The Changing Pattern of Utility Regulations.

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THE CHANGING PATTERN OF UTILITY REGULATION

A Dissertation

Submitted to the Graduate Faculty of the Louisiana State University and Agricultural and Mechanical College in partial fulfillment of the requirements for the degree of Doctor of Philosophy in

The Department of Economics

by

Howard Ross Smith
B. S., Simpson College, 1938
M. A., Louisiana State University, 1940
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To Victor Julian Sutker, who was a constant source of inspiration in the preparation of this work, but who did not live to see its completion: To Dr. H.L. McCracken and Dr. S.W. Preston, who guided the development of the thinking herein—the writer wishes to offer his sincerest gratitude.
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ABSTRACT

The purpose of this dissertation is to present the sources and nature of the changes that have taken place and are taking place in the relationship between government and business in America; and to consider these changes in a setting consisting of social, legal, and political aspects in addition to the economic aspects providing the principal orientation.

To accomplish this end an analysis of regulation in three distinct parts was undertaken. First, the integration of regulation in its original form was presented in terms of the social philosophy of individualism. Second, the environmental changes affecting the internal consistency of the original integration was analyzed. Finally, the pattern of regulation that emerged from this evolution within the environment was discussed. This pattern of control was then related back to the principles of individualism to uncover and measure the elements of contradiction and conflict implicit in the new configuration.

One of the primary types of data used in the study consisted of court decisions, particularly decisions of the Supreme Court of the United States. This data was selected because emphasis upon constitutional procedure in the United States has placed upon the courts the final responsibility for consistency in social processes. Another important source utilized consisted of previously published works in the field of social control, particularly public utility regulation.

Although much writing has been done on the subject of regulation the present analysis goes beyond this writing in one important respect. The emphasis here is upon the social underpinning not only of the original
pattern of control but of the changes that have been instituted in that pattern. In consequence the legislative conflict that accompanies specific alterations in the regulatory adjustment becomes much more than a simple clash of interests. Rather this conflict is indicative of an ideological clash with each interest emphasizing one aspect of the philosophy of individualism to the exclusion of other aspects. The dissertation itself isolates the major interests in the struggle and relates each to the underlying social philosophy.

Individualism as a social principle requires both freedom of choice and equality of opportunity as its two limiting dimensions. In the extreme form these two dimensions would be identical. On the basis of this identity government regulation was not presumed to be necessary at the time the Constitution was written. In economic terms the spontaneous operation of competition was to maintain identity between freedom and equality. Competition was to operate according to the principle of opportunity cost, which principle depended in turn upon complete economic elasticity.

As the economy developed, the degree of elasticity postulated was not fully attained. As a consequence the two dimensions of philosophy tended to separate. To restore equilibrium, a measure of government control was instituted.

This original pattern of control was predicated primarily upon an industry classification. Into one category was placed businesses in which inelasticities had appeared. Since inequality existed in the operation of these businesses to the extent of the inelasticity, regulation was
allowed as an offset to inequality by eliminating monopoly and discriminatory behavior. Businesses other than these public utilities were placed in a residual category and were not formally regulated.

Although regulation was instituted for utilities limits were placed upon its operation. For the same reason that the regulation itself was dictated by the philosophy, the limits to regulation were also fashioned by the philosophy. To prevent control from resulting in a greater loss in freedom than gain in equality the concept of 'fair return on a fair value' was adopted as the principal tool for assuring to regulated industries residual rights equal to those enjoyed by non-regulated industries. This tool, it will be noted, was simply the adoption by government of the competitive principle of opportunity costs.

Even while this adjustment to the regulatory problem was being developed by the courts the changes in the economy that had made it necessary were intensifying. These changes consisted of an increasing inelasticity of physical capital and an increasingly elastic market for claims upon income. The incidence of these developments upon the philosophy of individualism was a growing area of inequality and a greater difficulty of restoring equilibrium through regulation.

Had these changes in the environment been the only forces influencing control patterns an adjustment in regulation could probably have been made. But the required degree of control if applied only to utilities would have violated the principle of equal residual rights, while if extended to all businesses it would have violated the competitive
principle of opportunity costs. In opposition to these potential inconsistencies the interests of freedom began to organize themselves against extremes in control. Thus the interests attaching to the respective dimensions of individualism came to be arrayed against one another in the process of setting precise metes and bounds of regulation.

The result of this ideological clash was essentially a compromise in which regulation was extended to non-utilities and stopped short of the extreme for utilities. In this way regulation endeavored to avoid inconsistency in its operation by failing to make the economic environment entirely consistent with the philosophy. As a result of this compromise the economy was neither free nor equal, although containing as high a degree of each as could be made compatible with the existing degree of the other.

Continued development of the forces at work in this sphere of social relationships required a further evolution of control. The direction being taken by this evolution at present is the partial abandonment of the competitive norm and the substitution of norms determined by the group exerting the greatest amount of power. These norms represent a phase of the underlying philosophy disproportionately emphasized. To this extent control has lost its society-wide basis and political maneuvering is substituted for debate of principle, although limits to political activity are still set by underlying philosophy.

This newest development in the evolution of regulation in America — a degree of control through power norms — constitutes a real
threat to community solidarity. Whether or not social crisis will result from loss in solidarity can not be determined in the course of a single dissertation. The test, however, will be whether or not current conflict between the forces of freedom and the forces of equality can in time be minimized through a discovery of a larger area of common ground.
INTRODUCTION

Part 1: The Problem and its Setting

Public utility regulation in America has, in the past two decades, been subjected to an increasingly severe criticism by two distinct groups of people. There are first those persons who would like to see, and strive to justify, a substantially lesser degree of control than is presently exercised. A second group takes the position that regulation errs in the direction of liberality rather than strictness, and advances numerous reasons for extending controls.

If either or both of these groups were obviously and demonstrably wrong in outlook this difference of viewpoint would be scarcely worthy of comment. But both groups are able to marshall to their support strong forces and convincing arguments. As a consequence the actual course of regulation is a compromise wholly satisfactory to neither extreme.

In a relatively well knit society such as the United States, where a common heritage and a common background are taken for granted, it is important to try to understand the source and the consequences of such a vast compromise. It is the purpose of this dissertation to make a beginning toward such an understanding.

Compromise in utility control falls conveniently into two parts—control over the rate level and control over the rate structure. Control over the rate level has, since just prior to 1900, been formally constructed around 'fair return on a fair value.' Yet today this dual concept term is little if any nearer to precise definition that it was when originally set forth by the Supreme Court. Actually it seems to have been used more to carve out the current compromise than to add precision to control principles.
Fair return has been made a more or less inactive partner in regulation, while fair value has almost officially been defined as historical cost or reproduction cost whichever is the higher. Among the federal commissions there is some indication of a trend toward a more exclusive use of historical cost. But even if this were to occur the evidence indicates that fair return will simply be substituted for fair value as the compromise tool in regulation. The consistency with which the Court recognizes the existence of a zone of reasonableness is ample indication of this probability.

In connection with the rate structure as well as in connection with the rate level compromise has had an important place. A dual approach to utility rate structure is frankly implicit in the cost-of-service and value-of-service technique customarily used by courts and commissions. The inevitable degree of arbitrariness inherent in the allocation of overhead, and the practice of intermittent exercise of control further demonstrate the existence of this area for compromise.

Perhaps even more important, however, than the existence of two significant areas of compromise is the fact that these areas themselves are consistently held to a range that is well within the limits of tolerance, even though the resulting adjustment is not entirely satisfactory to any single group. Both the compromise itself and the limits to compromise therefore, must be considered as parallel phenomena in an analysis of regulation in America. In consequence, the subject matter of this work will be the structure and concrete nature of the pattern originally intended for regulation, the environmental forces requiring an adjustment of this pattern, and the compromise that evolved from the adjustment.
Although the above statements suggest the contrary, this work is not intended as a dissertation on society. Nevertheless the concept of society is implicit — and on occasion extensively explicit — throughout. This concept, it is felt, must be at the base of all social study rather than be reserved for use in the field of sociology. Scientists must be doubly careful in today's specialised community that understanding does not become so particularised that interchange is impossible. Only through and for communication is education an instrument of social good. As Professor Parsons aptly states: "The empirical scholar will follow his problems wherever they may lead and refuse to be deterred by any signs which read 'Foreign Territory'."

Thus the reader will find in the ensuing pages analysis that is more usually found in studies devoted to other subjects than economics. Some of the analysis in these associated fields will unquestionably demonstrate to experts the lack of formal training of the writer. It is hoped, however, that such demonstration will not be taken to prove that this attempt at correlation should not have been made. Overlapping studies today are vitally necessary. If scientists in the various social studies, rather than automatically label 'unclean' the work of the outsider, will be critical and cooperative the communication of knowledge can proceed equally with the acquisition of knowledge.

The social problem to be understood in the present instance is the control of industry. This is not to suggest that this problem is widely misunderstood today. A number of able treatises are available presenting social, legal, or economic aspects of the subject. Likewise there are works that have built a foundation for a combination treatment. Outstanding

among these are *Legal Foundations of Capitalism* by John R. Commons, where the economic and the legal are analyzed in combination; *Ideology and Utopia* by Karl Mannheim, where the social and the economic in control are ably blended; and *De la Division du Travail Social* by Emile Durkheim who dealt with the social and the legal in modern life. But the few who have contributed real breadth to the field of social control are only a beginning. Many more must follow in their footsteps in order that this most significant phase of modern life may be brought within the grasp of a much wider group within the electorate.

The present work will attempt to build a little higher the foundation thus far laid. Here three phases of regulation — the social, the legal, and the economic — will be brought into close juxtaposition in terms of American economic life. Admittedly most of the gain in breadth may be lost in depth. Space limitations alone would dictate this result if inadequacy of training did not. Particularly will this be true of the chapters discussing social and legal phenomena. For that reason these subjects are presented in outline form only, and at the beginning. The latter part of the work contains a detailed examination of some of the economic implications of the concepts developed in the first part. If, then, students in the fields treated in outline form care to use the respective outlines as points of departure for additional depth a composite body of consistent theory will be developed. Thus, despite the loss in depth and detail, the writer is earnestly convinced of the usefulness of broad analysis.


3 Translated by O. Simpson under the title *The Division of Labor in Society*, originally published in 1893.
Because of the difficulty of thoroughly integrating this particular type of exposition in the course of detailed presentation, and in order to provide the reader with a basis for perspective, the core of the argument to follow will be summarized here. This summary will also serve to sketch the plan to be used in developing the subject.

The thing that distinguishes a society from a mere collection of individuals is a 'feeling of togetherness'; a common set of ends; a common culture; in short a basic and fundamental agreement as to the foundation of life together — in association. This agreement will here be referred to as community, and will be developed as the prime social force holding compromise in the group within tolerable limits. Because of community men are willing to compromise marginal desires as long as the basic ends of life are common.

But men do not always agree in detail upon ways and means. In every group there is an element of disagreement. Differences arise as to certain of the goals of existence or the means of attaining goals agreed upon. As these differences take on sufficient importance to stimulate conflict a struggle arises between men of opposing active attitudes. Granted a sufficient amount of community to make compromise possible it is precisely this disagreement that produces the areas for compromise referred to in connection with public utility regulation. In fact the degree of community that exists can quite accurately be measured by the size of this area of compromise in inverse ratio.

To protect and foster the twin ideals of equality of opportunity and freedom from coercion, society in America organized itself into a government. When this government was first faced with the problem of regulating business it was necessary to devise an approach to this problem whereby a degree of
restraint could be placed upon industry without violating basic community purposes. The principal tool with which this was done was an industry classification promulgated and made as consistent as possible by the Supreme Court. Into one class was placed the so-called public utilities. These businesses were those found in a position of power exceeding that of individuals related to them in the economy. As a consequence it was agreed that these businesses could be restrained in their relationships with the public at large. In this way the public was strengthened by social organization until it was equal in power to the businesses regulated. Into a second and residual class was placed all other businesses. These last could not be restrained (except as to incidental matters only) since they represented no threat to equality as unrestrained.

With regulation, of course, came the danger that the public would be strengthened beyond the point of equality with the enterprise regulated. To avoid this the Supreme Court devised the tool of 'fair return on a fair value.' Thus, although restrained, utilities must be allowed an operating net result equivalent to what they would enjoy if not restrained and not in a position of unequal power. In short, a regulated concern could not be confiscated.

Within the framework set by these tools detailed regulation has evolved. Accounting regulation, control of security issues etc. as well as control over rate structures and rate levels have developed to aid society in measuring and devising offsets to excess power within the community. For without means with which to measure power and devices with which to combat power social ideals might become gradually though severely diluted.

Throughout the process of refining these tools, however, industry itself evolved into a set of relationships from which it became increasingly difficult
to follow through the classification demanded. Thus the growth of intricate interrelationship throughout modern capitalism, the growth of overhead as an industry problem with the consequent difficulty of non-arbitrary pricing, and the apparently increasing threat of cyclical fluctuation to business stability have together made the earlier clear-cut distinctions between businesses less distinct. The economic concept that describes this development is economic rent, which, although at one time properly identified with the utilities for purposes of regulation, is today such an integral factor in many business that the segregation of utilities has become less realistic.

In one other major way industry has evolved in such a manner as to render less realistic the pattern of regulation as originally promulgated. This evolution has been in the property concept. As the definition of property shifted from an emphasis upon use value to an emphasis upon exchange value, the significance of the strictures against confiscation in protecting utilities lessened in importance. For with the emphasis upon exchange value, property became associated with expectations, and it became impossible to correct a past injustice without cutting across expectations in a way injurious to owners. Although this is not defined as confiscation in the regulatory pattern of today it does interfere with free choice, and is, therefore, in an ideological sense, confiscation. This development in business-government relationships has been treated in terms of the financial concept of capitalization.

Regulation has moved to meet this evolution in two ways. In the first place, non-utilities have come in for a considerable amount of control; and in the second place, utility control has stopped far short of the extreme that would have resulted had the original classification remained
substantially intact. Non-utilities have been subjected to regulation designed to enforce competition, stabilize employment, and improve working conditions. Utility control has been modified in that fair value and fair return have not been precisely defined, in that a 'zone of reasonableness' has been allowed by the courts, and in that value of service and cost of service have both been given weight in pricing. The detailed discussion following does not treat all phases of this process exhaustively, or even equally. Attention is centered primarily upon public utility aspects, presenting these in sufficient detail to enable the reader to visualize better the basic processes involved.

The significance of this evolution in regulation in America is the development of a basic conflict between two segments of society. On the one side stand the proponents of equality insisting that the tools of power held by enterprise be still further circumscribed. On the other side stand the proponents of freedom insisting that only with freedom can American ideals be fully realized. One aspect of this conflict, or course, consists of a rationalization of two sides of the status quo. The other and potentially most important aspect is a noticeable rift in community occasioned by a process of redefinition of our ideological concepts -- freedom and equality. This rift provides at one and the same time a basis for compromise in public utility regulation and establishes a better foundation for a degree of insight into future developments.

Part 2: Social Philosophy in America

There seems to be substantial agreement today on the proposition that American social philosophy has been largely identified with the word
liberalism. Although this concept is by no means self-defining the following statements summarize the substance of what is typically understood by the term. "The root of liberalism, in a word, is hatred of compulsion, for liberalism has the respect for the individual and his conscience and reason which the employment of coercion necessarily destroys." "Liberalism is the belief that society can safely be founded on this self-directing power of personality, that it is only on this foundation that a true community can be built." In short liberalism is basically identified with individualism.

Before attempting to describe individualism in terms of the structure of social control in America it is desirable to briefly sketch out the framework of the broader philosophy of which individualism is a part. This broader philosophy — materialism — was set forth by a series of English philosophers of whom the most influential upon the development of American concepts was John Locke.

The materialism of Locke begins with the science of knowledge. All knowledge arises from experience. This must be true because, he claims, the mind at birth is a blank page. Whatever it becomes later must therefore be attributed to what happens after birth, or experience. It follows from this that an individual is conscious of and impressed by only those things that appeal to the five senses. From an economic point of view this

1 Myers, Gustavus, The History of American Idealism. (Boni and Liveright, New York, 1925.) Liberalism is used here in the broad social sense rather than the narrow political sense.


3 Hobhouse, L.T., Liberalism, quoted loc.cit.
necessitated an industrial organization predicated upon the creation of
material things, and, what is even more significant, a social organization
coeextensive with industrial organization. Locke's defense of the state
largely centers around the duty to protect private property, and he is
most emphatic in his belief that the church should be excluded from
organized intercourse.

This presentation should at once make clear that laissez-faire in
the economic sphere was no small part of total materialism. Since an
individual has few if any wants that are not material, the economic machine
becomes all-important. Since no one can know anything he has not himself
experienced, every individual must be his own judge in both production and
consumption. Finally, since society is additive of persons rather than
multiplicative, an individual working for himself (sensual satisfaction)
signified the noblest work of God.

The specific attempt in theory to integrate these concepts was the
creation of a competitive society. The core of this creation is quite

1 For a much fuller discussion of the philosophical implications
of materialism see Windleband, W., A History of Philosophy. (The Macmillan

2 Larkin, Paschal, Property in the Eighteenth Century. (Longmans,
Green and Company, New York, 1930.)

3 This does not follow strictly from philosophic materialism,
but it came early and stayed late as economic interpretation of materialism.

4 Ricardo, David, Principles of Political Economy. Classical
economics, of course, is nowhere as extreme as the above would indicate.
familiar to all economists and to many others. Repetition, therefore, need not detain us long, but cohesion necessitates giving some attention to the outer workings of competition. In essence a competitive society assumes that an individual will work only for himself (individualism), and will be interested in maximum satisfaction of wants (materialism). Therefore he will put himself and his property to work at that task that will be most productive (individualism - materialism). The individual being the only one who can judge his own potentialities (individualism), only he can properly allocate his services or those of his property (laissez-faire). If someone else happens to be doing a job that an individual believes he can do better, competition is permitted even though the inferior is ousted thereby (laissez-faire).

As an essential result of this type of society the following pattern of resource-allocation was expected and desired. Every factor of production, and every unit of every factor of production, would be placed in the most productive position. In consequence no unit of productive capacity would be able to better itself by moving to displace some other unit. Every firm would be operating at lowest average cost, and selling price and average cost would be identical. All factors would receive their marginal product, and no amount of bargaining could bring them more. It follows that every productive act would add to the well-being of its sponsor. Since this sponsor
would be also a wise consumer, it would add equally to total social enjoyment. Every individual act, thus, would contribute identically to individual and to social betterment.

The term 'social betterment', however, is relative. Entirely apart from the metaphysical problem of the existence of absolute values it is still true that even the broadest social motivations appear only in a setting that makes them really motivations rather than merely abstract concepts. In the above description the analysis has not concretely set forth such a setting. Rather it has made a complete circle. Starting with the ideal of individualism as the motivating force behind social action and social relationships, there was derived a resultant social good that must in turn be defined in conjunction with a definition of the ideal.

The usefulness of this circular approach to individualism is to emphasize that social philosophy is both cause and effect. If it is not both — if it does not perpetuate as effect the conditions through which it is a cause — an inconsistency arises with consequent social dissatisfaction and change. The problem that must next be resolved is that of sketching in theory the content of individualism in such a way as to make it internally consistent and at the same time consistent with the social ends postulated above.

Two concepts, better than any other, can be used to describe the content of individualism in America. These concepts are free choice and reciprocal power. Free choice was demanded by the fact that the individual is his own judge and jury. Reciprocal power was demanded by the fact that

1 Smith, Adam, *Theory of Moral Sentiments*. It is in this essay that Smith develops most carefully the "invisible hand" that guides individuals acting selfishly toward the betterment of society as well.
individuals work for and by themselves and thus individuals would always
be compared with individuals rather than with organisations. These two
aspects of individualism frequently go by the more popular terms of
freedom and equality.

It is most important to note at the outset that although
individualism may properly be said to have two dimensions, they are not
all separate and distinct entities. Actually they are so much a part
and parcel of the same thing that neither can be defined except in terms
of the other. Free choice can not exist except where reciprocal power
exists, and reciprocal power essentially means free choice. It is
for this reason that care must be taken to avoid the tendency in popular
parlance to lay disproportionate emphasis upon one or the other.

Not only are the two special aspects of individualism consistent
with one another. In addition, this philosophy is identical as both cause
and effect. A situation characterized by free choice and reciprocal power
could not result in anything different, and at the same time a resultant
free choice and reciprocal power could not be produced by a different
situation's cause. While these two statements may seem to be a belabouring
of the obvious yet the indicated internal consistency is a prime requisite
for any working social philosophy.

It is not enough, however, that a philosophy be conceptually
consistent. To be accepted and utilized as a framework for group living
it must also be reasonably consistent with the external environment. It must,
in short, fit the facts. In the days of John Locke, the typical business
organization was the family-farm. This period, too, was the age of the frontier,
when the next best alternative to the status quo was movement to the frontier.
As long as opportunities were plentiful on the frontier an individual always
had a desirable alternative available. This lack of organization and this availability of the frontier made a philosophy of free-choice and reciprocal power reasonably believable, producing a degree of consistency with the facts adequate for stability and solidity.

Contrary to this view, it has been argued that social philosophy in America was inherently unstable from the beginning. As evidence it has been demonstrated that the Constitution was written by property owners to protect property. However, in the context of the economic organization of 150 years ago that fact does not warrant the extreme conclusion sometimes drawn from it. Human rights were at that time still so nearly identical with property rights that it could not be said that the emphasis upon property was injurious to human rights in 1790, nor that as a consequence the Constitution represented a basic conflict between forces.

The property bias of the Constitution was very important in another way, however. That bias, incorporated into law and court decisions, made property the vested interest in American economic history. As a consequence control over property by the organized community was placed on the defensive and expanded only with difficulty. As control expanded the vested interest naturally allied itself with the freedom dimension of social philosophy, while regulation was primarily justified on the basis of the equality dimension.

Control over property would not have been developed, of course, in an environment identical with that prevailing in 1790. It was only after an evolution in economic relationships had produced an environment clearly violative of the ideal that regulation as we know it today began to develop. With property (freedom) entrenched as a vested interest it is only natural to look for violations of the equality dimension in a search for an environmental basis for regulation.
The essence of economic equality as it has been emphasized in America, is a condition in which social organization precludes the using of individuals merely as means to an end. In other words advantage is to be taken of no one. Undue advantage exists if and when one individual has a right not correlated with an equal responsibility. Such a non-correlation of rights and responsibilities produces privilege, not equality.

It is a well-known fact that a right is relative; that for every right there is a corresponding duty. If "A" has a right to work, "B" has a duty not to prevent "A"'s working; if "A" has a right to board a train; "B" has a duty not to stop "A" from so doing, etc. But this type of correlation, which is definitional rather than substantive, provides no guarantee of equality in society. It could happen, and has, that most rights are concentrated in the hands of a few, while most duties are concentrated with the remainder. The few in this case are privileged, not equal. The significant criterion of equality is the distribution of rights as compared with the distribution of duties.

For this reason equality is here predicated upon the correlation of rights and responsibilities for each social unit, rather than upon the correlation of rights and duties for the group as a whole. The distribution of rights and duties is fair (equal) when and only when every right for an individual creates for this same individual a social responsibility. If, therefore, an individual is held accountable as a member of society as well

1 A fair exposition of this viewpoint by an economist can be found in Hadley, A.T., Standards of Public Morality. (Putnam and Sons, New York, 1896.)

2 Hall, Jerome, Readings in Jurisprudence. (The Bobbs-Merrill Company, Indianapolis, 1938.) Chapter XI.
as in his individual capacity, society will be integrated.

