historical filter; indeed, it had become almost inconceivable as a problem for policy to solve. Instead, inflation was now the pressing issue, and thus the same protectionist regulations that had been applied in the 1930s to combat deflation now seemed inappropriate to the new economic context. Both ideas remained alive, but a different time meant a different choice for public policy. To state the same point in a more general sense, it is clear that in American history both the producer-oriented protectionist tradition, on the one hand, and the consumer-oriented antitrust tradition on the other have remained hostage to immediate economic conditions. The strengths of each tradition have ebbed and flowed in response to several external forces: the business cycle, the different degrees of maturity reached by different product markets, and the conditions of international war and peace.

In speculating about the future, it is difficult to foresee with much additional precision what new historical contexts for regulation might develop. But if the past is any guide, a good deal of caution is in order. What I have called in this book the “economist’s hour” of the 1970s and 1980s, for example, represents a phenomenon of unpredictable duration. Certainly the economist’s hour in the history of regulation came relatively late, long after other notably different hours during which the muckraker and the lawyer alternately held center stage. This history makes it seem unlikely that any single approach to regulation will ever triumph. Therefore, although we may live in the golden years of regulatory economics and its practitioners, we should be in no hurry to crown the economist as permanent king of the regulatory hill.

Economic analysis, however, will always remain directly relevant to regulatory policy. This is true because every industry, whether regulated or not, does possess a certain underlying economic structure: characteristics that make it different from other industries and that help to shape the internal conditions for regulatory opportunities and constraints. More than any other single factor, this underlying structure of the particular industry being regulated has defined the context in which regulatory agencies have operated. Sometimes the differences between industry structures can be radical: the railroad industry, with its huge fixed costs and enormous scale economies, could hardly differ more fundamentally from the securities industry, with its paper assets and labor-intensive structure. In other cases the differences can be more subtle, as in the contrast between center and peripheral firms, and the related distinction between tight and loose forms of horizontal combination.

Because the underlying characteristics of the industry so often
shape the limits of governmental action, the industry may be regarded as the dog, the regulatory agency only as the tail. Yet many students of regulation have assumed that tails wag dogs and, further, that one standard type of tail can wag whatever breed of dog may be attached. Such observers, by focusing primarily on the similarities of regulatory commissions (most of which were bipartisan, appointed by the executive, expert in their fields, and so on), have missed a larger truth: the industries that these similarly-structured commissions regulated were extremely diverse. Thus these observers have duplicated the errors made historically by many regulators themselves, who often paid more attention to legal processes and administrative procedures than to the greater task of framing strategies appropriate to the particular industries they were regulating. For all parties who seek to understand regulation, the most important single consideration is the appropriateness of the regulatory strategy to the industry involved.3

The process of fitting regulatory strategies to particular industries is a difficult task, partly because industrial structures, like regulatory ideas, can change over time. The railroad industry represented a true natural monopoly when the Interstate Commerce Commission first emerged to regulate it during the 1880s. But several decades later, this natural monopoly status of railroads had disappeared before the rise of alternative modes of transportation—the automobile, truck, and airplane. Clearly, by the 1930s, some central assumptions behind the whole scheme of national railroad regulation needed to be revised, and regulatory policy adjusted accordingly. Yet until the 1970s little was done, as assumptions remained those of the 1880s. In the meantime, the Interstate Commerce Commission kept rates inflexible, prevented industry rationalization by blocking truck-rail mergers, and delayed for years the widespread application of unit-train technology. The ICC took so much time to recognize the revolutionary changes in the transportation industries that regulatory policy lagged badly behind market reality, causing unintended injury to the very railroad industry the commission was trying to protect.

Elsewhere, a similar process of unacknowledged change occurred in the communications industries. When Congress created the Federal Communications Commission in 1934, legislators acted on an assumption, valid at the time, that the electromagnetic spectrum (what physicists used to call the "ether") was finite. The lawmakers reasoned that if too many stations used the ether at once, radio signals would become garbled and communication would be impossible. Thus competitors had to be limited in number, through regulatory allocation of different parts of the spectrum to different broadcasting stations. Later on, however, new technology completely altered the situation. Through the use of satellite communications and dish receivers, community television companies in effect created vast new amounts of ether, thereby accommodating dozens of additional broadcast stations. When that occurred, the market power of the three major television networks diminished rapidly, and television broadcasting as an industry began to drift away from center status and toward peripheral.

To cite still another example, a situation of natural monopoly prevailed for many years in long-distance telephoning, based on the once-valid principle that a single set of transcontinental wires could most economically serve consumers' needs. But in the 1960s and 1970s, a technological revolution in microwave communication destroyed that premise and ended the natural monopoly in long-distance telephoning. As the significance of this technological shift became clear, new companies emerged to compete for long-distance telephone business, and just as quickly a movement to deregulate the telephone industry began. By 1984, the giant Bell System, once the most conspicuous natural monopoly in America, had divided itself into a number of much smaller companies. What had been a thoroughly center industry (telephoning) now became part center (local telephone service, heavy equipment manufacturing) and part peripheral (long-distance service, high-technology research and development, and light manufacturing). As a result of these seismic changes in industry structure, the regulation of telecommunications became during the 1980s one of the most publicized and controversial problems of state and federal government.4

For scholars, the evolution of both the telephone industry and television broadcasting provided outstanding examples of the protean nature of industrial organization. Not since the early emergence of center firms out of the advanced production technology of the late nineteenth century had there appeared such clear instances of the relationship between scientific change and subsequent shifts in the structure of existing industries. Traditionally,
such shifts had been from peripheral to center status, but the communications revolution showed how the movement could work in the opposite direction as well. The implications for regulators were profound, and the task of framing effective regulatory strategies, always one of the most difficult of governmental arts, became in these industries still more challenging.

In thinking about the future of regulation, whether in broadcasting, telephones, or any other industry, it is important to keep in mind the ambiguous record of the past. Even though much of regulatory history is tinged with apparent failure, regulation cannot properly be said either to have "failed" or "succeeded" in an overall historical sense. Instead, individual regulatory experiments and episodes must be judged against a standard true to the particular historical moment. Many observers hold a contrary view and insist on a single overriding verdict of failure. Because of this prevailing opinion in our time, it becomes useful to speculate about ways in which the same judgment might be applied to other parts of government. Can it be said with equal justice, for example, that legislation in general has failed historically, or that the court system has failed, or that the office of the presidency has failed—without specifying exactly which legislation, which court on what case, and which president on what issue? Although the answer might seem self-evident, the fact remains that in popular perceptions over the last three decades regulation has been regarded as a synonym for failure. Even in some of the best scholarship on regulation, failure has often been applied not merely as a conclusion but also as a premise, a tacit assumption hidden behind apparently scholarly explanations presented in theoretical forms: the theories of capture, of public choice, of taxation by regulation, and several others.⁶

To weigh against these multiple theories premised on failure, we have only one premised on success. But it is a very useful one: the theory of "public use of private interest." According to this idea, regulators should always exploit the natural incentives of regulated interests to serve particular goals that the regulators themselves have carefully defined in advance.⁶ And, in fact, the historical record suggests that regulation in America has succeeded best when it has respected these incentives instead of ignoring them; when it has based its strategies less on some idealized vision of what the economy should do and more on a clear understanding of what the economy actually is doing. Regulatory strategies framed in ignorance or disregard of real economic conditions and market incentives—and the number of such attempts has been legion—have usually led only to unfortunate results. By contrast, strategies framed with these conditions and incentives in mind have often produced strikingly successful outcomes, as the stories of Adams, Landis, and Kahn demonstrate so clearly.