Thus it is that a competitive society such as the one outlined earlier in extreme terms is not, in theory, an atomistic society, and not integrated merely by the fact that the self-interest of different individuals are coincidentally harmonious. Rather such a society is integrated by the fact of agreement on the desirability of the social norm. It is this implicit and more or less automatic faith in the equation of rights and responsibilities that constitutes equality and freedom, that keeps individual activity within the bounds of harmony. Thomas Hobbes in *The Leviathan* clearly presented the consequences of the truly atomistic society — the war of all against all. The subsequent writings of many classical economists were intended to prove Hobbes wrong. What they did prove rather was that society was not atomistic in the first place — not that the consequences pictured by Hobbes were erroneous.

Stated in more general terms the self-interest postulated in Classical economics is the calculated type of social relationship. However, self-interest does not operate in an unlimited field. It is built upon a community underpinning, a basic and common set of values that spontaneously closes to the individual self-interest a large part of the theoretical field of activity. The real sovereign even in this society is thus the community spirit.

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1 For a fine presentation of this approach with reference to the individual and the social side of private property, see Ely, Richard T., *Property and Contract*. (The Macmillan Company, New York, 1914.) Volume I.

2 Parsons, op., cit., pp. 89 ff.
If, in original outline, society was spontaneously integrated, it becomes of vital importance to understand why and how this spontaneity was lost. Modern business organization, in contrast to that in the eighteenth century, is a process of bargaining. Capitalism itself is practically synonymous with exchange, since a high income for a society presupposes specialization, and specialization necessitates exchanging surpluses. Thus, economic purpose, as we know it, is centered upon exchange; not upon the isolated dual exchange that constitutes a single transaction, but the series of such exchanges that the courts recognize as a going business. Concretely, this purpose is a maximum net of output over input in whatever terms these are measured in a particular case. In popular terms, the aim of a business is to maximize net profits through buying and selling. Every exchange relationship contains potentially an opportunity for a strong party to dominate a weaker party. Net profit is the excess of domination over submission. Net loss is the opposite result. The type of society that we have defined as representing the social ideal—a free and equal society—would leave no net balance either positive or negative. For a right is a dominance; a responsibility is a submission. Where these two have been defined, for


3 Modern economic theory is using more and more the idea of a "stream" of inputs and outputs, which stream Professor Commons considers the going concern. Commons, John R., *Legal Foundations of Capitalism*. (The Macmillan Company, New York, 1924.) Chapter V.
accurately correlated, therefore, they cannot diverge.

But freedom in society presupposes choice. Where the principal social organization is a prowess of bargaining, the actual choices that men make are of paramount importance. Essentially these choices will be to earn a living in one way as compared with another. In a free society these decisions will be made on the basis of the net result as above outlined. Individualism necessarily forces every individual to have regard for that course of action that will prove most advantageous.

Each of the choices that an individual makes as to alternative courses of action amounts to a choice of degrees of power over others, maximum advantage being the highest possible degree of power over others in the game of business, or the largest net balance of domination in the economic order. Laissez-faire economics correlated rights and responsibilities quantitatively; that is, predicking only one degree of economic power as basic. In technical economic terms this degree of power represents equality between average cost, marginal cost, and selling price for every seller. Advantage to every bargainer was equated to disadvantage; or to general social advantage. Society was equal because it could not be otherwise.

In the face of the development of an environment substantially different from the one on the basis of which the philosophy was originally constructed, it was inevitable that basic inconsistencies would arise and in


2 Commons, op. cit., chapter III.

time produce dissatisfaction. It was also to be expected that a pattern of adjustments would be worked out to lessen the degree and one-sidedness of the dissatisfaction. This pattern of adjustments is otherwise known as regulation.

As regulation expanded the original bias in favor of property protection lost much of its force, and society found it necessary to balance more and more carefully the interests involved in order to assure a compromise of agreement rather than a compromise through power. Today the gap in philosophy that must be bridged by regulation is so wide that power compromises are becoming apparent in some areas. Evidences of this type of social relationship are 'log-rolling' and legislation through blocs and pressure groups. Through these and similar elements in our government it sometimes happens that calculated interests become formalized into law through power rather than compromise.

Summarized as part of an introduction the above process of development appears clear-cut and simple. Actually forces of extreme complexity, operating in many and devious ways, have all contributed to the result indicated. With primary emphasis upon economic forces, and drawing material mainly from the field of public utility regulation, this dissertation attempts to trace some of the significant phases of the indicated evolution.
A social philosophy, of course, can not be understood solely through an understanding of its broadest sources, aims, and principles. To be really useful in integrating a society, philosophy must be ultimately translated into narrower terms consistent with the concrete environment. The second step toward an understanding of social philosophy in America is therefore to reduce it to the problems that its application brought to the surface. The purpose of this chapter is to consider the two dimensions of individualism in terms of the broadest problems of application, while the following chapter will consider them in terms of a still narrower set of applications.

The principal subject matter of this chapter will be the Supreme Court of the United States. So closely allied to philosophy is regulation that jurisprudence naturally plays an important part in working out the details of social organization. This is particularly true in the United States where, for reasons that will be made more clear later, a supreme jurisprudential body was created for precisely this purpose. As Felix Frankfurter aptly remarks:

"Our basis problems—whether of industry, agriculture, or finance— sooner or later appear in the guise of legal problems. Professor John R. Commons is therefore justified in characterizing the Supreme Court of the United States as the authoritative faculty of economics".

If, now, for purposes of analysis, we take the position that the working out of the pattern of social control in the United States can be 'funneled' through the Supreme Court, we must at the outset concede the corollary of that position. We must understand that individual court decisions are not isolated facts in our political community but are carefully integrated by human minds assiduously trained in the art of consistency.

On the basis of this corollary it is at once obvious that a first step in presenting the legal pattern of regulation will be to set forth the principle of integration in terms of which individual court decisions are consistent. It will be suggested immediately that the Constitution provides such a principle. However it is one of the specific aims of this chapter to demonstrate that the Constitution is not the sole—indeed, not even the primary—source of consistency for regulation. The deeper source is a fundamental community belief in free enterprise, individualism, equality of opportunity — from which belief the Constitution itself was derived.

Law or regulation is an attempt by the community to protect its values. Whenever the action of individuals or groups violates a basic community value laws are passed. Since in the typical case a law affects only a small group within the community it can perhaps be fairly said that law is the imposition of the will of the community (through force if necessary) upon those who by their actions have indicated a tendency to live outside the area of proper behavior implicit in community ideals.

It is not at all strange that, in a society predicated upon freedom and equality, the first legal principle the Supreme Court actually set forth was the principle of principles. If the individual (enterprise) is to be the vital element in the economy it is imperative that the individual know
the rules of the game whenever he wishes to make a commitment. No one
can plan either a life or a business if such important factors as the
attitude of government are unknown or subject to change without notice.
For guidance on this point the Court went to the Constitution and took
the provision against ex post facto laws as a concrete demand for a
principle in all things. John R. Commons has elaborated upon this
statement in the Constitution and has developed what he claims is the essence
of the relationship between the individual and law in American capitalistic
society. This principle is that no individual (business) can be punished
(controlled) as an individual (business) but only as a member of a group
of individuals (businesses). Thus no law can be passed punishing John Jones
for murder. A law can be passed, however, punishing all murderers of whom
John Jones may be one.

Assuming, now, the existence of principle, it might be helpful to
inquire into the reason for its desirability. The average person, of
course, takes principle so much for granted that to even ask the question
may at first seem foolish. But the underlying basis for emphasis upon
principle is so intimately and intricately related to the entire system of
underpinning for the American way of life that a brief examination may be
well worthwhile.

Behind our Constitutional system is a fundamental belief in natural

1 Since our form of government is predicated upon reason it is
evident from an even broader viewpoint why it is believed that principles
are possible. Generalization (principle) is the essence of reason.

The law of man — constitutional law — is simply a summary statement of natural law. The flow of law, following this analysis, is from the minds (not the hearts) of men to the Constitution rather than the reverse. If, in short, men know what is right they will do what is right. Since men are reasonable beings, therefore, right will be done.

It is true that the above was originally intended to prove that government was unnecessary. In the growth of American jurisprudence, however, while we have gradually moved in the direction of more and more government we have formulated that government on the basis of the above concepts. Thus the end has been not "no government" but "a government of laws not men", or no arbitrary government. In accomplishing this end we have consequently insisted that an essential requirement of good government must be that the laws actually applied be applicable to all and known in advance. The only assurance that these conditions will actually prevail is to avoid ex post facto legislation and insist that all judgments by government be the logical outgrowth of a socially acceptable (constitutional) principle. In short, in so far as possible, all cases must be pre-judged by the fact that every citizen has full knowledge of the law.

The essence of a legal principle is the provision of standards that determine right from wrong in particular cases. With the aid of standards—and only with such aid—is consistency in decisions possible. Only with standards can all similar cases be treated similarly and equality be assured both as between individuals and between points in time.

1 Clark, J.M., op. cit., chapter V.

Emphasis upon principle must be intended, otherwise every case would be decided as it arose rather than in advance. The essential element in standards is their relationship to the future. A principle laid down by law is the pre-judging of all subsequent cases. Law thus establishes a continuing and consistent probability for persons to base their calculations of the future upon. It must be continuing because principles are invoked until altered; and it must be consistent because only so can control by mood be avoided.

It could hardly be overemphasized that a law for the future has been peculiarly favorable to the growth of the modern institutions of capitalism. A business concern, engaged in producing or distributing the goods that make up our standard of life, is predicated upon profits. Profits (or losses) are closely related to the unknowables in enterprise. Law could be a sufficiently large unknowable — presumable in an adverse way — to severely limit technical advancement were it not for the provisions against retroactive law. This is more and more true as fixed and specialized capital makes up a larger and larger proportion of total business assets.

Having firmly established the principle of principles, and starting with a presumption against government interference, it was next necessary for the Court to establish a principle to enable a determination as cases

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1 Recent distribution theory is placing more and more emphasis upon the relation of risk and profit. The classic thesis can be found in Knight, Frank H., Risk, Uncertainty and Profit. (Houghton-Mifflin Company, New York, 1921.)
arose as to what regulations would be permissible and what regulations would not be permissible. Analysis of this problem is the principal requirement for a discussion of the legal pattern of regulation and to it the remainder of this chapter will be devoted.

The process of defining proper subjects for regulatory laws must be approached in two distinctly different ways. It must be defined in terms of the Constitution, the 5th and 14th amendments, and also in terms of the common law, the source of the police power.

Police power is the right of a government to govern. Originally police power meant only the right of a government to establish conditions relative to any or all activity that affects the public health, safety, and morals. However, when the traditional definitions of these terms made them inadequate to the task of enabling government to cope with the capitalistic economy that had developed under a substantive laissez-faire approach to business relationships the police power was expanded to include the right of a government to determine proper prices to be charged consumers by any business declared to be ‘public utilities’.

It is at once obvious that police power is neither a self-defining nor a static concept. Experience in the form of specific judicial pronouncements is constantly defining and re-defining its implications. The problem then is to attempt to uncover with some exactness the content and limitations of the police power.

A superficial answer to this problem can be immediately given. Police power is defined through its polar partner — due process in the

1 Freund, Ernest, The Police Power. (Callaghan and Company, Chicago, 1904.)
For due process is itself neither self-defining nor static. The result for regulation is that we have polar approaches to the relationship between government and industry, both of which must be considered as mutually limiting and defining the other, but neither providing a sufficiently precise or fixed content to serve as definition or limitation of the sphere for government action.

Since these polar and mutually limiting approaches to regulation are so far apart it would appear that there is room for a considerable amount of arbitrary dealing by regulators. Actually the relationship between government and business in this country could not be said to have been arbitrary at any time in its development. Rather the rules existing at any one time have exhibited a rather high degree of consistency, and while there has been, as would be expected in a nation as large and dynamic as America, a changing trend in the relationship of government to business, this change itself has been consistently and gradually in the same direction. Although there are a few who might refer to this trend as arbitrary most would agree that, considered in the large, it has not been so.

It strikes the thoughtful person immediately and forcefully that a consistent pattern of regulation in both the dimension of time and the dimension of space is itself proof that regulators — finite men that

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1 Due process is not to be thought of in the procedural sense of trial by jury, but in the substantive sense of just compensation.
they are — do utilize principles and standards. It is the belief
of the writer that the principles available for this purpose can
come from only one source — social philosophy. The fact that at any
given time regulation is consistent is evidence that the community
ideal has a tendency to penetrate most minds similarly. The fact that
there has been a discernible trend in the scope and content of regulation
simply demonstrates that community ideals change as the external
environment, so to speak, poses new problems.

Given, now, the existence of a division of labor between the police
power and the due process clauses of the Constitution, it should next
prove instructive to examine the direction this division of labor has
taken in the history of regulation. The division has developed in two
parts. The first of these is in terms of the scope of regulation, or the
balance between public utility regulation and general police power
regulation. The second is in terms of the extent of regulation, or the
balance between confiscation and due process.

Historically the police power has been divided into the two
categories mentioned earlier. The first of these gives the government,
federal or state, power to establish conditions surrounding any or all
activity that affects the public health, safety, and morals; the second

1 This type of analysis has been most powerfully developed in
the field of sociology. See Parsons, Talcott, op. cit., p. 193.

2 Freund, Ernest, op. cit. The Police Power. This is an exhaustive
account of the development and status of this category. It is noteworthy
that this volume includes all government activity in America under this
one head.
gives the government, federal or state, power to determine proper
prices to be charged consumers, by any business declared to be a public
utility.

The economic thesis of the Supreme Court in defining these separate
and distinct approaches to the police power, although never explicitly
stated, seems to have been the following: control over business details
affecting public health, safety, and morals is by nature an incidental
control that has little or no relationship to the ability of the controlled
to stay in business or make a profit. On the other hand, control over
prices is in very essence an external "attack" upon the most vital aspect
of the entire business process. Therefore it was a most logical step
for the court to permit virtually any regulations that could be demonstrated
to be merely incidental to the major operation of the business concerned,
but to be extremely cautious about permitting over-all regulation of a
particular business. Since economic freedom had become deeply instilled in
public consciousness, it was felt reasonable to suppose that price
regulation should be placed on the defensive.

1 This is, perhaps, the proper word, for the reason that while
the doctrine of public interest was being formulated, the cases coming into
court were attempts by government to limit the sphere of action of
transportation companies.

2 In other words, what J. M. Clark calls the heart of the contract.

3 "Regulation to be valid must tend to some ulterior good to
which the destruction or curtailment of rights is merely incidental."
But the court's entire economic thesis is not complete at this point. The justices seemed to be emphasizing that activity in our industrial society must be interpreted in one of two ways: either it is composed of single, isolated acts having no substantial relation to a business considered as a whole; or it consists of general acts, interrelated with the composite of all other acts making up the particular business process under consideration. The former group consists of any and all acts that, taken in and of themselves, permit of superficial and extensive control without detriment to the ability of the business to sustain itself. The latter group consists of those acts that directly relate to the financial well-being of the concern, and do not permit of superficial control. The court has apparently felt that any all-embracing act must be regulated on an intensive basis, and that regulation of such an act must be justified on somewhat more elaborate grounds than control of superficial acts.

The position of the court, admittedly complex and confusing because never stated forthrightly, can perhaps be made clearer by pursuing a slightly different line of discussion. Let us suppose that an act, a tiny fraction of the composite activity of a concern, is considered detrimental to social well-being. To prohibit this act will leave the business in the same position as before. As justification for its regulation, therefore, a legislature must prove only that this particular act is injurious to the public interest if unchecked.

1 "In the first place, it is established by a series of cases that an ulterior public advantage may justify a comparatively insignificant taking of private property." Justice Holmes in Noble State vs. Haskell, 219 U.S. 104. Emphasis supplied.
Let us now suppose that another act, an act which itself embraces numerous acts—say quoting a price to a consumer—seems also detrimental to social well-being. But in controlling or limiting this one action, limits are also placed upon many (perhaps all) other acts of the business. Thus control spreads itself to action not specifically contemplated by the law itself until it embraces the entirety of the operations of the concern controlled. Thus control is established over, not an act, but an entire business process. Therefore, a legislature must prove that, not the act, but the entire business, if unchecked, is potentially injurious to the public interest. Actually, in Munn vs. Illinois the first and precedent-setting case in the matter of price regulation, the court came as close as it ever has come to establishing the above-stated economic thesis. In that decision Chief Justice Waite remarked:

Indeed, there is no end of regulations with respect to the use of property which may not be legitimately prescribed, having for their object the peace, good order, safety, and health of the community, thus securing to all the equal enjoyment of their property; but in establishing these regulations it is evident that compensation to the owner for the use of his property, or for his services in union with it, is not a matter of any importance: whether it be one sum or another does not affect the regulation, either in respect

1 It is a well established principle of American Constitutional law that Constitutional guaranties are no bar to legislation "not operating unreasonably beyond the occasions of its enactment . . . " 11 American Jur. 991. See also Borden vs. Louisiana State Board of Education, 168 La. 1005.
to its utility or mode of enforcement. One may go, in like manner, through the whole round of regulations authorised by legislation, State or municipal, under what is termed the police power, and in no instances will he find that the compensation of the owner for the use of his property has any influence in establishing them. It is only where some right or privilege is conferred by the government or municipality upon the owner, which he can use in connection with his property, or by means of which the use of his property is rendered more valuable to him, or he thereby enjoys an advantage over others, that the compensation to be received by him becomes a legitimate matter of regulation. Submission to the regulation of compensation in such cases is an implied condition of the grant, and the State, in exercising its power of prescribing the compensation, only determines the conditions upon which its concession shall be enjoyed. When the privilege ends, the power of regulation ceases.

Essentially, then the court demands the same proof, whichever category of the police power is being invoked. In the one case, however, proof of public interest is extended to a single act; while in the other case this proof is extended to the entire business. So far as the writer is aware this fact has never been made clear by textbook writers in the field of public utilities. Once it is clearly recognized it can be further used as a tool for investigating the ramifications of the court's economic postulates.

This "all or nothing" approach by the court, pushed to its ultimate conclusions, looks weak when judged in the light of today's economy. But it should be noted that when the principle was first set forth the economic environment and thus the need for regulation had not yet developed to a point intricate enough to actually push the court's approach to anything like its ultimate conclusions. What is important here is that

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1 94 U.S., 113,146.
a principle was required delineating the proper sphere for government control. In order that this principle might be as definite as possible the court formulated the line of demarcation between the environment to be controlled and that not to be controlled in extreme terms.

Two things stand out at this point. First, all regulation has a common denominator. That common denominator is, as would be expected, public interest as defined in terms of social philosophy. Second, price regulation was forcefully placed on the defensive — a result clearly called for by the ideal. A succinct understanding of these significant facts will help clear the way for an understanding of the second part of the division of labor between the common law and the Constitution — the balance between confiscation and due process.

Obviously the fact that the Supreme Court defined the categories of regulation in absolute terms, could not, in our social setting, be interpreted to mean that the right to control was itself to be absolute. Such an interpretation would be the equivalent of placing the public utility industries at the mercy of the law rather than within the sphere of legal protection. Accordingly it was necessary that a supplementary principle be devised to set forth the proper extent of government regulation. As such a supplementary principle the Courts promulgated and developed the legal concept 'fair return on fair value' and its opposite 'confiscation', both interpreted in relation to due process.

Government regulation has been replete with references to the
due process clauses of the Constitution. Thus persons may not be deprived of property without "just compensation." This test — called the test of confiscation — is invariably applied in utility rate cases as a constitutional limitation upon the exercise of this aspect of the police power. Yet it is a "firmly settled" concept of law that the due process clause has no effect upon the exercise of the general police power (protection of the public health, safety, and morals).

At first glance this would appear to be an irreconcilable conflict between the Constitution on the one hand and the police power on the other hand. However, an examination of decisions makes a reconciliation of the conflict quite simple. It is said, for example, that due process limits the improper exercise of the police power. Also it is said that due process prevents unreasonable or arbitrary exercise of the police power. The conclusion to which we are thus forced is that the court will disapprove an injury to property rights only if the injury is improper, arbitrary, or unreasonable. Sometimes

1 Fifth and Fourteenth Amendments.

2 11 Am. Jur. 998. See also Murphy vs. California, 225 U.S. 623. There are numerous state cases emphasizing this same point.

3 Grenada Lumber Company vs. Mississippi, 217 U.S. 433.

4 Dobbins vs. Los Angeles, 195 U.S. 223.
private rights can be abrogated, and sometimes they can not.

However, nowhere in all the multitude of pertinent decisions handed down by the courts on this subject, are the terms improper, arbitrary, or unreasonable unambiguously defined. Such a definition is one of the legislative problems in the sphere of regulation. The group that defines these terms is, to all intents and purposes, a substantive legislative body, even though the elected representatives of the people do write the formal language of the law. Thus the Supreme Court has forced itself -- or been forced -- to become a basic legislator on the subject of property rights and their limitations.\(^1\)

The legislative position of the Supreme Court can perhaps be understood more adequately by reference to an earlier point. Disapproval of regulation is found inside the Constitution in the 14th, 10th, and 5th Amendments. Approval of regulation is found outside the Constitution in the police power. Thus the responsibility of the Court is to steer a consistent course between the Constitution and the police power. In the absence of explicit definitions to serve as standards a consistent course must utilize certain implicit definitions or standards. Since the court has been quite consistent in its interpretations it seems proper to think in terms of an integrative principle for decisions. In the nature of

\(^1\) Jerome Frank has contributed a candid recognition of the fact of judicial legislation. Frank, Jerome, Law and the Modern Mind, (Tudor Publishing Company, New York, 1935.) Chapter IV.
things it seems inescapable that this principle can be no other than the dimensions of social philosophy presented earlier.

The question as to the specific content of due process is not so easily dismissed, although in general terms it follows a rather definite pattern. "Just compensation" in the Fifth Amendment and "due process of law" in the Fifth and the Fourteenth Amendments are equivalent terms. Just compensation and "fair return on a fair value" are also identical in connotation. Although the precise substance implied by these vital regulatory concepts is primarily economic, the strictly legal implications do warrant further examination here. The purpose will be to link more closely the balance set forth by the courts, between general and public utility regulation on the one hand, and between confiscation and due process on the other hand.

An important corollary of the philosophy upon which our society is based is free will. An equal society must be one in which members have equal choices. Ordinarily, therefore, the government may not

1 Smyth vs. Ames, 169 U.S. 466. Here "due process" was not argued as such. Instead Justice Harlan centers his famous remarks around "just compensation." The equivalence of these terms is inherent.

2 Board of Public Utilities Commissioners vs. N.Y. Telephone Co., 271 U.S. 23. Here Justice Butler appears to use the two phrases interchangeably.

3 Since much of our early constitutional thinking was inspired thereby, reference might be made to John Locke's Two Treatises on Government, so influential in solidifying England's judicial system, as well as in formulating ours.
some choice should be demanded.

The problem is that when it was so, excessive freedom to enter the business of
Agricultural commodities increased competition and was harmful to the community
statement. The introduction in the United States of the concept of the
certainty of the laws.

In the present Public Utilities Commission, 371 U.S. 283. Page 5, 359
Post X. Railroad Commission of California, 271 U.S. 593, Smith X. Canon,


In the case of public utility regulation the problem is much
in the case of general regulation, it will be remembered, the

The next affirmative force removed from the one
blocked, the next affirmative force removed from the one
that set in the business to the rest of society was substantial.
Therefore the regulation—

In the case of public utility regulation the problem is much

In the case of public utility regulation, it will be remembered, the

Public utility regulation

2 of public business, but regulation may obstruct basic choices for a
interference with basic choice. By "ordinary," it is meant in the case
Without unduly extending this analysis the above relationships can be brought into even closer juxtaposition. The typical case of government intervention is one that can in some sense be described as monopoly as contrasted to the free competition upon which unenforced equality must be dependent. It is a well recognized characteristic of monopoly that the choices of actual or potential consumers are much more narrowly circumscribed than where enterprise is competitive. Thus government intercedes for the consumer when the latter's choices are in danger of being interfered with by business. And this process is precisely the obverse of intercession by government for business when the latter's choices are in danger of being interfered with by the public interest.

It might be helpful here to summarize the legal pattern of formal control to this point. The argument has been developed as follows. Beneath and behind society in America is a belief in natural law, a belief that envisages government as a resultant of society rather than a cause, and which considers equality of opportunity as the natural and thus the ideal social state. When it became necessary to superimpose a minimum of government upon this superstructure of equality the need for principles of control became paramount. Without principles some few might pass beyond restraint while at the same time others might drift outside the protective custody of society.

To meet this need for principles two opposing ideas have been constantly counterpoised against one another, both in determining the
scope of regulation and in determining its extent. The first of these is the police power, or the positive right to govern. The second is the Constitution, or the negative obligation to respect the status quo. The result of this opposition insofar as the scope of regulation is concerned was, as would be expected, a compromise. For most businesses the victory was with the status quo, with the exception that clearly incidental regulation to protect the public health, safety and morals was to be allowed. But for some businesses — called public utilities — the victory was with police power in that price regulation as well as incidental regulation was to be allowed. This key problem of industry classification is not automatically solved, of course, by the division of labor indicated. The actual process of classification can only be accomplished through a rather general agreement as to what is necessary for the realization of the twin ideals — equality and freedom.

Insofar as the extent of regulation is concerned the same opposition between the Constitution and police power is evident. Here, however, the principal factor is primarily type of regulation and only secondarily type of industry. Where regulation is merely incidental the police power is absolute. The charge of confiscation can not be successfully raised to avoid such regulation. But where regulation goes to the heart of the contract the Constitutional provision of due process is utilized to check the operation of the police power. And again the ultimate determinant as to which shall rule must be a general agreement as to what is necessary for the realization of the underlying ideals. In
making final determinations as regards both scope and extent of regulation the Supreme Court plays a most important part.

To this point the legal pattern of regulation has been discussed without extensive reference to the legal terms that are most commonly heard in this connection — rights and property. It seems desirable now to fit the above analysis firmly into a more traditional terminology.

It is a relatively common thing to define property in terms of rights. Private property thus becomes rights accruing to individuals. But these private rights are not absolute. The state may decrease or increase these rights, not capriciously, but according to certain reasonable principles. These principles all comprehend or are comprehended by the police power.

The police power comprises all the power of the State except the power of taxation and the power of eminent domain, and these powers are themselves merely auxiliary powers in aid of the police power. The object of the power of taxation is to raise money to enable the state to exercise the police power and the object of the power of eminent domain is to enable the state to acquire property for the same purpose.


2 "Rights and privileges arising from contracts are subject to regulations for the protection of the public health, the public morals, and the public safety, in the same sense and to the same extent as is all property." 11 Am Jur. 1000. See Stephenson vs. Binford, 287, U.S. 251, and Thornton vs. Duffy, 254 U.S. 361.

This statement has a peculiar significance in the field of regulation. It could accurately be said that regulation by the state is the source of all limitations on the sphere of rights surrounding private property. If, then, the police power is also the source of all regulatory property-right limitation, there must exist a relationship of identity between the police power and regulation.

A semi-syllogistic presentation of this significant relationship between regulation and the police power might be outlined as follows:

1. All limitation of rights stem from the police power.
2. All exercise of the police power results in a limitation of rights.
3. All limitation of rights stems from what we are here calling formal control or regulation.
4. All formal control results in a limitation of rights. Things which are equal to the same thing being equal to each other, it must follow that regulation (formal control) and the police power are identical concepts. This is a highly significant fact from the point of view of the student of regulation. Police power is simply the political theorist's name for regulation. Regulation is the economic theorist's name for

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1. This is a simple truism, only formulated here to help emphasize a set of relationships not adequately emphasized before.

2. Or a power concurrent with the police power in a particular case. The courts can validly distinguish between police power and some concurrent power (e.g., taxation), but the former is inherent in all limitation of property rights. Freund, op. cit.
police power. Stripped of superficial verbiage, economists and lawyers have for many years concerned themselves with the same problems—kept apart by inadequate and often quite irrelevant distinctions that served only to bescloud the issues.

Private property is the political approach of our society to equality. As such, equality (or some concept of equality) is enforced by the police power. But private property is also the economic approach of our society to equality. In this guise equality is enforced through economic regulation. Standing alone in either the political or economic sphere private property could have little meaning. Taken together these two represent a most important element in what we think of as our social organization. It must follow that metes and bounds in both spheres can likewise have little meaning unless interrelated into a significantly unified whole.

We have by now briefly outlined the method by which limitation of property rights is made the common denominator of all regulation. In a society in which equality is important this limitation cannot itself be potentially unlimited; that is, in a world of private property, where property is defined as a bundle of rights limitations of rights must not be arbitrary or capricious, but carefully equated to social needs and desires. If we look upon the rights taken away it would follow that

1 In the words of the court: "When the legislature appoints an agent to act within that sphere of legislative authority, it may endow the agent with power to make findings of fact which are conclusive, provided the requirements of due process which are specially applicable to such an agency are met, as in according a fair hearing and acting upon evidence and not arbitrarily." St. Joseph Stockyards Co, vs.United States, 298 U.S. 38.
regulation treats businesses or persons unequally. But if we center attention upon the rights retained in these same cases, equality is evident as the governing rule. This may be merely restating the difference between a pessimist and an optimist, one saying his glass is half empty, the other saying his glass is half full. But the realistic approach must consider the pertinent fact to be the size of the residual bundle of rights. Though practical politics and administrative error may militate against realization of the ideal -- equality in the size of these residual bundles -- it would be a crass and undemocratic person indeed who would deny that this equality in the size of residual bundles is the end-in-view.

In conclusion it may be helpful to point up once again by way of emphasis the concepts developed in the course of this discussion. In the first place it has been demonstrated that social control has numerous dimensions among which the economic, the legal, and the sociological are of prime importance. The economic dimension is private property. The legal dimension is definition of private property through the courts. The sociological dimension is the existence in the minds and hearts of men a belief in equality and freedom as characteristic of the ideal state.

In the second place it has been emphasized throughout that the specific approach to be taken by regulation can not be derived exclusively from the Constitution. Rather the Constitution and the police power provide polar and mutually limiting approaches to regulation, the precise division of labor between them being determined in the last
analysis by the idea existing in the minds and hearts of men as to
the meaning of social philosophy.

Finally, it was pointed out that the Supreme Court drew a
very sharp line of demarcation between the police power and due process
as to both the scope and the extent of regulation. The court permitted
incidental regulation of all incidental business activity, but allowed
comprehensive regulation of only those businesses whose acts could not be
said to be incidental. Where incidental regulation only is allowed
due process is not invoked; while in those cases in which comprehensive
regulation is permitted due process is relied upon for protection.

This, then, is the legal pattern of regulation. Just as in our
society equality is considered to be important, so is the legal community
organized to enforce that state where inequality arises. The operation
of that organization is through limitation of rights—primarily
property rights. Its procedure is a simultaneous restraint and protection
for every citizen. Where a basic inequality exists police power acts to
restrain while at the same time due process acts to protect. Where a
non-basic inequality exists police power operates without due process on
the thesis that no real injury is potential.

Before turning to the economic pattern of regulation there are
a few items of broad significance that will repay mention. Regulation, it
will be noted, was not invoked to protect the freedom dimension of
philosophy. This was to be expected since freedom or the private use of
one's property was the vested interest in terms of basic philosophy. Thus
the equality dimension was the stimulus for control.
It will be noted too that this legal pattern operated in such a way as to keep the freedom dimension in the vested interest category by placing property right limitation on the defensive. And, so difficult was it made to classify an industry as a utility, there was really very little price regulation for many years. In this situation freedom was scarcely touched by regulation. Obversely, the reason freedom was touched but slightly was because inequalities had not extensively developed. Thus it was easy for both sides to compromise their differences, and it follows that the compromises required were small. As a consequence the motivation for power control rather than compromise control was limited. The result was a situation in which relationships were largely harmonious.

Finally, to anticipate briefly a later part of the discussion, the concretely harmonious adjustment of property relationships does not characterize the entirety of the history of regulation in America. As capitalism matured control was forced to operate in areas and directions not contemplated from the beginning. The result was a modification of control to allow for a somewhat different interplay of interests and a somewhat different economic environment. The following chapter presents the concrete framework for modification by outlining in some detail the specific steps regulation must take to insure the existence of reciprocal power where inequality is threatened. The present chapter and the following one can be considered as Phase I in the development of social control. Later chapters will present further phases of this evolution.
CHAPTER II

THE ECONOMIC PATTERN OF REGULATION

The function of the law in proportioning the two dimensions of individualism—freedom and equality—is not limited to the broad function of classification as might be inferred from the preceding chapter. In addition the courts have the task of applying the classifications and assessing limits to them in particular cases. However, the tools used in the process of detailed application are primarily economic rather than legal. It is for this reason that this more detailed pattern necessary to give concrete substance to regulation is termed in this chapter the economic pattern.

Before elaborating upon these economic tools several important relationships should be made more clear. In the process of regulation as such freedom was not an important consideration for the reason that the issue of freedom was decided through classification. Business organizations that were to be 'free' were set aside and regulation was not allowed. Businesses not so set aside were those that the dimension of equality demanded not to be free in the same sense. Thus, up to the point of confiscation, at which point residual rights were considered equal, regulation did not need to concern itself with freedom.

If the dimension of freedom was not an important consideration for regulators, the dimension of equality assuredly was. It has been developed that utilities were defined as threatening inequality. For this reason they were to be regulated. Still, however, regulation was not to be wanton. Every regulatory act was to be reasonably related to the end in
view, namely, greater equality. This requirement is a part of the concept of equal residual rights. Freedom, by definition, can exist only where equality exists, and as long as regulatory procedures are specifically designed to produce equality, freedom, as broadly conceived, could not be an issue. It is precisely for this reason that it was necessary that rights and responsibilities be defined carefully to permit of accurate equation. From this necessity the economic pattern of regulation directly stems.

Right equal to responsibility means reciprocal power. It means that no one shall exert a greater amount of control over the economic system than the economic system exerts over him. It means that no business may be given authority to extract from others a greater sacrifice than others may extract from it. It means that there is to be no net balance of domination at any point in society. It means that the outward flow of transactions shall equal the inward flow of transactions, both quantitatively and qualitatively. It means finally that economic input shall equal economic output. Economic theory would define this concept as a condition in which every factor of production received its opportunity 1 cost — i.e., a sufficiently large sum to keep it producing at maximum efficiency, in other words, cost-of-service.

It is not to be thought that society ever does actually equate sacrifices in anything like this ideal way. Even this all-important

element in government must follow the very pragmatic economic principle. Thus if formal control can work to close some gap between right and responsibility, without opening a bigger one somewhere else, control is very apt to become an established fact.

Following the economic principle further, scarce enforcement facilities will be transferred from a small gap to a larger one until both are approximately the same size. Thus, making allowance for politics and mistakes, society simply does the best it can. At any time, therefore, regulation may be said to represent the nearest practical approach to the ideal.

The legal right of a seller is the right to charge a price for his goods; the right of a utility is to make a charge for its services. The economic responsibility of a seller is the responsibility to reward factors of production for their services. As a matter of practical expedience both of these are measured in dollars. Formal control cannot stop with equating these superficial emblems, however, but must endeavor to assure that the dollar sacrifices really represent the real sacrifice involved. This last is probably as important as the comparison of dollar amounts. Regulation has tended to concentrate mainly on dollars. Recent trends, however, are toward

1 Knight, F.H., Risk, Uncertainty and Profit, p. 65.

2 See Clark, op. cit., chapter VII, for an analysis of dollar versus other social sacrifices.
a broader view. The approach here taken will include both dollar and real sacrifices.

Right and responsibility are equal if payments by customers equal payments to factors. This condition suggests that price and average cost should be equal. It implies, further, equality between average long-run cost and average long-run revenue, the orthodox competitive equilibrium.

This equation between consumer payments and factor payments immediately suggests the problem of knowing the magnitude of each. Inequality might conceivably be remedied by raising one magnitude or lowering one magnitude, or possibly both methods might be used. If consumer payments exceed factor payments, for example, factor payments might be raised or consumer payments might be lowered. In the typical case the latter is most apt to occur. Where factor payments exceed consumer payments, on the other hand, a reduction in payments to the factors or an increase in payments by the consumers may equally solve the problem. But before remedial measures can be adopted the magnitude of the inequality must be known.

This question of knowledge is familiar to students of regulation as control over accounts and reports. All comprehensive regulation must make use of this particular tool or fail. Although this fact is

1 West Ohio Gas Company vs. Public Utilities Commission of Ohio, 294 U.S. 63. There have been a number of recent decisions of this same general nature.
quite obvious regulation had developed quite far before accounting regulation became an accomplished fact.

A business is a flow of transactions. This flow is always in two directions: the inflow of assets; and the outflow of assets. This exchange of assets is the business or bargaining process. The inflow of assets represents the relationship between the business and the environment which it dominates (rights). The outflow of assets represents the relationship between the business and the environment which dominates it (responsibilities). The economic difference between the two is the net balance which the business desires to maximize if positive, or minimize if negative, and which regulatory authorities desire to minimize whatever the direction.

But these asset-flows cannot be measured by the business world in general terms. They must be reduced to the unit of account—money—in order to be comprehensible and comparable. The translation of these flows, for purposes of record, into monetary terms, is the accounting process. The result of this accounting process is formal evidence of the size of the two flows of assets. As such it indicates the existing relationship between rights and responsibilities. This latter relationship is the starting point of control.

But this relation between asset-flows is a valid starting point for regulation only if the recorded flow in dollar terms is identical

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1 Wilson, Herring, and Butsler, Public Utility Economics. (The McGraw-Hill Book Company, New York, 1938,) Chapter IV.
with the actual flow in dollar terms. In other words the accounting fact must be consistent with the actual fact. If the asset-inflow is understated, or the asset-outflow is overstated, the net balance of right-responsibility indicated by the formal records will not be representative of a true substantive relation.

Thus accounting regulation must first beware of actual fraud. This is done by forcing the business to submit production reports, sales reports, etc., to enable the regulatory authority to satisfy itself that all outflows of dollars represent inflows of assets, and that all inflows of dollars represent outflows of assets. By thus correlating physical units and monetary results the controllers can exert a considerable pressure for honesty on the part of the corporation. The more items of income and expenditure the business must have proofs for, the more careful they are apt to be about not distorting facts.

The economic pattern of equating rights and responsibilities is not complete with an exposition relating to equality between the recorded dollar facts and the actual dollar facts. An equally important problem for the regulatory authority is to be certain that the recorded and actual dollar facts are consistent with the economic facts purported to be represented. If, for example, the economic fact involved is greater than its symbol stated in dollar terms, the business has assumed rights in excess of its responsibilities. If the dollar fact as stated is greater than the economic fact, the business has assumed responsibilities in excess of its rights. In the first case the business is earning a profit in excess of factor-cost. In the second case the business

1 Boulding, Kenneth E., Economic Analysis. (Harper and Brothers, New York, 1941.) Chapter XX.
is not fully reimbursing the factors used.

Stating these facts in terms of the accounting problem suggested above produces the following line: a business is a series of economic happenings; some are favorable and some are unfavorable, in the profit sense. But all of them taken together make up the business organization; favorable happenings corresponding to rights, unfavorable happenings corresponding to responsibilities. These two sets of circumstances are dual in nature. On the one hand a real sacrifice is involved. On the other hand there is set up a monetary symbol as representative of the real sacrifice. To some extent there is a tendency to concentrate on the symbol to the neglect of the substance beneath. But the problem of regulation considered here is how to make actual dollars (assuming they have actually been spent) correspond precisely to the flow of economic goods and services into the business. In more orthodox terms this simply means that the productive process should be economical in the real sense rather than merely in the monetary sense.

There are innumerable aspects of this problem. To satisfy them all would be to outline the entire set of ramifications of economic

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1 Commons, op. cit., chapter V.

2 Sacrifice is used here to mean that economic resources are to be used, which, if used in this way, cannot be put to other uses.

3 Veblen, Thorstein, The Instinct of Workmanship. (B.W. Huebsch Company, New York, 1918.)
regulation. Only the basic ones will be considered. Perhaps as good a starting point as any would be the certificate of convenience and necessity. This is a device which permits a business to organize or extend its operation within the sphere of operations covered by certain regulations. Essentially control in this sphere aims to place an initial check upon rights as compared with responsibilities. If the applicant is ready and willing to assume responsibilities, rights will be accorded him. If there are so many rights already in the field that there are no responsibilities remaining, rights will not be accorded the applicant. If, of two candidates seeking the same rights, one is more qualified or willing to assume responsibilities equivalent to the rights granted than the other, the former application will take precedence. If, after rights have been granted, the applicant begins to be lax in responsibility, his rights may very well be taken from him.

This initial check is not solely for the purpose of making business responsible to society. It might equally be designed in a specific situation to make society responsible to business. If when an applicant wishes to extend his activity with the approval of the regulatory authorities, the authorities feel that there are not enough rights remaining in the field without injuring rights already distributed to warrant the

1 This term, convenience and necessity, has a technical and restricted usage in the public utility field. The connotation here implied is much broader than this, applying to all inclusions and exclusions that legal authority must approve, rather than simply to ingress and egress.

2 Mosher and Crawford, Public Utility Regulation. (Harper and Brothers, New York, 1933.) Chapter VII.
assumption of the particular responsibility desired, the application will be denied. This would be the case wherever a commission refused to grant a certificate because operations would thereby become financially unprofitable. On every occasion that supply in a given industry is in excess of the amount that can be sold at cost, society has been awarded rights in excess of its responsibilities. Certificates of convenience and necessity are designed to provide an initial check upon all such cases where either the flow of factor-sacrifice exceeds the flow of consumer-sacrifice, or the flow of consumer-sacrifice exceeds the flow of factor-sacrifice. The need for a recognition by society of a responsibility to business was much slower in developing than the assessment of business' responsibility to society. But the economic pattern of regulation that our society utilizes does work both ways.

A further ramification of the principle of equating real sacrifice to dollar outlay is closely related to accounting regulation. Regulated businesses frequently wish to purchase new assets — or perhaps bid in the assets of a competitor. This would have the effect of increasing the inflow of assets. As to outflow of assets, several things might happen. Outflow might not be increased, or at least by as much as the inflow was increased. Perhaps outflow to consumers will increase through being able to charge higher prices in the absence of competition. Or, finally productive efficiency might be increased so as to increase outflow by more than the amount of increase in the inflow.

Whichever happens, rights will be increased by the asset purchase, in the sense that the economic power of business is potentially greater.
The first alternative means responsibilities are not rising in proportion. Efficient regulation will probably not permit the purchase. The second alternative refers to an increase in monetary responsibility, but none in real responsibility. Efficient regulation here also will probably disapprove the purchase. The last is representative of situations, not rare, in which the monetary outflow (payment for the asset) is not commensurate with the real asset inflow. In such a case the purchase will probably be allowed, but rates to consumers will be subsequently lowered. In all of these cases, and others could be suggested if space permitted, regulation will select that alternative which most nearly equates right and responsibility. In selecting this alternative the new result will be calculated in such a way that the asset-inflow of domination will be equal to the asset-outflow of submission.

Another problem that looms large in the economic pattern of regulation, is that of securing capital. Capital cost, with the exception of labor in some instances, is the largest single cost of the average public utility. The reason fair return has always been such a vital element in the theory of control is because it is important. Regulation can only afford to neglect minor issues, and then only until all bigger issues are solved.

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1 The normal public utility corporation must have an operating ratio of less than 70 percent in order to make 6 percent as a fair return. This is assuming a 12⅔ percent capital turnover. A 70 percent operating ratio means that capital cost is 30 percent of gross earnings.
The cost of capital brings into focus an entirely new group of persons — the owners and creditors of the corporation — who are otherwise members of society itself. Thus an entirely new set of responsibilities must be comprehended as a part of the relationship between this group and the corporation and the consumers. The securing of capital produces for the corporation an immediate set of rights for future use. The responsibilities created are continuous, emphasizing themselves whenever payments to suppliers fall due. If the rights themselves grow less in value over time, the regulatory authorities must consider, at least, limiting responsibilities likewise. If opportunity arises after the bargain is consummated to limit responsibilities, authority must make a corresponding adjustment of rights. This would involve an adjustment of fair return.

The implicit content of the capital bargain, then, is not a single set of rights and responsibilities, but two sets. The flow of assets into the concern must be equated to the flow of services to consumers. Also the flow of assets into the firm must be equated to the possibility of a flow of payments back to the capital suppliers. These two sets of relationships emphasize, better than any other illustration could, the triangle of regulation, consisting of the consumer, the owner, (and creditor), and the business. All three are related to each of the others, but all relationships are indirect. That is one reason for the complexity of regulation.

A very new facet of the economic pattern of regulation is the regulation of utility expenses. This control is not as complex as many others, largely because it is more transitory or more minor. But when

1 Minor only in the sense of being scattered rather than concentrated into a single bargain. Actually it is only the more concentrated items that have thus far warranted commission control.
connected with another new set of problems in regulation — that of intercorporate relations — it is of compelling significance. The relationships here considered are not the year to year relationships comprehended by the capital and depreciation problems. They are the week to week relationships involved as the business endeavors to keep itself supplied with the labor and materials needed for daily operations. These two items are the items that can most properly be referred to as "flowing" through the business. Together they make up about 50 percent of a utility's total expenses, including capital costs. This daily flow of services into the business process contributes to the flow of services to consumers in a certain way.

The right of the management to stimulate this inflow of services is correlated with the responsibility to continue the flow through the firm to consumers. Several circumstances may disrupt this process. In the regulation of service companies the Securities and Exchange Commission discovered many flows into these concerns that did not contribute to the servicing functions in any way. Since the corresponding flow to consumers was lacking, the Commission forced the withholding of a part of the inflow. This has been the usual treatment of non-utility expenses where commissions have jurisdiction.

1 Concern in this field dates back to the Federal Trade Commission investigation of holding companies, completed and published in 1927. Senate Document 92, 70th Congress, 1st Session.


In addition to this possibility of divergence between right and responsibility, there is another important one. In a society built around the competitive principle, it is initially assumed that every bargain is a competitive one, each party to the transaction seeking to buy as cheaply as possible or to sell as dearly as possible. Every transaction thus is to be typified by "arms-length" bargaining. This is probably an illicit assumption in view of the fact that the bargaining process comprehends competition only as to the net result. But the transfer from this view to the position that competition is a silent partner in each isolated transaction could not have been avoided in the type of society postulated. But in every transaction that results in an inflow not justified by the outflow, regulation is intended to intercede.

One more facet of the economic pattern of regulation will be noted — service regulation. The quality of service furnished by a utility is a function of the costs to the company. High quality must result from high costs, and low quality must result from lower costs. For any quality of service there is one and only one cost that will equate rights and responsibilities. The commission must so control the

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1 This term was popularized by the Securities and Exchange Commission in connection with the sale of utility securities through investment bankers who were friendly toward their clients. This is an amicable method of defrauding. that the Commission has sought to check through competitive bidding of underwriting. The phrase itself, however, has a much more universal significance.

operations of the regulated enterprise that every flow of service-quality to consumer can be equated effectively to the proper flow of factor-costs. Failure to understand this relationship can be a serious gap in regulatory jurisdiction or actual practice.

In addition to the above discussion of measuring and equating rights and responsibilities throughout society at large there remains the more concrete task of presenting both in terms of the rate level and the rate structure. Of these two separate aspects of utility regulation the more significant is the rate level. This greater significance stems from the fact that the rate level is the central meeting point of buyer and seller. Though not necessarily the place where responsibilities are equated, it is the place where they must be equal. Whatever happens behind the price charged must be reflected in the price charged, or the happening itself has no economic significance for the concern under consideration.

Rate structure, on the other hand, is a gross result of business operation rather than a net result. Errors in rate-structure, from a business point of view, can be compensated for by simply shifting responsibilities. But errors in regulation that affect the rate level are permanent errors, beyond repair by the expedient of shifting burdens.

Simply stated rate level regulation consists of two basic elements. In the first place, regulated businesses must be limited to a degree of power consistent with the competitive ideal. In the second

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1 Barnes, op. cit., chapter XXX.
place, they must not be forced to accept a degree of power less than
the competitive ideal. It is obvious, of course, that these two
requirements can be consistent with a single net operating result.
Furthermore regulation must endeavor to achieve this single result
without guaranteeing utility earnings. Earnings received by a utility
in a competitive environment are an economic phenomenon basically
related to a demand and supply situation rather than to regulation.
Only government ownership can constitute a guarantee. Since government
ownership is not here at issue, the statement that regulation cannot
guarantee earnings is a truism.

But merely stating this truism does not exhaust the subject. The
statement that government must allow a competitive return is the same
as the statement that government must guarantee earnings up to a fair
return, to the extent warranted by economic conditions. There is no
other way of viewing the injunctions of the High Court.

The above significant concept can be graphically illustrated. In
the accompanying diagram let RR represent the total possible revenues
from the various possible quantities of output shown on the OX axis. Let
CC represent actual cost of producing various quantities of output. The
diagram thus illustrates what is a well known fact in public utility
economics, that there is a wide range of output that can produce a revenue
in excess of cost.

The significance of this range of output producing a revenue
in excess of cost is that it demonstrates the non-reciprocal power
situation represented in the case of public utilities. Every different
output that could be sold at a profit is a degree of power that the
utility can exert over consumers. The uncoerced choice as to which
output to produce would be determined on the basis of the principle of
the greatest net domination. The purpose of regulation is to make the
single degree of power resulting in equality between outflow and inflow
the one actually exercised. As long as this result is achieved
consumers do not make coerced choices and the concern itself is com-
penated to precisely the same degree that it would be if competition
rather than regulation limited it to a single degree of power over the
environment.

Under the conditions illustrated the ideal output is ON, to
be sold at price MX. This output and price essentially defines the
precise balance that the regulatory commission must strive to find as
between output, cost, and revenue. Any output less than ON (say ON')
would sell for some price between N'M as a minimum, and N'Y as

1 The maximum price at which a given output can be sold, with or
without regulation, is defined by the RR curve. The minimum price a
seller would voluntarily offer to take for his goods is defined by the
CC curve.
a maximum. The $N'M$ price does not allow the maximum utilization of plant and equipment. The $N'Y$ price permits economic rentals to the factors. Any output greater than $ON$ (say $ON''$) would sell for a maximum and minimum price of $N''Z$ — the $N'M'$ price being out of the question by definition. A commission could not insist upon such an output, for it would then not be allowing an economically possible fair return. Thus the task of the commission is always to assume as full a use of facilities as is consistent with economic conditions.

But even regulated industries have depressions. Many times a fall in prices will strike utilities with as much force as unregulated industries. Such times pose the greatest problems in regulating the rate level. This type of problem can be illustrated in a diagram similar to the one above.

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1 Full utilization is demanded by the fact that a public utility is considered necessary to social welfare. Economic conditions, of course, refer to the relation between $CC$ and $RR$, as representative of the coordination of the rights and responsibilities involved.
Here there is no combination of price and quantity that will permit the utility to recover costs. However, since it must continue to operate, it must select some combination between output and price. The optimum output for all concerned will be, under the circumstances, the output $O_N$. The revenue from this output will not return costs. But neither will any other output. The real virtue of $O_N$ output, as compared with $O_N'$ or $O_N''$ is that $O_N$ comes closer to returning costs than any other output.

It is quite plain in the two cases that, regardless of general operating circumstances, there is one output preferred above all others. It is the task of the Commission and the utility together to find that output relative to any given situation. Such a task is extremely difficult.

It is immediately evident that for any utility operating with $O_N$ output in case 1 and $O_N$ output in case 2, actual return is less than fair return for the reason that the utility receives back its cost in the former circumstance but falls short of this goal in the latter circumstance. No regulatory commission could look upon this operating result as desirable. Yet it is clear that no remedy can be sought in case 2. Thus the commission (and the utility) must turn back to the situation in case 1. An output slightly less than $O_N$ would produce a surplus revenue that could be used to make up the deficit in case 2. Then actual return would equal fair return.

The basic idea embodied in this latter approach is that of a time dimension. There is no abstract virtue in an equation of cost and revenue in a particular year. One year's operation in the life of a public utility is but one point within a process. One year's operation can no more be
considered apart than an individual can be considered outside the totality of society. Indeed there is no purpose to be gained by such a conception. Business, to be interpreted realistically must be looked upon as a flow, not a fund. Thus the time dimension is a really basic fact.

The portion of the economic pattern presented above has been stated throughout in terms of equating total rights and total responsibilities. This analysis should help shed light upon a problem that has long confused students of regulation — the zone of reasonableness. Many persons seem to implicitly accept the view that several rate levels may be equally reasonable for all concerned. Between the upper level of excessive profits to the company, and confiscation of the company’s property, the commission may use its own discretion as to the actual rates permitted. From our approach it would seem that for every possible outflow there can be only one proper inflow that will equate right and responsibility. It may be that this theoretical ideal is unattainable. In such a case a zone of reasonableness might be defined as the area between this ideal and the nearest approach the commission can make. But if the equation of rights and responsibility is treated as a practical matter, this definition would not be helpful.

1 Kabbett vs. Northern Connecticut Power Company, P.U.R. 1933 D 119. There have been a number of similar cases.

2 Certainly it could not be agreed that his zone is the series of rates between competitive price and monopoly price. The correlation between rights and responsibilities would be wholly impossible if such a definition were adopted. Thompson and Smith, Public Utility Economics. (The McGraw-Hill Book Company, New York, 1941.) P. 266.
If there is a zone of reasonableness it is legal, not economic.
Legally, since the courts are not supposed to substitute their judgment
for that of the commission, there may be such a zone, although the courts
have made no insistence upon this view as an economic fact.

Equally as difficult as the specific problems of the rate level
are those connected with the rate structure, or the internal consistency
in terms of the underlying philosophy of the rates of a utility concern.
In brief the key problem here is that of penetrating into the
indivisibility of a modern corporation deeply enough to actually allocate
costs in terms of various conditions surrounding actual operations. It
follows that the greater the degree of indivisibility existing in the
regulated concern the more difficult is a solution to this key problem, and,
perhaps, the less likely regulation is to achieve the precision required
by the equality dimension of the underlying philosophy.

It is a well known fact that customer personnel is a variable
group. It is equally well known that much property used by many regulated
concerns does not destroy itself in the service of the consumer group

1 "It cannot be assumed that any railroad corporation, accepting
franchises, rights and privileges at the hand of the public, ever supposed
that it acquired, or that it was intended to grant to it, the power to
construct and maintain a public highway simply for its benefit, without
regard to the rights of the public. But it is equally true that the
corporation performing such services and the people financially interested
in its business and affairs have rights that may not be invaded by
legislative enactment in disregard of the fundamental guarantees for the
protection of property." Smyth vs. Ames, 169 U.S. 466, 545. Surely no
clearer mandate for reciprocal duties (which must be exact by definition)
could be given by a court.
existing at any given time. Utility property is typically depreciated on the basis of a 40 year life. Thus it is not enough to be sure that over this period rights and responsibilities are equal as between the business and its customers. It becomes equally important to be certain that rights and responsibilities to each 'generation' of customers are kept equal.

A machine or any other permanent asset is a continuing flow of assets-in and assets-out. The consumer-sacrifice is made more or less regularly as long as the outflow of services continues. The factor-sacrifice is made only once, when the asset is purchased. Both these sacrifices, following the terminology here used, must be equal. If the factor-sacrifice were the result of the consumer-sacrifice the problem would be much simplified. But since the factor-sacrifice is determinate once and for all when the permanent asset is added to stock, consumer-sacrifice must be the derived element. Thus each year the outflow from and inflow to the business (that part of it directly resulting from the fixed asset) must be equal. If these two are equal over the life of the asset, but unequal in certain years, then the business is making itself under-responsible to the group of consumers over-charged,

1 Depreciable property in public utilities will represent from 80 percent to 95 percent of total assets.

2 The Securities and Exchange Commission considers 15 percent of total operative expenses as a representative figure in its calculations. In many instances the percentage will be higher.
and over-responsible to the group under-charged. It is the function of depreciation accounting and its control to avoid these latter injustices as much as possible.

Depreciation is not the only situation in which the two main flows are equal, but subsidiary flows diverge. Any business with a degree of complexity will have different classes of customers or different types of service. Each class of customers or each type of service represents a portion of the total asset-flow, both in and out. Actually, for example, customers are usually classified on the basis of their relationship to the total flow. Those having the same relationship to the total flow are classed in one group and treated similarly.

But the classification itself, whether of consumer or type of service, difficult though it frequently is, only suggests the problem of pricing. Every pricing entity (consumer or commodity) is recipient of certain contributory flows from various parts of the business enterprise. Each entity is also responsible for certain inflows from consumers. The

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1 For an excellent discussion of the purposes of depreciation, as well as things which are not purposes of depreciation, see Mason, Perry, Principles of Public Utility Depreciation. (American Accounting Association, Chicago, 1937.) The views expressed here represent a consensus of opinion among students of regulation.

2 Re Rates and Rate Structures, P.U.R. 1931 C, 337. This is a discussion of the principles of customer classification. Courts, commissions, and writers alike seem to agree that classification should follow cost lines.

3 The problem of rate regulation proper is the problem of the rate level. This problem under discussion here is that of the rate structure. This last is probably the most complex, but perhaps not the most important, for reasons we can investigate later.
problem of the rate structure is to devise a system of pricing that will relate these two opposite flows in a more or less equitable fashion. This is similar to but not quite identical with the depreciation problem.

The pricing complication arises because the service-flow from assets to services is not direct. Rather the flow is first into a central hopper, and from there out to the various services. And since the consumer-sacrifice must again be derived from the factor-sacrifice, the flow from the latter must be broken down into its component parts as a part of the pricing process, otherwise a situation of over-responsibility and under-responsibility will arise between groups of customers. Thus this problem arises in all cases where an asset produces a single flow of service, which flow contributes to more than one service or class of customer. These will be called here non-allocable flows. The regulation problem here is to separate flows into their component parts.

The right involved here, is the right to reimbursement for the factor-cost. The responsibility therefrom is a single flow, but which culminates in several different places without ever actually separating. This series of subsidiary responsibilities must be made to add up to the single right, and be themselves equitable with relation to each other. This problem, of course, is much bigger than the accounting problem.

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1 Economists typically use the term joint cost. There is, however, a very real difference between joint cost and non-allocable cost. The former implies necessity as to the production of two products simultaneously. Both terms refer to impossibility of separation. But non-allocable cost does not imply the necessity inferred by the term joint-cost.
that produces it. But if the problem is not met at the accounting level, it can be effectively met nowhere.

Following from this analysis another confused point in regulation may submit to partial illumination. It is now generally agreed among students of regulation that value of service has little significance for the problem of rate regulation. But in other circles the concept is still current. Where this is true cost of service is supposed to set the lower limit to price, and value of service the upper limit. If ever there were a situation that could be defined as the area between competitive price and monopoly price, this would be that situation. As popularly interpreted value of service is simply any point on the demand curve for total product that is not on the cost curve for that particular consumer class or type of service. Any condition of this nature, if allowed by the regulatory authorities, gives the regulated industry several possible degrees of economic power over consumers. If one of these degrees of economic power equates rights and responsibilities as between a consumer class and the utility, none of the others can. And it is very little help to assert that cost of service is used in fixing the rate level, while value of service assists in adjusting the rate structure. The right-responsibility relationship is not altered by the distinction.

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1 Thompson and Smith, op. cit., pp. 260 ff.


3 Value of service may be invoked verbally on failure to calculate cost. This procedure is dictated by expediency, however, and has no substantive meaning in regulation. See Barnes, op. cit., pp. 291-292.
Before concluding this discussion of the economic pattern of regulation a few comments to link this chapter more closely with the one preceding might be helpful. Although in totality regulation inevitably sounds quite contrary to social emphasis upon individualism, this surface incongruity tends to disappear when related to the larger whole.

In the preceding chapter the legal approach to property defined as "a bundle of rights" was accepted as satisfactory. This definition, however, considers the individual only in his relationship to his own property, together with the tools used by the courts to protect property. Individual rights and property protection are socially valid only if placed in a substantive setting. Private property would have little reason for being as an integral part of a social philosophy unless society were represented. Ely considers private property as an entity held in trust for society, to revert back to society if ever social purpose can be served better in that way. This statement, however, does not define the real content of the social relationship recognized. Substantively, property is more than a bundle of rights. It is also a bundle of responsibilities, the size of which society is continually comparing with the size of the rights-bundle. Whenever society discovers an inequality in the size of these two bundles that appears to be larger than "necessary", an adjustment is made or attempted.

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1 Property and Contract, Volume I.
In all of this public utilities are not unique. Their relationship to society is fundamentally not different from the relationship between society and any other item of private property. But with the above economic background much of the argument of the previous chapter should stand out more clearly. The economic philosophy of equal society is the correlation of rights and responsibilities. Wherever this task is efficiently performed by informal control, regulation is not necessary. At all points where there is a divergence between the two under informal control, regulation is indicated. In most business this equality is spontaneous. In public utilities regulation is needed to produce equality. Through the concept of equal residual rights the net result in both cases is identical. Thus all business, or all property, is on precisely the same footing in terms of both the underlying social philosophy and the actual application of that philosophy to individual cases.

Professor Glaeser, in his classic treatment of public utilities, has presented an analysis of the theory of the origin of separate treatment for public businesses. He traces the peculiar relationship of these concerns to the public back to the feudal relationship of rights and duties.

1 Glaeser, Martin G., Outlines of Public Utility Economics. (The Macmillan Company, New York, 1927.)
2 Pp. 168 ff.
We conclude, therefore, that the significance of the phrase "business affected with a public interest" resides not so much in the character of the industry thus classified, as in the complex of rights and duties that go with such classification. This implies that its importance is that of an institutional development. The core of it is represented by the feudal conception of relation, which has been hardened into a social habit by becoming commonly accepted. The conception, thus generalized, has been given greater solidity and rational, coherent form by being organized into a definite mode of legal procedure. There was a persistent need for developing such forms of procedure and, as a consequence, these forms have crystallized into an institution which controls the continued performance of the function.

It would be more than futile to deny this relationship between the feudal economy and capitalism. Basically, Professor Glaeser is well grounded. But it does not necessary follow that the feudal relationships were transferred only to the public utility field. Rather it seems implicit in the entire laissez-faire philosophy. It is a thesis of this dissertation that the "complex of rights and duties" is a superficial distinguishing characteristic of the utility enterprise, and that these rights and duties arise out of industry itself. Certainly it could not be agreed that the utility concept has a universally accepted connotation. Indeed it is a difficult part of teaching a course in Public Utilities to define the term. Rights and duties, in the sense presented by Professor Glaeser — rights and responsibilities as we have been using these terms— are the universal content of all business (private property)

1 P. 171.
in our capitalistic society. The only thing "peculiar" about the utility business is that its rights and responsibilities needed formal correlation before such correlation was necessary in other businesses.

This chapter, like its predecessor, has presented regulation in extreme terms. That regulation has nowhere appeared in this form is essentially a result of two factors. In the first place, regulation could have reached this point only through a process of evolution, for only gradually could the business environment have changed sufficiently to have necessitated the extreme of social control. In the second place, when the environment did necessitate near-extreme measures in terms of the early classification set up by the courts, the same environment was forcing changes in the classification and resulting in a weakening of the principle of equal residual rights. As a consequence certain issues of regulation were compromised drastically, preventing extremes in control. The two chapters immediately following will discuss respectively the breakdown of the classification and the weakening of the principle of equal residual rights.
CHAPTER III

RENTS AND REGULATION

The two preceding chapters outlined the more or less ideal adjustment — legal and economic — to the problems posed by regulation. This adjustment would have minimized the scope of regulation in the interest of the freedom dimension of social philosophy, and, carried to its logical extremes, would have maximized the extent of regulation for that area of the economy where control over the 'heart of the contract' was permitted. This adjustment fitted reasonably well the environment that produced it. But the later developments in onrushing capitalism made this ideal adjustment less and less realistic, finally resulting in vast compromises in the adjustment in two major directions.

The first environmental development — the growth of inelasticity — resulting in one type of compromise — relating to the scope of regulation—can best be described through the concept of economic rent.

Although economic rent has been variously defined by economists, the substance of accepted usage today is to define rent as the unearned surplus received by a factor of production. With this general definition in mind, we shall proceed to a brief study of the economic factors involved in the concept of rent in the economy of today.

Perhaps the best discussion of the "surplus" theory of economic rent is that of Joan Robinson in her famous chapter "A Digression on Rent." Her definition of rent in the following terms is typical of the

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1 Baddy, J.P., Profits. (Hodges, Friggis and Company, Dublin, 1940.)
2 The Economics of Imperfect Competition, (The Macmillan Company, New York, 1934.) Chapter VII.
new approach: "The essence of the conception of rent is the conception of a surplus earned by a particular part of a factor of production over and above the minimum earnings necessary to induce it to do its work." 1

Equally instructive for our purposes is Mrs. Robinson's explanation as to why rent has always been so closely associated with land. According to her analysis, the concept is reducible to a reward to the owner of "free gifts of nature." These goods are free gifts in the sense that they do not owe their existence to human effort. Therefore these gifts need not be paid to perform their function. The most important example, historically, of economic goods that do not need to be paid to exist, is 2 land. These facts broadly outlined the discussion of and controversy 3 over economic rent for well over a century.

It seems advisable here to summarize a portion of Mrs. Robinson's treatment in order to secure a clearer grasp of the total rent picture, 4 before proceeding into its corollaries. The first requisite for the existence of economic rent is an inelastic supply for the factor under

1 Ibid., p. 102.

2 Mrs. Robinson continues as follows: "But the conception of rent has often been too closely interwoven with the conception of land. Particular units of factors of production which belong to the other three broad categories, labor, entrepreneurship, and capital, may also earn rent."

3 For an orthodox treatment of rent as a concept applicable to the land factor, see Froman, op. cit., Volume II, chapter XXIV.

4 Op. cit., chapter VIII. This summary follows Mrs. Robinson's analysis quite closely. No attempt has been made to be original.
Consideration. If it is to be had in whatever quantities desired at the same price, it is in perfectly elastic supply, and no rent will be earned. Suppose, for example, individuals would be willing to work any amount for $3 per day, and that at a lower wage no one would work at all. The wage rate could not rise above $3, because no entrepreneur would offer more. The wage rate could not fall below $3, or the economic machine would stall completely. Thus every unit of the labor factor would be receiving enough, and just enough, to keep it at work, and no rent would be paid.

On the other hand, suppose that more work is to be had in a given industry only at the price of higher wages. Let us assume that 100 more workers would be available at every $1 per week increase in the wage rate: 1,000 men would be available at $21 per week; 1,100 at $22 per week; etc. If wages were to rise from $21 to $22, everyone who was previously contented with $21 would be receiving a "free gift", or a "surplus" over and above that necessary to keep him at work. This rent arises from the inelasticity of the supply of labor, or the fact that new units hired cost more and the price of previous units rises for this reason. It makes no difference to the theory whether the new units cost

1 Mrs. Robinson uses capital as her example, rather than labor. She gives as the reason why interest will never rise above 5% in her illustration, that at a higher rate a veritable flood of savings would be thrown on the market, forcing the price down. This is not implicit in her assumptions, nor is it necessary to complete the picture. It is sufficient that no entrepreneur would hire capital at a greater price. If he did there would be a rent.
more because they are less efficient, or because they are more efficient elsewhere. It is enough that the price does rise as more are hired.

It is at once apparent that the conception of rent here defined is capable of two very different interpretations or applications. It might refer to the total economy — *i.e.* how much whole factors of production receive over and above necessary costs ($300,000 per year may be necessary for a single top executive as long as there are numerous other $300,000 a year executives located elsewhere. But the whole group taken together could be cut materially without destroying these valuable services). Or it might refer to the payments made to one segment of the economy — *i.e.* how much fractions of factors receive in excess of that required to keep them in this particular segment of the economy. The first necessitates defining the costs that are essential to keeping a given factor at work; the second necessitates defining the costs that are essential to keeping a part of a given factor at work where it is. The former poses the problem of distribution; the latter the problem of regulation. It is this last connotation that is relevant to present purposes, and which will be the primary concern from this point.

1 See Boulding, *op. cit.*, pp. 229 ff. The definition of rent given in this work is as follows: "Economic rent may be defined as any payment to a unit of a factor of production, in an industry in equilibrium, which is in excess of the minimum necessary to keep that factor in its present occupation."

2 Mrs. Robinson's treatment stops short of the application of rent to regulation. It is at this point that the present work hopes to shed new light upon the relationship between government and industry.
These latter applications of rent theory can best be appreciated in terms of opportunity costs. In an economy as complex as ours, virtually no factor of production has a single use. The versatility of a factor, in fact, is measured in terms of the number of alternatives for occupation that it has. Non-specialized factors have many of these alternatives; specialized factors have few alternatives. In a capitalistic society the owner of every factor is desirous of employing each unit of ownership in the most profitable of the available possibilities. It must follow that no unit of a factor will work in one capacity, if it could better itself in another capacity. Thus the necessary cost of any productive unit is that just necessary to keep it from transferring its services to another segment of the economy. These costs are the necessary payments made to all agents contributing to a given production and are called opportunity costs.

However, there is no magic relationship between necessary payments to factors and actual payments. The contract between the factor and the entrepreneur is a product of bargaining, and nothing is a bargain if it could be gotten cheaper. With this qualification, opportunity or necessary costs represent only the minimum that will be voluntarily accepted by the factor. The actual payment will be worked out according to the relative bargaining strength of the contesting parties. Whatever the factor receives in excess of necessary payments — which will be measured

by the quality of the next lowest alternative — is a free gift, so
to speak, or economic rent; that which could be dispensed with
completely without injuring economic effectiveness.

The potential amount of the economic rent depends upon the
size of the bargaining area. This in turn is a function of the margin
between the two best alternatives. If the margin is wide, a factor with
much bargaining power can retain a substantial surplus; if the margin
is narrow the maximum surplus will be small. In the case of Edgar Bergen,
margins are probably wide — alternatives defined as "with" McCarthy
compared to "without" McCarthy. This may present the alternatives
unfairly, but the issue can be clearly seen. The ordinary workman deals
in small margins. That is, the amount he can get from one industry is not
far different from that which he might get from some other industry
requiring about the same skill — assuming he could get another job,
which factor might be an important limiting consideration.

Further analysis requires additional terminology. Earnings
1 equivalent to opportunity costs will be called transfer earnings, since
they are the lowest possible earnings that can be paid to the factor
without its transferring its services elsewhere. Each unit of production
receiving no excess over transfer earnings may be said to be at the
margin of transference, since any reduction of earnings would result in
actual transference. The actual receipts of any unit of a factor will be

1 This terminology is suggested in Henderson, H.D., Supply and
Demand. (Harcourt, Brace and Company, New York, 1922.) Pp. 94 ff. See
also Robinson, op. cit., p. 104.
called actual earnings, as distinct from transfer earnings. Each unit receiving more than transfer earnings will be called an *intra-marginal* unit, as distinct from the unit at the margin of transference, which unit will be known as the marginal unit. Finally, since intra-marginal units may represent an infinite variety of cases, the term *degree of intra-marginalness* will be employed to designate such difference.

Immediately, it can be seen that there is a unique relationship between capitalism and economic rent. Bargaining is for the purpose of maximizing returns. The essence of capitalism is the bargaining process. Thus every unit of a factor is most vitally interested in the greatest net returns. Net returns has the same connotation here that it has in economic terminology — gross receipts minus cost of output. Cost of output to a unit of a factor of production is its transfer earnings. Since this is a constant amount at any given time, net returns is equivalent to actual earnings minus transfer earnings. Economic rent, therefore, is identical with net returns, and will henceforth be used in place of the latter term. Reduced to essentials, economic rent is the amount that every unit of a factor seeks to maximize in the bargaining process.

Economic rent can now be presented in a slightly different light. Transfer earnings represent the nearest approach to the concept sometimes referred to as real sacrifice. The excess of actual earnings over transfer earnings is a "free gift." In the terms already discussed

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1 This refers to a unit of a factor within an industry, rather than to an entire factor. The latter analysis could be made in similar terms, but its essential features are sufficiently distinct to warrant its exclusion at this point.
at some length, actual earnings can be thought of as related to individual rights; while the real sacrifice represented by transfer earnings can be considered the social responsibility implicit in a given bargain. Economic rent is an excellent monetary measure of the excess of right over responsibility or vice versa.

This principle of rent maximization is quite an important corollary of our economic system. It is, for example, anticipated that a factor will be interested in minimizing responsibilities and maximizing rights. Such an approach is the basic content of free bargaining in a capitalistic system. It has long been recognized that a firm endeavors to generate a maximum output with a minimum input. This has the same general substance as the equivalent statement — a maximum of right with a minimum of responsibility. But the firm and buyers represent only one side of the bargaining process, the output side. On the other side stands the factor or factors that represent input, in a similar relationship to the firm. Our analysis of economic rent broadens the bargaining principle of maximization to include all business relationships (transactions).

With the outline thus nearly completed, a restatement of the business process should be instructive. Free enterprise contemplates a struggle between the various bargaining units — the prize being a maximum amount of net income as compared with other units. These bargaining units determine their own size and extent on the basis of profitableness. Buyers, as bargaining units, are virtually compelled to play alone. There are certain fundamental reasons why some business units or some factor
units tend to grow large more rapidly or slowly than others. But, regardless of size or extent, every bargaining unit has but one over-all aim — to maximize economic rent. The firm, in bargaining with buyers, seeks to maximize total rent accruing to it; while the factors, in bargaining with the firm, seek to maximize an individual portion of this economic rent. The strongest unit retains the largest share of the rent. The weakest unit retains the smallest share. (It might be well to bear in mind for future reference that strength may be a function either of size or of a peculiarly favorable situation). The over-all summation of rights and responsibilities are disposed of in this way. The strongest emerge with the largest share of the individual rights; while the weaker emerge with responsibilities. The economic setting of regulation becomes the size of the bargaining area and the relative strength of the opposed bargaining units.

It is now necessary to revert back to the generalized theory of economic rent that is the hub of the argument in this chapter. Mrs. Robinson has very carefully pointed out that "... if the supply curve of a factor, drawn up on these principles, is perfectly elastic to an industry we shall know that none of the units contained in it are earning rent from the point of view of that industry". It is of much

1 These are the advantages of large scale production. For a fuller description see Jones, Eliot, The Trust Problem in the United States. (The Macmillan Company, New York, 1922.)

2 Since it is highly undesirable to confuse the issue with the highly controversial consumer's surplus, no analysis will be made of economic rent for the consumer. Such an analysis would belong more properly to the larger problem of distribution.

more than academic importance to emphasize this fact. For it follows from the present analysis that any correlation between rights and responsibilities must hinge upon some relationship analogous to elasticity of supply for the factors of production.

Perfect elasticity of supply means essentially that every unit of factor affected is equally free to adjust itself to a new situation. To the individual firm, elasticity of supply means a horizontal supply curve for the factor, which in turn means that every added unit costs the same as the preceding unit, and is equally efficient. For the factor, elasticity of supply means that the next best alternative is an equivalent one, both in terms of reward and in terms of output. In both these cases all factors directly concerned encounter no obstacles in adapting themselves to a new dynamic situation.

Imperfectly elastic supply, on the other hand, connotes precisely the opposite. For the firm, added units of a factor cost more or are less efficient. The same phenomenon, stated from the viewpoint of the factor considered, refers to leaving situations of increasingly higher reward. In other words, whether considering the firm or factor, alternatives have become separated, leaving a bargaining area between separate alternatives, which area means economic rent.

It is essential to the economic principle that opportunity costs should tend to equalize. Unequal opportunities, viewed by a factor of production, are the impulse to shifts in employment by factors, the shift being from a situation of smaller profitableness to one of greater

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1 Ibid., pp. 107 ff.
profitableness. In the process of this movement, the profitable opportunity will become less profitable, while the unprofitable one will become more profitable. The movement will stop only when all opportunities are equally profitable. The economic principle in these terms states that a factor of production will distribute itself among the various possible alternatives, until one more unit could be hired in any one of these alternatives it being a matter of complete indifference which alternative is selected.

From the standpoint of economic rent this equalization of opportunity costs has a real significance. In the first place any factor would necessarily be in perfectly elastic supply, since an entrepreneur adding to output could draw one factor from each alternative employment, and therefore at the same price. By definition there would be no difference between these factors in reward. Therefore they would all be available at the same price. Thus no economic rent would be paid. And not only would every unit of all factors find their equilibrium, but dynamic changes would find each factor equally able to adjust itself to the new conditions.

Immediately the important qualification of the theory of opportunity cost equalization becomes apparent. The theory rests upon

1 Gemmill, op. cit., pp. 391-392.
2 Knight, op. cit., pp. 83 ff.
3 It might be urged that these factors from different employments, though receiving the same reward, have efficiencies differently adapted to the new employment. Certainly this is possible. But to advance the argument is simply to add a qualitative difference to a quantitative problem. No essential damage is thereby done to the theory of the bargaining area advanced here. The problem only becomes more complicated.
an assumption of complete and perfect mobility of the factors of production, both in terms of reward and in terms of efficiency. This mobility of the factors makes economic rent impossible. To the extent that there are obstacles to factor shifts, or opportunity cost equalization, economic rent can and will exist.

All of this can be partially clarified by illustration. Pipelines for petroleum and petroleum products have typically been highly profitable. During the recent depression many of them were earning 20 or 30 percent on invested capital, while other agencies of transportation were going bankrupt. The reason for this anomaly is that the alternatives facing one who has oil to transport are not at all close to one another. Shipping by pipeline is cheaper than the next best alternative, whether the pipeline earns 6 per cent or 25 per cent, these percentages giving a rough index of the large bargaining area existing in the oil transportation field. Whatever capital receives in the pipeline industry in excess of what it would receive elsewhere, is economic rent.

The pipeline industry well illustrates the fact that divergence between the quality of alternatives, gives rise to an economic rent to the factor most favorably situated. This industry also illustrates why factors do not move to wipe out the differential. A pipeline is a very specialized commodity. Between two points one line is usually enough to handle all business. If one line can earn profits of 50 percent, while two lines would only earn a profit of one percent, the situation is not

1 Knight, op. cit., pp. 81-2.
one that can be remedied by factor movements.

It seems desirable to translate this illustration into the terminology introduced earlier. Capital invested in the pipeline industry has transfer earnings of, let us say 5 percent. To the extent that this capital comes to earn more than 5 percent, it becomes intra-marginal. The degree of intra-marginalness is the bargaining area between the capital owners and oil shippers. To the extent that the capital owners have a maximum of bargaining strength, they receive all of the rent. A substantially different situation is quite conceivable. To the extent that the over-all situation permits factor adjustments, alternatives will become continuous again. Otherwise the inelasticity involved will be permanent rather than temporary.

At this point again, it should be instructive to refer to pure competition, and its relationship to the equation of rights and responsibilities. Under pure competition all factors, as well as all individual firm demand curves, would be characterized by perfect elasticity.

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1 It is very important to realize that in our financial society the capitalization process serves to close those gaps in the continuity of alternatives. However, the gap cannot be closed without giving rise to an economic rent, which is the item capitalized in the process of revaluation.

2 In actual practice this excess will be capitalized in the capital market. Here it is sufficient to note that in a particular case capitalization is not a true "process", but simply an occurrence. That is, it does not take place over a period of time, but all at once. This is the main reason why rents are difficult to contend with in regulation.
Perfect mobility of productive factors would eliminate economic inelasticity and equalize opportunity costs. Every unit of a factor of production would be at the margin of transference; no units would be intra-marginal. Actual rewards would represent real economic sacrifice (in so far as a sacrifice can be measured in monetary terms), and the cost to the consumer would be the true economic cost involved.

It is now possible to demonstrate more fully the essential nature of the bargaining area uncovered by dynamic economic change. The relationship between a factor and a firm is a power relationship. Each endeavors to exert a maximum degree of economic power over the other. Under pure competition, this would still be their goal. But under pure competition, with all that is implied by that term, each bargaining unit would be faced with only one possible degree of power, equalized opportunity costs. This one degree of economic power would be precisely that degree that would equalize rights and responsibilities (transfer earnings and actual earnings).

The condition of "equilibrium" for economic units can be stated broadly as follows: no bargaining unit that is in position to decrease its economic power, has an incentive to do so; while no unit that has an incentive to increase its economic power, is in position to do so. That generalized statement can cover every situation, whether economic rent exists or not. But the purely competitive situation, and

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1 Knight, op. cit., pp. 76 ff.
that desirable if equalizing rights and responsibilities is important, must be stated more carefully. Classical equilibrium for the bargaining units in the economy contemplates a situation in which the degree of power exercised by the unit is identical with the degree of power it must be allowed if it is to remain at work. That is, any decrease in the economic power it exerts (its reward) would necessitate a shifting employment. Whenever this statement and the above generalised statement do not say precisely the same thing, rights and responsibilities are not equal.

Obviously any bargaining area is inconsistent with the above formulation. As has been indicated previously, the existence of more than one degree of economic power in the hands of a bargaining unit is incompatible with equality in society. In so far as regulation has in mind enforcing equality it will operate to remove from bargaining units this bargaining area. This will entail abolition of economic rent, which in turn can be accomplished only by doing away with economic inelasticities.

Economic inelasticity and economic power are virtually synonymous terms. But this power may spring from two different sources. First, it may come from an inelasticity that, as far as the factor itself is concerned, just happens. Second, it may be an inelasticity deliberately planned by the factor. If the inelasticity is planned, the planning factor will maneuver itself into a position enabling itself to receive it. If the

1 The classic treatment of this subject is Progress and Poverty, by Henry George. (Sterling Publishing Company, New York, 1894.) George, however, carried his reform suggestions to impossible (and illogical) extremes.
inelasticity just happens, the factor receives it because of its present situation. An example of the first might be the creation of a monopoly in which the monopolist creates an inelasticity because he is in position to receive a rent therefrom. An example of the second might be the discovery of oil on property bought for pasture purposes. Here the owner receives the rent simply because he is the owner.

These two types of economic rent are quite important in distribution theory. More and more economists are thinking of rent in the terms here expounded, and confusing it somewhat with distributive profits. This confusion is unwarranted. Profits are rents created through deliberately constructed inelasticities; rent proper is the economic rent accruing to a factor from the vagaries of nature (economic forces) that find the factor peculiarly well situated.

The justification for regulation is ultimately reducible to a divergence between right and responsibility under informal control. Public utilities were singled out for special treatment because divergence between right and responsibility appeared in these fields before others, and seemed larger and more permanent here than elsewhere. Further development has indicated that divergences of the nature here considered result from inelasticities in the economy, frozen structures that do not

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1 This distinction is not basically different from that developed by Arthur Beddy in his book on Profits, op. cit. However, the writer has developed his thesis from an entirely different base point, and was unaware of the work of Professor Beddy until the present ideas had been formulated in detail.
allow competition full opportunity to adjust to dynamic change in all areas at the same time or in equal proportion. These inelasticities operate to convey to some bargaining units an unwarranted degree of economic power over others. Regulation was conceived to destroy this privileged relationship in favor of equality.

In concluding this phase of analysis of the public utility concept, a final definition of inelasticity, following lines previously suggested, will be offered as an analytical tool. An inelasticity in the economy is any condition, or set of conditions, wherein a dynamic change permits one bargaining unit to substantially alter the quality of alternatives facing another unit or group of units. To the extent that the operation of the dynamic change uncovers inelasticity, its result is economic rent, which is the quantity that bargaining units desire to maximize, and which regulation endeavors to minimize.

A relation of this analysis specifically to public utilities resolves itself into a discussion of the economic characteristics of utilities. A most common attribute by various writers is that of furnishing an indispensable service. Economists are much more careful

1 The situation is this more complex than it is frequently understood to be. Note this statement by Wilson, Herring, and Eutsler, *op. cit.*, p. 94: "Since public utilities generally operate under conditions of monopoly, any given public utility is free to fix the rates for its product or service at the point that will yield it the largest net profit."

2 See Thompson and Smith, *op. cit.*, p. 56. "... The significant factor surrounding public utilities has been the imperfect operation of economic forces, thereby giving the utilities an excessive amount of economic power over those obliged to bargain with them."

now than formerly in the use of this term because it has no universal meaning. In fact it has no meaning at all without quite arbitrary definitions and distinctions. What is meant by the term indispensable, the writer believes, is that the real quality of alternatives can be altered by certain dynamic changes. If the price of electricity in a city were to be suddenly doubled, the quality of alternatives for the population would be seriously altered. Some would be forced to curtail their consumption sharply. This would be a definite hardship to almost any user. Others would cut down on other things, which curtailment would likewise be a hardship. In other words control over a basic service gives the controller degrees of economic power, not consistent with the responsibilities he has assumed. The inelasticity involved centers in the fact that the transfer alternative is widely separated from the present alternative, leaving the dependent units under the control of the independent unit within the bargaining area thus left.

Clearly "indispensability of service" could not stand alone as a justification for regulation. Probably no one would gainsay that the service performed by soft drinks in a city is indispensable. If all soft drinks were denied persons in the city, or the price were summarily doubled, the population would probably consider itself ill-treated. Certainly the quality of their alternatives would be substantially altered. But, contrary to the case of electricity, no bargaining unit by itself can thus control the quality of alternatives. The independent units in this case have no power to widen the bargaining area between the transfer alternative and the actual alternative for the dependent units.
Both of the above cases can be compared with the manufacture and sale of the "yo-yo". Even if control of this entire activity were centered in one bargaining unit, society would not be likely to interfere. If "yo-yos" were suddenly taken completely off the market the alternatives of people could not be said to be substantially altered. The same would be true of any industry making a contribution to the economy that is not considered particularly significant by the individuals who take advantage of it.

An allied concept frequently advanced describing the public utility is the privilege of eminent domain. Eminent domain is the right conferred by the state to limit compensation for a piece of needed property to a reasonable amount. This power is not limited to use in helping public utilities, but extends to any function that the state wishes to perform and in which the state has jurisdiction. It is quite important in the utility field. Suppose a utility needs a particularly advantageous water site. The owner has placed a price of $10,000 on the property, while transfer earnings (opportunity cost) are $5,000. This owner, as a bargaining unit, is definitely in a position here to alter substantially the quality of alternatives of the utility. The bargaining area represented by this quality of alternatives is the area

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1 Ames vs. Union Pacific Railway Company, 64 Fed. 165. Eminent domain can logically be shown to be subsidiary to the public utility concept itself.
between $5,000 and $10,000. This difference in money amounts is economic rent. Eminent domain (regulation) in this situation will equalize transfer earnings and actual earnings, thus destroying economic rent and equating bargaining power between units.

It is frequently observed that public utilities are natural monopolies. A natural monopoly is a business so constructed economically that it is impossible to operate it as a competitive enterprise. This definition of itself is not selective as between businesses. All businesses have some characteristics that tend toward expansion. But most of these are not public utilities. In the broad sense, therefore, natural monopoly is only a matter of degree. But in the narrow sense, the term can be used selectively. The more narrow definition contemplates only that situation wherein a resource is used that is limited by nature. In this category could be listed city streets, water supply, dams, etc. This characterization of the public utility as compared with the private business is only another way of defining regulation in terms of the protection of alternatives. A city desires to inaugurate a utility service. There is only one suitable location for certain of the necessary appurtenances. The unregulated control over alternatives by the bargaining


2 Triffin, Robert, Monopolistic Competition and General Equilibrium Theory. (Harvard University Press, Cambridge, 1940.)
utility would permit of various degrees of power. For the population the alternatives uncovered by a rise in price would be to do without the service or do without the things that equivalent money would purchase. Either alternative is qualitatively much inferior to the lower price. The bargaining area (zone of inelasticity) is the difference between the no-profit price and monopoly price. Monopoly profits are the economic rents that regulation desires to eliminate. This elimination takes the form of identifying the actual alternatives with the transfer alternatives — thus equating rights and responsibilities by moving the bargaining unit to the margin of transference.

It is further contended that utilities are regulated because competition is ruinous, forcing rates down to unremunerative levels. Unremunerative levels, economically speaking, simply mean levels below opportunity cost for the several factors. This applies particularly to the capital factor. But whichever factor is forced to receive rewards lower than transfer earnings, it is contributing to society in greater proportion than society can claim as a right against the factor. In such a case the right-responsibility divergence is opposite to the usual relationship, society rather than the factor receiving the economic rent. But poorly paid factors are, in one important sense, just as much a legitimate cause for concern in society as overcharged consumers. Thus regulation has a similar social function to perform in both cases.

1 Jones and Bigham, op. cit., pp. 70 ff.
The above suggestions should indicate in part why utilities were selected for regulation before other businesses. But the reason is somewhat more subtle than usually recognized. The fact that regulated industries are frequently service industries rather than producers of commodities is not significant in and of itself. What is important is that the closer the relationship between the producer and the consumer the more apparent is the unfairness connected with economic rents. No more is it significant that the product is locally consumed. This, incidentally, is by no means universally true, except in so far as this is merely a restatement of the fact that services are in general regulated before goods. The significant fact is that technical conditions make transportation difficult, and decreasing cost factors will virtually dictate market saturation with a single firm — thus producing a monopoly. The statement that the products of regulated industry are highly standardized, also, is by no means universally true (e.g. the radio industry). Again the more subtle significance of standardization is that discrimination is easily visible without service (cost) differences,

2 Dorau, op. cit., p. 186.
3 Economics has run into much difficulty by not consistently defining a market. Here a market will be defined as a homogeneous group of customers. Thus a market is the competitive area. Stated in this way a market and the cost conditions of industry take on a more correlate meaning than is sometimes given to them.
4 Dorau, op. cit., p. 187.
but hard to detect where qualitative differences are also present.

The economic inelasticities that surround the utility industry are the basic justification for regulation to equate rights and responsibilities. All of these inelasticities are but manifestations of one principal inelasticity that basically patterns all others. This same inelasticity is present in all industries in varying degrees. This inelasticity is that of capital structure. Public utilities have a very low capital turnover, estimated by the University of Illinois, Bureau of Business Research at 0.127. This turnover fraction means that the annual gross income of an average utility is one-eighth of its capital investment. This might be compared to the retailing business, for example, whose annual gross is three times capital investment. This capital structure in the utility industry is basically fixed. This fixity is at one and the same time its inelasticity. For once invested it cannot be invested elsewhere, or increased without substantial other adjustments. The difference between the actual value of the investment and its opportunity cost is the bargaining area between the utility and the rest of the economy, the area within which actual returns may fluctuate without causing the specific item of capital to be removed. This area may be positive or negative, advantaging the factor

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1 Standard Financial Ratios for the Public Utility Industry. (University of Illinois, Urbana, Illinois, 1929.)
or society. But in both cases its regulation status is the same.

In substance, however, it seems advisable to distinguish between these two possibilities. In prosperous times the economic rent is positive, favoring the factor. Here the inelasticity revolves around the fact that capital goods cannot be increased immediately, that some strategic location may already be taken, and that the business operates according to a principle of short-run decreasing costs. In depression years actual earnings may fall substantially below transfer earnings. But since capital can not be moved for technical reasons, the result is relatively permanent losses.

But, whether times be bad or good, the business as a bargaining unit must concern itself with making every individual transaction contribute a maximum amount toward net returns. The potential contribution of an individual transaction to net returns has no automatic relationship to the partial right and responsibility involved. Inelasticities in the economic structure make it possible to claim as a right against one buyer as contrasted with another, higher charges than could be justified by a definition of the social responsibility involved.

Although the above analysis is stated in terms of capital inelasticities almost exclusively it is implicit that inelasticities

1 Professor J.M. Clark has furnished a full-length treatment of the problem of capital inelasticity. The Economics of Overhead Costs. (University of Chicago Press, Chicago, 1923.)
pertaining to human beings directly are equally contemplated. The economic environment and the criteria of success are such that the most effective individual adjustment is frequently a highly specialized adaptation. Social dynamics can just as quickly produce positive or negative rents in this as in the capital situation. When it does an inequality results that society may or may not take it upon itself to correct.

This subject of inequalities between human beings apart from the external environment, of course, opens up a wide field for discussion. The social philosophy of America, even in its more extreme forms, does not postulate absolute human equality. In fact the working out of the philosophy in practice takes extensive advantage of the existence of inequality. What is postulated, however, is an environment in which natural inequalities would be made commensurate with the assumption of offsetting responsibilities. As capitalism developed the environment lost much of this quality. As a consequence of this environmental development the adjustment to the regulatory problem had to take cognizance of the human counterpart to what has been here discussed in terms of capital inelasticity.

The above detailed discussion of economic rents resulting from inelasticities has several ramifications that are of importance here. It is obvious that the fact of specialization in the economy—both human and capital— and the existence of great aggregations of capital
were not instantaneous in appearance, but developed to their present status through a long process of evolution. Thus it is not surprising that the development of regulation has been gradual, in the sense of merely keeping abreast of changes in the environment. As a consequence regulation has slowly been intensified until in certain cases it represents a very high degree of control.

The relationship between rents and regulation also makes it quite clear that utilities are today not the only businesses that have characteristics making for a need of regulation. Most businesses are specialized and represent large aggregations of capital. The differences between businesses from the standpoint of control becomes one of degree only, rather than being capable of statement in the extreme terms once used by the courts.

A further important ramification is that regulation as formal control is a process of equalizing differentials in power throughout society (reciprocal power) in the face of the growth of a society of organizations rather than a society of individuals as was originally presumed. Men are today relatively less in competition with men; relatively more in competition with groups.

Most of the regulation of the past fits into a category that may properly be called negative regulation, or taking away rights. In the environment from which the social philosophy of individualism arose it was taken for granted that every individual would make his choices from opportunities some of which were favorable. Thus regulation developed to bring about equal treatment of individuals by certain businesses and to prevent inequalities from arising through profiteering. It is easy to see,
however, that specialization and all that is implied by the term could conceivably develop to the point where all opportunities available are unfavorable as defined by the philosophy. An excellent example of this is a period of depression during which large groups of people are unable to find employment and hence are unable to be 'individuals'. In order to deal with cases of this sort a positive regulation has developed.

These various ramifications, in addition to illustrating in part how environmental changes have forced a modification of phase I in the history of regulation, also serve to indicate in part the direction that this modification has taken. With the breakdown of the original classification of industries, regulation has been forced to develop subsidiary classifications the net result of which is to assure degrees of regulation commensurate with degrees of departure from social ideals. In a later chapter the nature of these subsidiary classifications will be delineated.
CHAPTER IV

CAPITALIZATION AND REGULATION

Specialization in the economy is only one of the ways the environment of capitalism has developed to make unrealistic the original adjustment to the problem of regulation. The other principal way in which this has occurred has been through the development of the capitalization process. The environmental changes that have taken place as a result of the perfection of this process have had their primary effect, not upon the scope of regulation as in the case of specialization, but upon the extent of regulation.

It will be recalled from chapter II that the limit to the extent of regulation was in large part set by the Constitutional provision of just compensation. Just compensation itself turned out to be simply the competitive return or fair return. If the norm of competition is attained, it was presumed, no one would be confiscated in the sense of losing by government decree the right to choose a degree of economic power consistent with the reciprocal power called for by the ideal. In this chapter a reexamination of the concept of confiscation will be undertaken, a reexamination made necessary by developments in the economy over the last 100 years.

So many of our legal relationships are shrouded by the fiction of the corporate personality that we frequently fail to understand just who it is that is confiscated by an unreasonably low rate
level. It is not the business entity itself that is wronged. To have suits brought by and against business concerns may fit the technical requirements of a judicial system, but it is a far cry from the dignity of the human personality upon which we pride ourselves. Rather it must be recognized that individuals only can be confiscated. If equality has any meaning in a democracy, individuals must be compared with individuals rather than with a ledger of accounts receivable and accounts payable.

Granting that individuals are the confiscated unit, it is next pertinent to inquire what it is they possess that is of value and that the law seeks to protect. Again, it is not the business. An owner may find satisfaction in the prestige of ownership and control but it has never been either the explicit or the implicit purpose of philosophy to guarantee this particular satisfaction. The choice as to whether or not to become an owner of a business does not center around the legal protection of executive authority. In a legal system where free will and choice are basic, an individual cannot be wronged by society in a relationship that society does not sponsor. Thus injury must follow philosophy.

1 In one of his first opinions as a Supreme Court Justice, Justice Black formally rebelled against considering the corporation as a person. See the dissenting opinion, *McCart v. Indianapolis Water Co.*, 302 U.S. 419. This extreme position is, of course, unnecessary to realistic understanding of the human problem involved.

2 The right to be "boss" of a business has no legal value. No business man has an exclusive right to his authority. All business relationships, even in a democratic society, are entered into with a congenital infirmity—subject to control by government in the public interest.

3 Even if power were the motivating force, an unreasonable return is no necessary deterrent. A railroad executive, for example, is not substantially injured by the fact that his road does not make a fair return.
The constitutional limitation of regulation is protection of property. If the property of individual participators in a business enterprise is not the business as such, what is it? It is simply an investment. And what is an investment? It is a claim. In his epochal book *Nature of Capital and Income*, Professor Fisher does considerable damage to reality by considering things of value to be physical assets. When the Supreme Court changed its interpretation of value from "use-value" to "exchange-value" it effectually destroyed the significance of physical objects as a source of value.

The creation and usage of claims to facilitate industrial expansion was an inevitable concomitant. Increasing per capita wealth and income were contemporary with a more and more elaborate division of labor in society. This minute and technical division of labor necessitated a highly developed exchange mechanism. This mechanism has more and more trended toward a type of market in which physical goods seldom appear, but in their stead claims to ownership of goods are transferred.

The most obvious result of the widespread usage of claims has been the divorce of the ownership of goods and the control of goods.

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1 (The Macmillan Company, New York, 1923.) P. 68.

2 The change of approval by the high court was parallel to a similar trend in academic economic circles. See McCracken, H.L., *Value Theory and Business Cycles*. (The Falcon Press, 1933.) Book II, Part I.

3 Boulding, op. cit., chapter XV.

In fact, this phenomenon, from the standpoint of financial
efficiency, is the principal advantage of the exchange of claims.
Furthermore this fact furnishes a basic definition of a claim, to
aid in further analysis of the significance of these instruments for
regulation. This definition of a claim is: an instrument enabling the
transfer of the ownership of goods without a corresponding transfer of
the goods themselves.

Another accompanying feature of the growth of finance
capitalism was necessarily a change in the definition of property. Instead
of considering property the mere possession of a commodity, it came to be
thought of as the possession of a right to an income from a commodity.
At this point lies the real significance of the separation of ownership
and control of goods. He who controls physical commodities has no
valuable rights if another has a prior claim to the income of these
commodities. The valuable rights accrue to the owner of the claim. Thus
the above change in the definition of property could not have avoided
making its appearance as claims became more and more socially significant.

To recapitulate in part: valuable ownership is not a business
but an investment. An investment is not a physical good but a claim. And,
finally, a claim is not valuable because it represents goods, but because

1 Commons, op. cit., Chapter II, gives an exhaustive treatment of
this new interpretation of property that Professor Ely did much to
popularize.

2 See Chicago, Milwaukee and St. Paul Railway Co. v. Minnesota,
138 U.S. 418.
it represents income. These statements are anything but isolated facts. Stated separately each one virtually contains the meaning of all together. Stated compositely they add up to one of the most significant recent developments in economic and jurisprudential theory—the concept of expectation.

The theory of expectations has had a rather unique history in economic exposition. Senior developed the term "abstinence" in order to incorporate "waiting" into economic costs. Later Bohm-Bawerk made the concept more general by expanding its use to include demand as well as supply. Specifically Bohm-Bawerk asserted that "present goods are, as a rule, worth more than future goods of like kind and number." Since Bohm-Bawerk interest theory has basically followed some variation of this theme. "Orthodox" theory accepts this approach without essential criticism. This does not mean that there is perfect agreement among theoreticians as to the precise relationship between time and production, but only that there is substantial agreement as to the fact of this

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1 Senior, William Nassau, Political Economy. This concept has been hinted at earlier by other writers, but a full discussion awaited Senior's treatment.


relationship in industrial development, due to the all-pervading influence of time in the modern business system. Some of the more important ramifications are as follows: production in advance of demand; fixed costs and the business cycle; stock market growth; risk and insurance; and "average" return in regulated industries.

Because of this very tacit treatment by the majority of writers, it is not surprising that a student of law and a student of economics would one day generalize time as an all-important influence in the social relationships of the day. The two men who performed this service were, respectively, Professor Commons and Professor Keynes. Although there is little difference between the two writers in terms of the basic problem treated, the work of Professor Keynes seems more pertinent to the present study, and will be drawn upon most heavily in further analysis. So effective has been the work of these writers that time and expectations are taken for granted today, whereas a few years ago they were scarcely mentioned. Here the problem will be to relate expectation to confiscation and the nebulous relationships that constitute due process.

1 Op. cit. It is not implied that Professor Commons is not an economist. But a careful study of his Legal Foundations, particularly footnotes and controversial issues, demonstrates that the principal training utilized was legal rather than economic, with respect to this particular treatise.


3 Perhaps the most refined (difficult) treatment of expectations as a part of general economic theory is Hicks, J.R., Value and Capital. (Clarendon Press, Oxford, 1939.)
In the same way that an entrepreneur's production plan is 1 
a bundle of expectations, so is the investment plan of an institution 
that has disposition control over money capital. Every investor is 
confronted with an almost endless maze of possible places to invest his 
capital. Each considered possibility conveys to his mind a certain 
probable (anticipated) result. These probable results are then 
assembled and compared one with the other, in relation to the over-all 
ambition of the investor. Finally that investment is chosen which 
is expected to contribute most to the over-all goal.

The basic ambition of the investor is monetary return, and results 
are principally measured with this yardstick. Financially, every 
opportunity for investment has a certain qualitative desirability for the 
investor, depending upon the returns which he anticipates from the 
investment. This quality of desirability is the composite result of all 
those characteristics that make an investor prefer one investment over 
another. For purposes of comparison, in the mind of the investor, this 
composite result is assessed a certain value, which can conveniently be 

1 Keynes, op. cit., p. 24, footnote 3.

2 Keynes' terminology may be helpful at this point: "... the 
bundle of vague and more various possibilities which actually makes 
up his state of expectation when he reaches his decision."

3 These characteristics are quite familiar to students of finance. 
An excellent enumeration will be found in Graham and Dodd, Security 
Chapter II.
1 called the present worth of the investment. The relation between present worth and expectation is as follows: a relatively high present worth is expected to accompany a relatively large composite expectation; and a relatively low present worth is expected to accompany a relatively low composite expectation.

In addition to a present worth, every investment also entails a cost. This factor can be much more accurately stated, in most cases, in monetary terms than present worth. In fact it is because cost is rather easily stated in monetary terms that it is necessary to reduce present worth to a common denominator with cost.

When the investor is able to compare present worths and corresponding costs, the choice of investments is simple. The situation is reduced to the level of any other transaction situation in economic theory. That investment will be selected which will (expectationally) bring to the investor the greatest excess of "value" above actual "cost."

It is at once evident that the significance of expectations in investment carries capital value clearly into the legal concept of choice suggested earlier. A given investment is a choice of one opportunity from the innumerable opportunities that are available to an

1 Williams, John Burr, The Theory of Investment Value. (Harvard University Press, Cambridge, 1938.) Chapter V.

2 It might be added that the exceptional qualities embodied in this type of transaction are not different from those involved in the purchase of any physical commodity in the economic system.
investor in our society today. Thus the legal relationship between a confiscating agency and the economic unit (owner) confiscated is basically reducible to the jurisprudential doctrine of will. The thing confiscated, or in danger of confiscation, is an expectation, and to interpret confiscation apart from expectation is apt to be quite meaningless.

Of course regulation does not deal with one investor and one investment. Its scope includes many investors and many investments. Therefore, rate control meets the problem of confiscation over the entire capital market, rather than in one isolated segment of it. It is this fact more than any other that has confused some of the more fundamental issues of regulation. An approach to confiscation through valuation assumes that it is the group that is confiscated. Approach through a generalized fair return makes the same assumption. Obviously the group, numerically at least, is composed of individuals. But the individualistic basis for American jurisprudence demands the conclusion that the group be considered as an aggregation of individuals, rather than that the group be considered as an entity in itself. Thus an investor can be confiscated in a group, but only as an individual.

All of this may contribute some little bit to an understanding of the general nature of confiscation. But it adds very little to an appreciation of the specific qualities of that elusive regulatory concept. In the market place where claims are bought and sold it is impossible to segregate individual expectations.
It is of the essence of investments that their quality should tend to equalize. The restless desire of individuals to part from an investment yielding 10 per cent and take up an investment yielding 15 per cent assures this tendency. All economic literature, from the beginnings of economics as a science to the present day, has emphasized the levelling process in an acquisitive society. In modern theory this process is known as capitalization.

Technically this process of capitalization means that value flows from income to capital, rather than from capital to income. This fact is parallel to the common definition of property as "the right to income." But whatever the inspiration, the fact of capitalization is very closely related to the legal concept of confiscation.

Perhaps an illustration can best elaborate the relationship involved. Suppose a claim is exchanging on the market for $100. This means that the actual and expected income, all things considered, has stimulated expectations valued at, roughly, $100 in the mind of a composite group of investors. We may further assume that the actual income, which is expected to continue in the future, is $5 per annum.

1 Ricardo, David, Principles of Political Economy, ch. IV.
2 Fisher, op. cit., chapter XIII.
3 This meaning for capitalization only reaffirms basic Austrian economics, which states that value is in the mind. See Commons, op. cit., chapter II, for a discussion of the shift in Supreme Court decisions to this viewpoint.
4 Ely, op. cit.
5 By the term "expected to continue" is meant that this investment, if held, will continue to yield $5; or that if the principal were withdrawn in the future it could be invested in a similar risk to yield the same income.
This relationship indicates that the over-all expectations of investors who purchase similar claims, warrants placing a value of twenty times annual income on this particular claim.

Now let us suppose that the government, through lowering rates charged or raising taxes paid by the concern whose claim is under consideration, lowers the income received by the claim holder to $4 per annum. Prior to the reduction in income the investor has a "right to income" which is valued at twenty years' income by the general state of expectation in the market. After the reduction the same situation persists, because it is clear there has been no fundamental change in general expectations by the mere occurrence of this more or less isolated incident. But, due to the fact that income is $4 instead of $5, the investor now has a claim worth $80 instead of $100.

Following from the spirit of social philosophy it would be argued that confiscation has really taken place in the above example. After all, 20 per cent of a man's property has disappeared through regulatory activity. The important fact, however, as far as confiscation is concerned, is that this type of thing is not confiscation in our legal process. The apparent contradiction in the above statements makes the definition of confiscation in actual use seem arbitrary.

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1 This is the "prevailing rate of interest." This term cannot be precisely defined, but it basically represents the general state of expectation in the money market.
But it has already been emphasized that an individual can not really be confiscated if he knows what his rights are in advance. Thus any definition of confiscation is satisfactory if rigidly adhered to by regulatory agencies.

However, even the most well-meaning and conscientious government must have difficulty along this line. For every time a new industry is brought into the regulatory field, every time important new regulations are found necessary in a regulated industry, every time a rate of return to a regulated company is found to be too high and adjusted downward—— in all of these cases the activity of government appears as retroactive legislation to all investors who do not predict government moves substantially in advance. Stated differently, if capitalists use the status quo as the basis for discounting the future — and this practice is in harmony with laissez-faire — any change in the status quo must cut across expectations and thus destroy capital in the way described.

It is at once evident that the above is representative of the typical situation in public utility rate control. An investor is confiscated, not when the return on investment falls below a certain level, but when the return on investment is forcibly and suddenly reduced. Even then the investor who is confiscated is not any investor who happens to own a claim whose return has been reduced by government action, but the individual who holds the claim at the time of the action that reduces the return. Thus confiscation cannot be represented as any given rate level, but as a reduction in this level.
There are further ramifications of this approach to the problem of confiscation. Due process means, substantively, that the rules of the game, so to speak, will not be changed except between innings. Section 9, paragraph 3 of the Constitution has the same meaning. Restraint upon retroactivity in legislation is a promise to citizens that no penalty shall attach to any action, if the penalty be not known to the doer at the time the activity was commenced. It is the essence of financial activity that it is continuing in nature, rather than spasmodic. Non-retroaction in regulation requires that choices be not interferred with — after they are made. Thus confiscation must be defined — from an ideological standpoint — as cutting across past expectations.

The important tendency for expectations to equalize throughout the capital market, casts further light upon the economic usefulness of the Fifth Amendment and its interpretation in regulation cases. If value can pertinently be considered in relation to expectations regulation not only must not take property without compensation, but it literally must not take property at all. Regulation is intended to leave everyone with equal residual rights, regardless of the number of rights

1 "No bill of attainder or ex post facto law shall be passed."

2 By "known" here is meant "part of the law." Of course mere ignorance is no particular defense, although basic misunderstanding might be.

actually taken away. Fundamentally, however, regulation does not have this decision to make in a financial society. The process of capitalization is the equalizer, and regulation of isolated segments of the economy does not substantially influence this process— even though universal and unchecked regulation might have considerable influence. If compensation is paid, property is not taken; and if property is taken compensation is not paid. Thus, not only does an attempt to apply due process result in an economic inconsistency, but the very wording of the phrase suggests an impossible situation.

It follows from this discussion that it is virtually impossible to regulate without confiscating property. Whenever a commission finds an undesirable situation existing, it can propose a remedy only by suggesting retroactive action— i.e., action that cuts across the lines of choice, which is by definition confiscation in our society. The course of action outlined by the commission may be non-confiscatory for the choices made from that time forward, but it is certainly confiscatory with reference to all past choices affected.

A case in point may be helpful. In 1928 the municipal government of Lima, Ohio, passed an ordinance prescribing the maximum rates that might be charged for gas. The time specified for the operation of the ordinance was five years, and the rates specified called for

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1 Unchecked regulation refers to any more or less whimsical action on the part of a "dictator", i.e., expropriation policies on a large scale.
substantial reductions from the schedule then in effect. The company appealed to the Public Service Commission for relief from what it considered an unfair and unreasonable structure. The Commission revised the schedule upward, but refused to allow as an operating expense the total asked by the company of an item called "unaccounted for gas" -- loss as a result of leakage, condensation, contraction. This account was being charged annually with 9 per cent of the total volume of gas handled. The commission insisted upon whittling this item down to 7 per cent of the total volume of gas handled, on the alleged ground that proper care would result in less loss. The company appealed the commission's decision, which appeal was finally carried to the Supreme Court. The Supreme Court, through Justice Cardozo, very properly disapproved the action of the Commission, implying that it involved confiscation, although the word was not directly utilized.

For our analysis here, only an outline of the opinion of the Supreme Court is significant. The Court inferred that the Commission had erred in fact, rather than that it was mistaken as to the principle involved. Obviously such an error is confiscation in its worst form. But at this point it seems desirable to consider the case assuming that the Commission was right as to the fact of waste. Of course, even so, this fact necessitates proof, a necessity strongly emphasized by the Court.

1 West Ohio Gas Company v. Public Utilities Commission of Ohio (No.1), 294 U.S. 63.
2 Loc. cit.
The company's business had been conducted for some time on the basis of a 9 per cent wastage factor. Its financial relationships with claimholders — the general world of expectations — was predicated, in part, upon this factor. To suddenly alter this circumstance would have forced the company to make a choice between two possible adjustments: either it would have had to be content with a 9 per cent leakage, and a 7 per cent Commission allowance; or a 7 per cent actual leakage, the additional expense of lowering this loss from 9 per cent to 7 per cent, and a 7 per cent commission allowance.

Clearly this is no alternative at all. Either alternative, from the facts of this case, would have meant a lowering of residual return by about 1 per cent in 6 per cent. Such a return, unless offset by some kind of financial elasticity within the business itself, would cut across previous expectations in a most drastic way.

The case cited above is one of an existing undesirable situation, that ordinarily must be corrected by a regulatory order — but

1 Obviously, if the cost of reducing the loss were the financial equivalent of the 2 per cent leakage, no "waste" is involved. This term could be applied only if the expense were less than the financial equivalent of the loss checked. That sort of analysis would indeed require evidence. And this kind of a decision is quite commonly considered a purely managerial decision.

2 The Commission might order the leakage loss reduced and permit the necessary costs to be included in the utility's expense account. However, there are few jurisdictions that will permit the inclusion of such highly conjectural costs.

3 This might be a reserve, a surplus, a padded expense elsewhere, or an upturn in general business fortunes. None of these, however, can be depended upon in a given situation. The first two probably could be used to better advantage elsewhere, or else should not exist; while the last two should not exist in any event.
in which confiscation can be avoided only by the most penetrating analysis and judicial decision. Frequently, in fact most commonly, the correction cannot be made even with analysis and judgment, without confiscation. This will invariably be the case when the Commission finds a utility earning an excessive rate of return.

This situation presents a real paradox for regulators to resolve. If they regulate for the future, the result is retroactive, confiscating past expectations. But if regulation is not for the future then prior excesses must be made permanent. Yet one choice must be made. There is no possibility for compromise. Basically, this paradox accounts for the precarious position of legislation in the matter of regulation in past years. A corrective approach is bound to tread upon someone's toes. Since the Supreme Court is the great "protector", it has been anyone's guess as to whose rights the court would choose to protect in a given case.

Even more interesting than the above paradox itself is the problem of how it developed.


2 The bulk of the litigated cases are of this nature.

3 It follows from what has gone before that the permanency of past excesses cannot confiscate holders of claims. This is true because they make their choices with previous facts in mind. But consumers, by definition in a public utility, have no such elasticity of choice, and can — figuratively — be confiscated.
The most significant aspect of this development is the fact that when the constitution itself was written "just compensation" was principally intended to provide for the necessities of eminent domain. In this type of property taking, note, there is an actual transfer of ownership of a physical good. The government reaches an agreement with the private owner (in or out of court) and gives to such owners a quid pro quo in money. Really nothing more is involved except a simple purchase and sale.

In public utility regulation the situation is not so simple. Here the government receives no property and makes no payment. Full possession remains with the private owner. The effect of government action is simply to lower the rate of return actually earned to a 'fair' return.

The essential difference between these two types of government relation to business is the time factor. Eminent domain is a relationship without time dimension. If the private owner is realizing $1000 per year on his property the price paid by the government will be a capitalization of that annual income at the going rate of interest. The owner is free then to do whatever he likes with the principal. If he chooses to reinvest in another property producing income at the rate of $1000 per year his financial situation has been unaltered by the transaction. The reason, of course, is that the action of the government carries with it no connotation of a wrong to be righted.

The situation is very different in public utility regulation. Here there is a specific wrong to be righted — a change to be instituted
for the future. An owner will have taken from him an asset earning $1000 per year and receive in return an asset earning $600 per year. Thus this sort of transaction does have a time dimension. The entire aim of a reduction in rates is to reduce an owner's claim upon his property in perpetuity.

An understanding of this apparent gap in legal and economic philosophy must hinge upon the constitution. That document and the early Supreme Court decisions growing out of it defined property as a use value only. If the value of property is its use, confiscation and retroactivity can easily be avoided. All that is necessary is to give to the owner an equivalent property to use.

Near the end of the 19th century, however, the meaning of property had changed and the change was officially acknowledged by the Supreme Court. The new concept was exchange value rather than the earlier use value. Regulation thus became in a sense continuous just as the businesses regulated were continuous. Action taken by the government therefore came to have a time dimension as one of its most significant attributes. Thus specific rulings — even though they did not violate the technical 'fair return on a fair value' requirement — began to cut through capitalistic expectations and thus to control retroactively.

Where a transaction is an entity in itself, as when property is held for use alone, when it is merely a point in space and time, government action can change the rules at any time non-retroactively. But when a transaction is not an entity — when it is a part of an
inseparable process in time — any change in rules must come in the middle of the game. Thus the change in the concept of property from use value to exchange value has resulted in a significant gap between just compensation and non-retroactivity.

It is in no wise to be inferred that the writer is unequivocally opposed to confiscation as here interpreted. It is simply suggested that the regulators are in a difficult position with respect to regulation, being forced to confiscate whether they wish to or not. This confiscation consists of decisions which determine, not whether rights are to be protected or not, but whose rights are to be protected. In determining whose rights should be protected, regulators likewise determine whose rights are to be sacrificed.

Clearly the problem here is much deeper than approval or disapproval. Confiscation is an inevitable accompaniment of adjusting past relationships. Since police power is principally exercised to prevent unjust enrichment of one section of society at the expense of another section, correction of prior maladjustments may frequently entail a taking from those who have been a party to the enrichment. This is, by

1 The traditional view of the function of the court is well expressed by Jerome Frank. "... most lawyers deny the reality of judge-made law." Law and the Modern Mind. (Tudor Publishing Company, New York, 1935.) P. 33, footnote.

2 The view that judges do legislate is well presented by both Jerome Frank, op. cit., and Norris R. Cohen, Law and the Social Order, (Harcourt, Brace and Company, New York, 1933.)
very definition, confiscation. To oppose this kind of confiscation is the equivalent of opposing regulation. It would take a hardy individual indeed to seriously take such an extreme position.

Another important aspect of the police power seems pertinent at this point. General police power -- the exercise of control over the public health, safety, and morals of the citizenry -- does not depend for its potency or impotence upon a confiscatory clause. It is a well-established principle of constitutional law that compensation need not be paid in such cases even though damage is done to the property through the exercise of control. That is the way "necessary" confiscation is handled under the general police power. But in public utility rate cases it is widely assumed that there is no confiscation at all. "Necessary" confiscation is just as important in the regulating of utilities as in control under the general police power. And such confiscation is to be justified upon the same grounds. This justification is the doctrine of congenital infirmity, which states that every social relationship entered into is subject to the law of the land, which law includes prospective regulation in the public interest, as well as past legislation.

1 The writer became acquainted with this term while sitting in class under Professor Eliot Jones at Stanford University. Although the term itself is not often used by lawyers, yet "No rule in constitutional law is better settled than the principle that all property is held subject to the right of the state reasonably to regulate its use under the police power ..." 11 Am. Jur. 1009.
The thesis of such doctrine is that whatever financial relationships are destroyed, the action of the government does not obstruct choice because the individual must be presumed to have understood the situation at the time of entering into the contract. This thesis is the inspiration of the very imposing name it bears — congenital infirmity, meaning a weakness at birth.

The clause in the Constitution forbidding retroactive legislation has gone far to make — and was no doubt intended for that purpose — that document a negative one. The only check to this tendency has been the development of "infirmity in the general welfare" as a working policy of control. This development is the basic positive element in our Federal System. As such it is vitally significant. If businesses could not be declared subject to regulation after their inception, democracy would be at the mercy of a dynamic economy. To avoid confiscation it would be necessary to predict the impending shift of a business from a private category to a public category. This, on the basis of the complexity of the problems involved, is a manifest impossibility.

1 Article I, Section 9, Paragraph 3.

2 The third category of utility suggested by Chief Justice Taft in 1923 consists of businesses whose owner "by devoting his business to the public use, in effect grants the public an interest in that use, and subjects himself to public regulation to the extent of that interest ..." Such businesses become public after their inception. Wolff Packing Co. v. Court of Industrial Relations, 262 U.S. 522.
Briefly summarizing, then, regulation is not a single necessity but two: the first is that of correcting evils that have arisen in the past; the second is that of preventing evils from arising in the future. The former necessitates confiscation, which is justified in our constitutional system by the doctrine of congenital infirmity (police power). The latter does not involve confiscation, following from the fact that, under our governmental organization, no individual can be confiscated by an action he has knowledge of before he enters into a contract. This situation would apply to all application of "infirmity" to utility regulation. Furthermore, as a practical proposition, someone must decide, in each case coming up for adjudication, whether the decisions shall reflect emphasis upon the future or upon the past.

Before embarking upon the next phase of this discussion it might prove helpful to emphasize the interrelationship between the two environmental developments presented in this and the preceding chapters. Rent arises from inelasticity. Capitalization is the institutional process by which business maintains a high degree of elasticity despite

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1 Technically, of course, it must be added that our philosophy of law also implies, as a necessary accompaniment, that government must accord identical treatment to all persons similarly situated.

2 Note the extreme quantity of energy, time, and money spent and being spent on trying to establish a dollar value for the aid given to various transportation agencies by governments and others over the past 150 years. This problem is being given almost as much attention as other problems combined.
inelasticity. At one and the same time, thus, evolution throughout
the environment made rentals much more common (inelasticity through
specialization) and made it much more difficult for society to
minimize rents without violating ideological principles (elasticity
through capitalization). Regulation could have proceeded to meet
this evolution in a fairly satisfactory way, as will be demonstrated
in the next three chapters. However, in thus proceeding regulation
would have resulted in substantial inconsistencies in social philosophy
application. To avoid these inconsistencies a compromise procedure
was developed to lessen the degree of inconsistency. The directions
taken by this compromise will be presented in Chapter 8.
CHAPTER V

THE RESIDUAL PROBLEM IN REGULATION

The prime function of the two preceding chapters was to demonstrate the two principal ways in which the economic environment has altered in such a way as to make less precise and less useful the ideal regulatory adjustment outlined by the Supreme Court. The growing qualitative change of the environment caused by the inelasticities of productive factors, and by the necessity of recognizing a time dimension in the exchange process is the environmental development principally responsible.

It will be the purpose of this and the succeeding two chapters to demonstrate that this dynamic element in the environment need not have destroyed at all completely the earlier regulatory technique. Thus the categories set forth by the courts have a considerable elasticity with which to meet changing circumstances. This elasticity is not, of course, unlimited. Beyond a certain point of stretch the categories themselves must give way. Furthermore, beyond a certain point in regulation it became the interest of the regulated themselves to break down the framework of control. The farther regulation must go the stronger both of these strains become. One of the basic ramifications of the following discussion is the indication of increasing strain from both of these sources.

As an introduction to the potential elasticity of regulation this chapter on the residual problem in control is essential. The principal
residuality involved is fair return. Fair return as here considered
is not to be thought of as a percentage of some nebulous fair value,
but as the concrete sum in dollars resulting from applying the percent­
age to the value. Students of utilities are more and more inclined to
agree that it is this sum that is the important item rather than either
the percentage or the value to which it is applied. Simply stated fair
return is the fund out of which residual factors are paid, or the net­
income-fund remaining to be distributed after contractual payments have
been made to other factors.

Economic rent, it will be recalled, may be either contractual
or non-contractual. If non-contractual, its relation to fair return is
clear. The greater the residual, the greater the economic rent received
by the residual factors.

On the other hand a reward (rent) may be contractual. No
contractual reward can contain an economic rent if it is bought and sold
in a market. Such a reward could be capitalized to the exclusion of
rent. But, whether capitalized or not, the existence of rent is predicated
upon net income, or surplus. If any factor receives an economic surplus

1 This refers principally to common stock. The rent in a
particular case, may be positive or negative. The meaning here is that a
larger residual will minimize negative rent, and maximize positive rent.

2 This statement simply indicates why a contractual reward con­
taining rent is impossible in the capital market, while possible in the
labor markets. Either factor, however, receives a rent only under the
conditions outlined below.
it does so by virtue of the economic power it exerts over the business unit hiring it. Economic power is not income. No factor can contract for a rent to an amount capable of forcing a business to operate at a loss. Thus no business factor can receive for any length of time a reward greater than opportunity cost while its employer is receiving less than opportunity cost. It follows that if the total residual income is made, through regulation, equivalent to opportunity costs no factor could contract to receive a rent.

The conclusion indicated from this analysis is that economic rent does not appear originally in the hands of a factor. It appears first as income to the business (accounting) unit, and is then distributed to the component factors on the basis of economic power. The significance of the process through which this is true will be the subject matter for the remainder of this chapter.

Not the least interesting phase of the subject of fair return, considered as a more or less independent item in the rate-making process, is the paucity of literature in the field. This fact is

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1 Loss here means any set of circumstances less favorable than another available alternative. This explains the fixed vs. variable expenses situation during depression years.

2 The writer is not aware that any other writer has emphasized the importance of fair return as residual income. Such an analysis has been briefly approached, however, on at least one occasion. Morgan, Charles S., Regulation and the Management of Public Utilities. (Houghton-Mifflin Company, Boston, 1923.)
particularly noteworthy in view of the plethora of expository material centering around fair value. In the period since the "fair return on fair value" mandate was first announced, there have been only two standard, full-sized works purporting to consider fair return as a major item. The first, chronologically, is actually one of the better contributions to the theory of valuation. The author uses the book as an avenue for advancing quite convincingly the doctrine of reproduction cost. Fair return is considered primarily through statistical interpretation, although the author does advance a suggestion for determining the return. The other book, that of Professor Wu, is devoted to fair return in railroad regulation, and again valuation is the principal emphasis, only a minimum of space being devoted to fair return as such. It is perhaps significant that Professor Wu also takes occasion to throw his influence with the cost-of-reproduction advocates. He, too, offers a brief statement as to a theoretical measurement of fair return.

Other writers have given attention to this matter. Seldom however, is fair return given an independent status; a non-parasitic raison d'etre. It could be argued, and vigorously, that fair return

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1 Smith, Nelson Lee, *Fair Rate of Return in Public Utility Regulation*. (Houghton-Mifflin Company, New York, 1928.)

was never meant to stand alone as representative of any final fact in regulation. Certainly the "rule of rate-making" would lend support to such a contention. But the same argument would deny to valuation the independent existence it has universally enjoyed for four decades. The general practice of deciding on the amount of return and then converting this amount into a percentage to suit whatever valuation meets the approval of the majority of the commission, is not carrying out the mandate of "fair return on fair value" in a realistic manner. Pennsylvania has little cause to be proud of the universal "7% regardless of circumstances," which her Commission used as a rule through two booms and two depressions. Two of our strongest Commissions, likewise, have little cause to be proud of the fact that they have "gotten by" with original cost valuations, when they were

1 Smyth vs. Ames, 169 U.S. 466. In this landmark case the Supreme Court appeared to give parallel importance to return and valuation. At no time since has the court repudiated this implication.

2 An observer could not but be impressed by the extended treatment given fair value in court decisions (or public utility texts), as compared with the little attention given fair return. Thompson and Smith note two important cases in 1937 with more than 100 pages on the subject of value, and seven pages dealing with fair return. Op. cit., p. 349.


able to do so only by liberality in the return allowed. In short, whatever can be said against the rule of regulation, it cannot be accused of impartiality. It does not condemn either of the companion components to a permanent satellitic position. Here it is proposed to accord fair return its "place in the sun" by considering it as the basic residual in a situation in which residuals are of paramount significance.

The lack of analysis of return would be understandable if it were not such an important part of the cost of utility services. It is axiomatic that most utility services require large amounts of fixed capital. But the exact relationship between this fact and fair return has not made as deep an impression upon students of regulation as it must if the significance of fair return is to be more widely recognized.

The specific studies that have been made on the subject of capital turnover in the utility industries conclude that this ratio is approximately eight to one. Stated differently this means that annual gross revenues equal 12 1/2 percent of total investment; and that the

1 Thompson and Smith, op. cit., p. 349.

2 This should not be interpreted as implying that fair value is not the most difficult element, interpreted from a technical viewpoint. Certainly when a decision hinges upon an estimate of how much it would cost to build a similar plant over the next two years or so, and depreciate it to a condition analogous to the present one, no minimization of the task involved should be indulged.

utility receives in income the equivalent of its assets every eight years. Let us assume now that such a composite utility is allowed a fair return of 6 percent. We will further assume that fair value and investment are equal. Such a utility would have to have an operating ratio of 52 percent in order to make its allowed return. Thus 48% of gross revenues would be necessary for the reward of investors, etc. And in the above illustration 6 percent, historically, would not be a liberal allowance at all.

In practice the modal operating ratio is not 52 percent. The actual figure is 72 percent. There are probably a number of reasons for this discrepancy. First, many utilities fail to earn a fair return. It might be added that many do not need to earn a fair return — in the legal sense — to maintain excellent credit. Too, it is possible that the above study has placed the capital turnover too high. Other writers hazard estimates considerably lower, and more in line with the calculated operating ratio. A superficial glance at a number of financial statements selected at random — admittedly unscientific, but perhaps helpful for the project at hand — indicates that the operating

1 It should be noted that reproduction cost would not be used in any event if it were greatly in excess of investment. In the latter case the percentage necessary for fair return would be greater for the same reason.


3 See Thompson and Smith, op. cit., p. 83.
ratios in the study cited are much more nearly representative than
the figures given for capital turnover.

But the point is not vital at the moment. Enough has been
said to indicate the importance of capital costs in measuring resource-
expenditures for utility services. Through a comparison with other costs
the significance of fair return becomes even more apparent. Depreciation
and maintenance amount to roughly 15 percent of gross income. This
figure would approximate that for a utility with a capital turnover of
5, with 90 percent of its assets depreciable, and assuming a composite
asset life of 25 years. Taxes represent another important cost for
utility customers. But they fail to even come close to capital costs in
magnitude. In 1939 the electric light and power industry paid 16.3 percent
of its gross revenues to various governmental units in taxes. The
comparable figure for the Bell interests for the same year was 14.1 percent.
A fourth item in utility costs is labor, running all the way from 20 to
45 percent of gross. Thus, it is unnecessary to pursue the thought
further. It is readily apparent that fair return is a most important
cost, and that inaccuracy and misunderstanding may result from its neglect.

It would be grossly misleading to infer that the idea of cost
minimization is a novelty in the regulatory process; or that the everyday

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1 This is the percentage used by the Securities and Exchange
Commission as a norm in its analysis of the financial structure of a
utility.

2 These figures are given in Thompson and Smith, op. cit.,
chapter V.
decisions of the various regulatory bodies take no cognisance of this principle. Quite the contrary would be more nearly accurate. But it would not be misleading to say that the cost aspect is often so camouflaged beneath precision detail that its significance is not immediately apparent. Even students of public utility problems are sometimes vague in their emphasis upon costs. This fact is to be explained, no doubt, by the fact that this particular approach is taken for granted, rather than to any assignable ignorance of fundamentals. However, regulation of any single industry in a "competitive" economy has two obligations—both stemming from and comparable to the individualistic system for which regulation has been selected as a substitute. The first obligation is to secure the commodity involved for the consumer at a price equivalent to cost; the second is to take whatever steps have been authorized in the public interest to keep these costs as low as possible. This dichotomy of problems has been treated more or less in detail earlier, as the problem of correlating rights and responsibilities in a society that considers equality an important concept. From this point forward the problem will be made more specific, proceeding with discussion of fair return somewhat independent of the broader social philosophy of which it

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1 Bryant and Herman, *Elements of Utility Rate Determination.* (McGraw-Hill Book Company, New York, 1940.) Chapters XV - XVII.

2 Behling, Burton N., *Competition and Monopoly in Public Utility Industries.* (University of Illinois, Urbana, Illinois, 1938.) Chapter XIII.
is an integral part.

The foregoing facts may at first seem commonplace and irrelevant to an attempt to set forth the economic principles of fair return. But they serve as an introduction to the real heart of the regulatory problem—the problem of securing a necessary service in the most economical way, i.e., at lowest total resource-expenditure consistent with the quality of commodity demanded by the public. In solving this problem it is highly important to note that it does not center upon the cheapness of any single item in the expense (cost) account. Rather it must involve giving to every item that attention and that care that will result in the lowest composite total costs.

In order to exemplify certain features of this relationship, we will refer to some of the typical issues that come before commissions in actual cases. First, assume a utility, operated with average or above average efficiency, with operating expenses of $1,000,000. Some of the items included will be large, some small. Many, probably the majority, of these items will be obviously in line with competitive prices, and thus will need little specific attention. But perhaps the President is receiving a $50,000 annual salary, and, due to estimates of efficiency by the Board of Directors (of which the President is probably a member) a $25,000 bonus has been voted — and paid by the

1 Behling, loc.cit.
company for the three years preceding the present hearing before the Commission on the reasonableness of rates. Naturally the utility will wish to include both the bonus and the salary as legitimate costs of operation. The Commission must make a decision on the point. If it is an alert Commission with adequate authority, it will certainly refuse the inclusion of the bonus, and probably would lop 10 or 20 thousand dollars off the salary itself. After making the appropriate remarks about "protecting public interest", and "good faith on the part of the management," the Commission will conclude the hearing by allowing the utility a 6% return on its value.

Such decisions are quite common, and they are widely heralded by public interests as placing a firm hand upon soulless corporations, while the Commissioners commonly point to such decisions as an example of its savings for consumer. But it is quite proper to inquire if the case is really ended there. Note, for example, that the President has received an "illegitimate" wage for years previously, and he may receive it again. The Commission has only refused to let it be included as an expense. If he does receive this increment, and the fair return has been set at a point that either ten cents a share will have to be taken from the common dividend, or surplus accumulation cease, then the

1 This weakness in the armor of much of our current regulation has been treated by Barnes, op. cit., chapter XVIII.
Commission has a further reckoning ahead. For next year it may happen that the utility will need to refund a bond issue, or expand its operations through the sale of stock. When that time comes, it may be suggested, the Commission is not allowing the securing of expensive capital, but is merely agreeing that the President should have had his $25,000 after all. And precisely because those bonds or that stock cost more on this particular occasion the fair return next time will have to be higher to maintain credit standing. Nor much, then, was "saved" for the public? A second excellent question would be this one: If the utility did pay, and continues to pay, an excessive salary to its executives without impairing its ability to secure capital, what is the probability that, either before or after the rate case, the rate of return was too high?

Another, more complex, situation suggests itself. Assume this time a utility that desires to set aside 3 percent of the cost of its physical plant for depreciation. Assume further that that is the amount needed to state operating expenses correctly. But the Commission, not adequately schooled in economic matters, decides that the proper charge should be 3 1/2 percent, and so orders. One-half of one per cent on physical plant does not appear to be a particularly large error. But

1 Depreciation expense is here considered solely as a device to accurately calculate operating expenses. For an elaborate justification of this approach see Mason, op. cit.

2 The assumptions here include a common stock issue amounting to 25% of total capital, a six to one capital-turnover ratio, and a 90% depreciable property ratio.
it would amount to roughly 2% annually on the common stock. This could be paid out in dividends in some jurisdiction. In other jurisdictions it would be forced into a top-heavy reserve and might tend to build up common stock equity (and general credit strength) in that way. Whichever happens, the public is obviously paying too much for its current services, for building up credit in this way is probably not the cheapest method possible.

Let us suppose that five years after entering its original order the Commission notices the above error. Again, a decision must be reached on a method for rectifying the error, for certainly the continuation of such a condition would be an injustice to the public. The wrong might be righted in one of two ways: to make a correction only for the future, or to attempt to adjust the past overcharges as well. If the former course is adopted the overcharge to the consumer can not be rectified at all — and probably the exact amount of the damage cannot be calculated, though it would probably be somewhat less than the 3 percent of gross indicated by the exact arbitrary to operating expenses.

If the Commission decided to make the correction retroactive it might follow a course of "immediacy" or of "gradualness": i.e., it

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1 Lindheimer v. Illinois Bell Telephone Company, 292 U.S. 151. The Supreme Court here dealt with precisely this type of situation, illuminating rather forcefully the inadequacy of present-day regulation in specific instances.
might order a single write-down entry for depreciation reserve; or it might extend the remaining net book cost over the remaining service life of the property. If either course is followed, and fair return is not altered, the common stockholders are given an unearned increment through either dividends or surplus. Thus, after the discovery of the error as well as before, the investor benefits at the expense of the consumer, unless adjustment is made in fair return. The thought occurs that perhaps the gain to capital will be given back to the consumer through lower demands the next time the utility asks for money. But if the capital market is at all competitive the exact opposite will be the result. Because the gains were only incremental and unexpected, their very uncertainty (for the investor reasons they might have gone down as well as up — which would certainly have been the case had the assumptions been different) causes them to be discounted against an issuing corporation.

One more example will be noted. The charge has often been made that Commissions have been too liberal in the percentage they allow as a fair return. Let us assume that in a given case this is true. (In using the term "liberal" the base is considered to be the amount necessary to overcome the resistance of investors, who could spend their money or invest it elsewhere.) Investors, taken compositely, are willing to part with their money on a 6 percent basis, and the Commission in fact permits 7 percent. But the investor has already contracted with (or purchased common stock from) the corporation on the basis of a 6 percent "resistance," which resistance cannot be altered by any declarations of a public body.
An alert investor who receives such a windfall, or sees it placed in a surplus as a protection he had not anticipated when he made his purchase, and connecting this fortuitous circumstance with the arbitrary action of public authority, is not apt to consider the situation permanent. Far from lessening his future resistance, such generosity could easily stiffen it, because it is so easy to assume that the same public authority could just as easily have taken an opposite arbitrary stand. Thus the consumer is charged more not only because of the generosity of the Commission, but because this same generosity leads to an uncertainty that is further held against the utility when it next seeks out the investor to secure additional capital.

It is scarcely an opposing argument to suggest that since commissions always lean in the direction of liberality, that the investor will be more favorably disposed toward public utility securities for this reason. As a matter of fact liberality is a misnomer. A truer name is error. For the capitalization process eats up increments and absorbs decrements without substantial regard for the benevolent attitude of public utility commissions. Actually benevolence is a regulatory impossibility. Both plus and minus deviations from truth are capitalized against the corporation. The only result of liberality is discrimination between present and future security holders.

These few illustrations, chosen from the dozens that might have been included, all point in one direction. Fair return can not be

1 See Morgan, op. cit.
considered as a cost by itself; neither can any other expense be
treated as a law unto itself, without considering the resultant
effect upon every other cost. The important fact is the total, the
composite picture of all resource-sacrifices. Nothing is to be gained
from a saving in one if a consequent burden is placed elsewhere. Indeed
it is probable that all such shifts create an unnaturalness in the
operation of the regulatory process; an unnaturalness that makes the
resultant burden greater than the earlier saving.

It is not an accident that common stock has become the
residual share in profit-taking. No more is it accidental that fair
return has been given the residual position in the machinery of
regulation. Obviously in the absence of guarantee, and given the presence
of risk, there must be some "last" factor. In the American way of
economic life, capital plays that role. But because it is in this
somewhat inferior position it can not necessarily be neglected. For
in the last analysis its very inferiority of position makes its demands
all the greater, and its retributions all the more severe.

In addition to the very close interrelationships between
fair return and all other items that make up the expense account, it
seems equally clear that the above statements make even more apparent the
inherent fallacy of discharging a duty to the public by making extensive

1 Bauer, op. cit.
calculations as to value, while only paying lip-service to fair return. The valuation problem does not even touch the delicate situations involved in rate-making. Fair return — as an amount, not as a percentage — is at the focus of every one of such situations. Technical valuations can be vastly altered without disturbing economic relationships. Fair return is extremely sensitive to the slightest touch. Only by the most careful attention to fair return as the element in the entire process of regulation can commission control keep abreast of a dynamic situation.

This point can perhaps be made clearer with reference to an actual decision made by the Public Service Commission of Maryland, one of the older and better respected regulatory Commissions. The case in point is the very famous United Railways and Electric Co. v. West. Here was involved a street railway in a declining market situation. It had survived the rising costs of World War I with a five cent fare. But after the war, still an integral part of the transport system of Baltimore, it requested an increase in its fares to improve a serious financial situation. In 1924, it was awarded a six cent fare. The company had suffered so long, however, from an inadequate rate that by 1924 even six cents was scarcely helpful. So the company requested and received commission approval of a seven cent fare. But by the time approval had been secured, the local market had become so saturated with rival transport facilities, both of a public and a private nature, that

the company was obliged to request a ten cent fare, as had many other companies in the country under substantially similar conditions.

The Commission flatly refused to allow the increase. In its 1926 decision it promulgated two principles upon which its disapproval was based. First, the street railway was an absolutely essential portion of the community's transport facilities. This fact was emphasized over and over in the decision. Second, the Supreme Court had ruled that the charge for the services of a utility must never exceed the value of the service to the consumer. More than eight cents, the Commission felt, would violate this principle. Therefore the fare allowed was an eight cent maximum.

No attempt will be made here to hazard a guess as to what the Supreme Court meant in 1898 when it first began making reference to the term "value of the service to the public." Suffice it to say that the court, while never forthrightly denying the principle, has never applied it (or permitted its application) in the manner proposed by the Maryland Commission. In 1929, when the instant case reached the Supreme Court for final adjudication, the court rendered its decision without making "value of service" an issue.

1 Smyth v. Ames, 169 U.S. 466, was cited as authority for this anomaly.

2 P.U.R. 1926 C, 441.

3 The present view of students of regulation on "value of service" as a rate-making criteria is excellently stated by Thompson and Smith, op. cit., pp. 260-262.

4 280 U.S. 234.
But the point that is to be considered here is the basic principle of economics involved. In any system of price relationships it is universally agreed that the economic importance of any good or service to a community can only be measured by the price it is willing to pay to secure the benefits. Thus the correlation between price and importance is always direct. The Maryland Commission, in the Street Railway Case, was holding out for an inverse correlation. Actually, if the railway services were completely indispensable in 1926, and in all probability they were, no price could be too high, the charging of which would result in no more than a "fair" return. An eight cent fare would not have produced a return recognized as fair under any set of supportable assumptions. Note, in this connection, that the Commission acknowledged that the company could not make a fair return under the 1926 order.

There are a number of pertinent conclusions that might be drawn from this land-mark decision. Those treated here will necessarily be limited. The Commission assumed that it was performing a valuable service for the public. In that the Commissioners were undoubtedly sincere. But it is almost incredible that the Commission could suppose that it was performing an economic service in such a non-economic manner.

In all fairness to the Maryland Commission, it should be stated that it had noted several times prior to 1926 that the capital structure of United Railways and Electric Company was in need of reorganization.

1 P.U.R., 1926 C, 441.
Perhaps rate order was intended to force the concern into bankruptcy. But public interest would always be served more adequately by forcing a reorganization before the credit of the company becomes irreparably impaired. It is probably to the point to note that even though the Supreme Court did permit the full ten cent fare, the company went into bankruptcy shortly thereafter and was reorganized in 1935.

If, then, a regulatory Commission can and does render opinions and orders at variance with economic fundamentals, what are the consequences of its action? We might assume a case where the concern involved was not thrown into bankruptcy proceedings. Obviously here would be a clear example of resultant credit impairment, and consequent difficulty in overcoming the resistance of investors the next time capital is needed. Thus fair return in such a case would necessarily be higher in the future, and rates correspondingly higher than would be necessitated otherwise.

But if the Commission can force rates low enough to precipitate foreclosure, the thought arises that perhaps the above result can be avoided. (It goes without saying, of course, that such an order would be illegal.) No Commission, however, or no series of Commission decisions, can alter the fact that a failure in any industry is a token of risk to the investor. Not only will such a failure be held against the particular company, but the whole industry must partially share in the discreditment. And, as if that were not enough, such cases are discounted

1 Moody, Public Utilities, 1936.
against all regulated industry, for rightly or wrongly depending on the individual case, such misfortunes are laid at the door of regulatory bodies. It is very probable that in any reorganization a number of individuals lost money. But it is highly improbable that utility customers get their services even as cheaply because of those few losses. Whatever disagreements there are still among theorists on the problem of interest, it is almost unanimously agreed that risk is a part of capital cost. To get a more general picture of the problem involved we need only pose for ourselves the question of how much cheaper capital might now be secured if no money had ever been lost in the stock market. Such influences are tiny when taken separately, but they loom large in the aggregate.

Thus far this chapter has been more illustrative than analytical. But the relationship to the theory of regulation is close. The problem of regulation is not many problems. It is only one. A business unit is not a series of separate and independent facts. It is one fact — with a series of interdependent aspects. The one problem and the one fact can both be subsumed under the concept of fair return. Fair return, far from being a legitimate item to relegate to a minor position, is a basic point in regulation.

A brief glance at the textbook material in the field of regulation should emphasize the fact that too often regulation has wholly

1 Knight, op. cit.
missed this crucial point. Particularly is this true with reference to the question of valuation. It is seldom recognized that no concern can be confiscated through valuation alone. Equally true is the statement that no concern can be confiscated by fair return calculations in and of themselves. But after the concern has paid its bills for the year, it either does or does not have enough to provide compensation for the residual factors of production used by the enterprise. If it has too much or too little, the factors receive economic rent. If there is just enough the factors receive no rent and regulation has been successful.

Only part of this confusion, however, is caused by the fact that we have a tendency to view things as parts rather than as wholes. Another portion arises from the traditional understanding of corporation finance. We live in a dynamic society. That being the case, businesses make profits some of the time and losses some of the time. Capitalism

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1 Thompson and Smith, op. cit. This volume is merely typical. The authors simply treat fair return as one factor related to the rate-making problem.

2 Bauer, op. cit.

3 Ibid.

4 Too little return, of course, is a negative rent made technically possible by the fixity of capital and the capitalization process.

5 The intimate relationship between fair return and valuation is aptly discussed by Bauer, op. cit.
could not have survived the dynamic necessities of the past had not some way been devised — through legal categories — to distribute profits and losses equitably. This distribution necessarily took the form of priorities as to claim against the corporation. The relationship agreed upon between priority and risk was the inverse relationship so familiar to students of corporation finance; the higher the priority, the lower the risk; and the lower the priority, the higher the risk. It is at once obvious how difficult it would have been to create a satisfactory money market if no claim-holder knew from one fiscal period to the next how his risk would be rationed on the next dividend date.

If the parcelling out of risk had been left to private enterprise, furthermore, it would have represented a violation of one of our most sacred ideals — that of non-arbitrariness — in addition to resting capitalism upon an insecure foundation. The aim in capitalistic finance has been to distribute risks by classes, not by individuals. To have given the owner the privilege of deciding such an issue for himself would have been to pave the way for all manner of personal discriminations not consistent with the fundamentals of social philosophy.


2 This is not to say that certain discriminations do not persist even under a system of legal classification. See Davis, Jerome, Capitalism and its Culture. (Farrar and Rhinehart, New York, 1935.)
Risk in enterprise might have been rationed in either of two ways. First, it might have been distributed in such a way that each class of claim-holders would proportionately gain or lose as dynamics altered operating conditions. Second, classes might have been given absolute superiorities and absolute inferiorities in distinct and certain ways. Basically, the second alternative describes the choice actually made. Bondholders are not paid proportionately with stockholders. They have an absolute claim on earnings up to the amount of their interest-claim. Bondholders do, however, share proportionately with bondholders, if earnings are less than interest-claims.

The phenomenon of profit and loss makes clear at the outset the inevitability, however risk is parcelled out to claim-holders, of the existence of a residual risk. A residual risk is to be defined as that risk born by a claim-holder for the reason that no one else is in a legal position to bear the risk for him. Concentrating for the moment only upon earnings — to avoid unnecessary complications — each class of claimholders bears the risk of the corporation not having a net revenue sufficient for paying dividends. A low-risk class of holders — bondholders — bear no risk up to earnings equivalent to their own interest payments.

1 A claim is defined as a certificate of ownership, unaccompanied by physical control of the assets represented. Types of claims are differentiated according to distance from physical control under certain circumstances.

2 The process of apportionment within a single class is an intricate one, still in a stage of evolution.
Low earnings is not a risk up to this point for the bondholding company group because there exists a class which is legally compelled to bear this risk for them. The same thing can be said of the low-risk class of stock, if the stock has been divided into several classes.

The strategy of the system followed by American corporations was dictated by financial expediency. Saving, under capitalism, is a planned activity. Thus it represents a definitely considered view of the future as a condition precedent. Before making a commitment an investor must make calculations that would be impossible unless the relative risks were known in advance. Thus the business expediency involved is that of overcoming as much resistance on the part of investors as possible. Some savers want only a little risk. Others will assume larger quantities. The job of those in charge of the corporate financial policy is to sell to each potential investor the type of claim that most appeals to him. The over-all result of meeting this expediency is "cost

1 Davis, John P., corporations: Their Origin and Development. (G.L. Putnam's Sons, New York, 1905.)

2 Absolute risk, of course, can never be known. Relative risk refers to the knowledge of how much risk is to be born by high-risk classes of holders — how much worse conditions can get before payments will cease to the investor making the calculations. Absolute risk is the fact of residuality.

3 It need not be emphasized that the money market provides compensation in the form of higher yields for greater risks.
The better pleased every investor is the cheaper the capital factor can be acquired by enterprise.

If total risk were a known quantity year by year, risk would still need to be parcelled out, although every type of risk could be made perfectly definite, rather than being partially residual. But total potential gain is virtually infinite. Total potential loss, no matter what the law may say, amounts to the quantity of capital invested. Actual gain or loss will always be between these two extremes in any fiscal period. Legal rules promulgated in advance of operations, therefore, could never parcel out risks in any precise manner. Law has thus been forced to compromise between the necessity of formulating rules for the future and the impossibility of assessing risks accurately. The inevitable result has been the residual risk. If the pre-parcelling process is over-conservative -- figuratively speaking -- the residual risk is highly paid; if under-conservative, the residual risk is poorly paid.

Historically common stock has been the residual risk. Fair return in public utility regulation includes payments to all groups of claim-holders. Herein lies a fundamental confusion of thought. Since common dividends represent the residual legal claim it is difficult to

1 Professor Knight has popularized the view that a sharp distinction can and should be drawn between calculable unknowns (risk) and non-calculable unknowns (uncertainty). Thus corporations must parcel out uncertainty and risk. Op. cit.
keep clearly in mind the fact that in a regulated industry the entire fair return takes on the qualities of a residual sum. If other expenses increase, total revenue remaining the same, fair return must shrink. The opposite must result if other expenses decrease. Obviously such a regulatory catch-all is as necessary as the legal residual. The two needs arose from the same source — the impossibility of accurate prediction.

Not only do these two residuals have a common origin, but they have an identical function. Each in a somewhat special field has the delicate duty of distributing profits and losses, within the limits set by the total operating conditions. The equity of the legal residual depends upon the distribution of risks between classes of claim-holders. The equity of the economic residual depends upon the distribution of the product of industry to the factors contributing to this product. Equity here, as always, contemplates the distribution of rights as compared with responsibilities throughout society. Equity in assessing residuals thus has virtually the same content as the concept of regulation.

The legal residual refers to distributing income as between parts of the capital factor. The economic residual refers to distribution as between the factors in general. Interpreted broadly no distinction need be made between the two. If understood each in the context of the

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1 Capital leverage makes this particular error loom larger at times. Fair return, as a residual, rewards both creditors and owners. But owners have a residual claim, while creditors do not. Thus the fixity of the claims of creditors makes the entire residuality of fair return impinge upon only one reward.

2 Actually the law does provide that labor shall be paid before bond interest, thus contemplating much more than the capital factor itself.
other, regulation can be made more nearly commensurate with actual economic society.

Economists have been most insistent upon their classifications of the factors of production. The traditional grouping calls for four factors: land, labor, capital, and management. The last-named is considered to be the residual factor, according to theorists. It is this factor that is principally reimbursed through fair return. The function of regulation is to eliminate economic rents from this return. Since rents legally belong to whoever is in a position to claim them, since they always appear first as income of the business unit, and since they are capable of being capitalised fully the moment they are distributed, the regulatory problem is seen to be a difficult one.

Economic rents do not always appear as residuals, and, of course, residuals do not always represent economic rents. Typically, however, rents are contained in the business residual. The specific problem of regulation insofar as these rents are concerned is to clearly separate factor opportunity costs from economic rent and keep the latter from arising; for once they arise regulation can not redistribute them without confiscation, sometimes confiscation of a third party having no connection with the collection of the original rents being involved. For rents that do not arise as residuals the regulatory problem is still to keep them from arising, for if care is not taken regulation may have the

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1 Froman, op. cit., chapter XXVII. This reward for management is the traditional "profit" of the orthodox economist.
result either of failing to eliminate a rent at its source only
to have it appear later in the residual, or of causing a negative
rent at the source only to have it reappear later in the form of
higher opportunity cost for the residual factor.

Every decision of a commission, particularly if an
important one, produces some impact upon the operating structure of
the business involved. If this impact clearly (and only) reflects
circumstances outside the control of either the commission or the
company, regulation has done all that it can do. It sometimes happens,
however, as witness the typical examples delineated above, that the
action of the commission serves merely to shift the impact upon an
operating area less well fitted to absorb it, but a different area than
would have been affected in the normal course of operation. Such a case
creates a "regulatory residual", different from the operating residual
heretofore considered, and usually undesirable in actual practice.

This chapter has been concerned with showing fair return as
a residual of residuals. Any control designed to destroy an economic
rent, unless it takes into consideration the total effect of a decision,
makes fair return a regulatory residual consistent neither with logic nor
operating efficiency. The two chapters immediately following will have
as their purpose the task of demonstrating how fair return could be
converted into a regulatory tool consistent with the dynamic developments
within the economy, namely capitalization of economic inelasticities.
CHAPTER VI

PRACTICAL ASPECTS OF REGULATION

Thus far this dissertation has been frankly theoretical in that general principles rather than specific cases have been the emphasis. However, in order to complete the integration intended in this work, it is now necessary to consider some of the practical ramifications of the theoretical analysis. The purpose of this and the succeeding chapter will be to suggest a few shortcomings of present regulation in terms of the preceding chapter, and to outline the changes in regulatory technique required to implement the ideal implicit in American social philosophy in the light of the environmental developments discussed earlier.

It must be emphasized at the outset that criticism of regulation is only partially justified. If by merely altering somewhat the approach of regulation to the larger problem of philosophy regulators could actually make the ideal realizable then studied criticism would be the logical end of a work such as this. It is characteristic, however, of dynamics in society that the original ideal becomes less desirable as it becomes more difficult. Stated in terms of regulation this statement means that a more realistic approach to the problem by regulators can result only in a more complete control of businesses regulated. Not only is this prospect an undesirable one for those regulated, but it has some appearance of illogicality to regulators in the light of the decreasing significance of the industry classification originally promulgated by the courts. For the present, attention will be focused away from these latter
considerations, and criticism of regulation will be predicated upon the degree to which the ideal pattern of regulation is still desirable.

Most students of public utilities recognize certain defects in the methods presently used in determining fair return. Most of these criticisms center about the problem of valuation, even though many writers candidly admit that too much emphasis is given valuation and too little given fair return. Nonetheless there have been notable attempts, among academicians at least, to outline an objective basis for return determination; thus making fair return more realistic by today's standards. Unfortunately, however, these writers typically begin their analyses with a peculiar type of assumption; one probably made necessary by their rigid observance of close relationship between value and return, but which can really only serve to cast sharp doubt upon the ultimate results obtained. The assumption referred to is the use of the concept 'average' as a practical approach to the problems of control.

A representative example of the use of averages and the possible error to be derived therefrom, can be had by further reference to

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1 For one of the most studied criticisms of present-day methods see the results of a study by the Rate and Research Department of the Federal Communications Commission in 1938 with reference to the proper return for the Long Lines Department of the American Telephone and Telegraph Company. These reports can be had only through the Commission in planographed form. Other works of criticism are too numerous to warrant any attempt at a complete list.

2 Both Nelson Lee Smith, op. cit., and Wu, op. cit., bemoan the neglect of fair return and yet devote the bulk of their books to valuation technique and valuation theories. These two authors are selected as examples, because their works are the only ones purporting to deal comprehensively with fair return.

3 For the fullest account of an objective alternative to current regulatory technique see A Bill to Enact the Prudent Investment Basis of
Professor Smith's analysis of return. He suggests dividing the valuation into two equal parts; one representing bonds, the other stock. To the amount representing bonds shall be applied the going rate demanded by bondholders; to that representing stock shall be applied a rate one half of one per cent higher, as the average relationship between bond and stock yields.

The significant errors permitted by this type of analysis hinge upon the fact that it implicitly necessitates a number of allied assumptions which are really untenable in effective regulation. The first of these assumptions is that always present when averages are used for more than description. Certainly few if any utilities correspond precisely to the average as to capital structure. To regulate all utilities as though the same capital-cost conditions prevail universally permits a preliminary injustice to all speculatively financed utilities—-with no distinction between cases of laxity and economic necessity; and

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*a Rate Regulation*, Report of Commission on Revision of the Public Service Commissions Law, New York, Legislative Document No. 75 of 1930, pp.411-422, prepared by James C. Bonright as a part of the Minority Report of Commissioners Walsh, Bonright, and Adie. This document is particularly worthy of careful study as a comprehensive attempt to give return an independent status in the regulatory process.

1 *Op. cit.*, chapter VII.

2 Professor Wu begins his analysis with a similar assumption and decides upon a similar technique.

3 To penalise a utility with high fixed charges, and whose bonds and stock must both offer investors a high yield to induce them to assume the risks involved, after permitting (in a sense) the incurring of the top heavy indebtedness, is to punish the child after laughing at its misbehavior. And certainly capital costs will be forced up for the future by inflicting the penalty. But regardless of the wisdom of this method of regulation as a general principle, adjustment must assuredly be made in favor of those utilities which have high fixed charges because economic conditions forced them to issue bonds, and those whose managers were interested merely in financial leverage.
permits unwarranted extravagance to conservatively financed corporations—
without distinction between mere good judgment in financing and excessive
past earnings. Further, the tendency under such a system of regulation
would probably be to gradually force the arbitrary capitalization upon
the utilities, regardless of the economic wisdom of such financing in
particular cases. And not only would this method violate the canons of
economy, but it would in addition be contrary to the legal injunctions
of the courts, the final arbiter in regulatory matters. Repeatedly the
Supreme Court of the United States has insisted that each case be
considered on its own merits.

A second untenable assumption to be found in an arbitrary
stock–bond ratio, is the assumption that the time of the inquiry can be
disregarded. An average prevailing ratio pertaining to utilities over
the years is not helpful in arriving at a proper return for a given
utility. Historically, for example, the New England Telephone and
Telegraph Company has financed itself with funded debt amounting to
30 per cent of total capital at a cost of 5.19 per cent. Southern
California Edison, with 45 per cent of its capital represented by bonds,

1 Wilcox v. Consolidated Gas Co., 212 U.S. 19; Lincoln Gas Co.
v. Lincoln, 250 U.S. 256; Galveston Electric Co. v. Galveston, 258 U.S. 388;
Bluefield Electric Co. v. Commission, 262 U.S. 679; United Railways
v. West, 280 U.S. 234. The following is a typical statement from the fourth
of the cases above cited at page 693: "...this Court...held that the
question whether a rate yields such a return as not to be confiscatory
depends upon circumstances, locality and risk, and that no proper rate can
be established for all cases..."
secured that particular capital at a cost of 4.95 per cent. At the extreme end in conservative finance stands Pacific Telephone and Telegraph with only 15 per cent of total capitalization funded. This company secures its debt capital at a cost substantially less than the parent company, the figure for P.T. and T. being 3.56 per cent. Yet Boston Edison, with more than twice the proportion of its capitalization funded, has secured its debt capital at a cost of 3.52 per cent, or .04 per cent cheaper than P.T. & T. Thus there would seem to be no necessary close correlation between the size of the bond ratio and the cost of funded capital. Obviously there is a correlation but the variations from the mold so set will, in specific instances, vary so significantly as to completely vitiate the use of an arbitrary ratio both as to actual ratios and their corresponding costs to say nothing of the widely different effects of particular bond ratios upon the cost of common stock.

A third misconception implicit in the arbitrary stock-bond ratio technique of utility regulation is a misunderstanding of the purpose of regulation. If our only interest in placing public service companies under state supervision were to accept and reflect whatever course utility managements wished to follow, arbitrariness tempered

1 The percentages quoted were computed by the Rate and Research Department of the Federal Communications Commission. For the method of computation used see The Problem of "Rate of Return," June 15, 1938, pp. 159 ff.
with generosity might be as adequate an approach as any. But in such a case regulation would have but little raison d'être. Such seems to be the result of the policy followed by the Pennsylvania Commission for 21 years, a policy allowing the same identical rate of return to all utilities regardless of local conditions and without consideration of the state of the business cycle.

The aim of regulation however, runs much deeper. We desire our utilities to operate, not under whatever conditions may occur to managements regardless of purpose, but the most economical conditions possible toward the end of producing the public utility service. Any regulation with a justified existence has always in the foreground the view of economical service, and is constantly considering the problem of economizing still further. Any regulation that neglects this aspect, is not functioning to the fullest of which it is capable. This aim of economy should be met first by managerial initiative, second by Commission guidance. Thus the Public Utility Commission should be in a position to observe, suggest, urge, demand — in that order — with reference to economy of service.

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1 Rose, Joseph R., Public Utility Regulation in Pennsylvania. (University of Pennsylvania Press, Philadelphia, 1939.) Note the following pp. 62-3. "The Commission had occasion to fix a return in approximately 148 cases during this time. Every type of utility was involved in these cases, electric, water, street railway, natural gas, sewerage and others, but in every case with little or no discussion the Commission found that 7 per cent was a fair return."
The facts about capital economy are sketchy and hard to obtain. But enough are available to fully demonstrate the inaccuracy of a frozen, artificial, regulatory mold. In March, 1932, the most economical form of capitalization consisted of 45 per cent bonds and 55 per cent stock. In March, 1935, the most economical form consisted of 55 per cent bonds. By March, 1937, the most desirable bond ratio had fallen to 45 per cent, while in 1940 it had again risen to 55 per cent. The comparable figure for October, 1935, was 0 per cent; and for October, 1936, 30 per cent. Surely no single ratio could be acceptable even for six months; and a "standard" that must be subjected to a semi-annual change is illusory indeed; while if unchanged it could only be positively injurious. Either the standard would become the actual, to the detriment of the consumer; or the standard would exceed the actual (in bonds), to the detriment of the consumer; or the standard would be less than the actual, also to the detriment of the consumer. The only possibility of non-injury to the consumer would be the extremely rare instance where economic conditions caused the actual ratio in a particular case to coincide with the standard as adjusted at the time of

1 Federal Communications Commission, op. cit., p. 151. For method of computation see pp.105 ff.


3 Federal Communications Commission, op. cit.
The above criticism, though prompted by and adapted to the suggestions offered by Professor Smith, is not to be understood as containing any but a general connotation. Dr. Smith's work is only typical of the approach most commonly encountered; an approach peculiar to those who endeavor to treat fair return somewhat apart from valuation — with the exception of those individuals who seek to guarantee stock dividends, and those who seek a more scientific basis.

1. It is not meant here to create the impression that fair return in a particular case should conform to the ideal situation of the moment; but to actual conditions that have, through regulation, been made to conform as nearly to the ideal condition as economically feasible.

2. Op. cit. It is only fair to recognize that the author would permit deviations from the norm. The following statement appears at p.175: "To suggest that the current yield basis on which the securities of a given utility sell be used in determining its fair rate of return is not to argue that each utility be permitted to set standards for its own regulation, nor is it to abandon the concept of a long-run norm. The current yield indicates merely the necessity of short-run deviations from that norm in particular cases if the credit of the utility is not to suffer." It would seem that any form of regulation that adds to the multitudinous adjustments necessary in any case, is not the most desirable system to adopt.

3. In addition to those previously mentioned see Raymond, W.G., What is Fair. (John Wiley and Sons, New York, 1918.)


In fact the technique under discussion is but a refinement of the procedure adopted by Public Service Commissions almost universally, even though lip-service is paid to scientific methods. It is said that a Chairman of the New York Commission was once asked how he arrived at a "rate" of return. He replied that he merely listened to the testimony of experts hired by the parties concerned, went home and had a good night's rest, and came back the next morning with the proper percentage in mind. The Rate and Research Department of the Federal Communications Commission has tersely summarized the situation similarly.

The errors enumerated as consequent from the assumptions implicit in "average" regulation, stem from a common source; the paramount necessity for adopting some definite point of departure. All activity predicated upon the future must consider as certain some fundamental concepts that have not been precisely proved. This element of uncertainty is characteristic, not of public utility regulation as such, but of any normative approach to social problems. But the working-certainty that must supplant actual uncertainty for purposes of

1 With the possible exception of Massachusetts. Her technique is a bit difficult to describe, and there is some dispute about its actual working in practice. But basically the Commission endeavors to keep the price of securities at par. For details see Barnes, Irston R., Public Utility Control in Massachusetts. (Yale University Press, New Haven, 1930.)

2 For a further statement on this point see Pegrum, D.F., Rate Theories of the California Railroad Commission. (University of California Press, Berkeley, 1932.)

decision is the assumption or assumptions that represent the point of departure for regulators.

If it be granted that assumption (uncertainty) is necessary in regulation, the question of what constitutes a proper assumption becomes of paramount significance. The objections voiced here to the typical assumptions of writers on regulation center around the thought that the assumptions are illicit. They are illicit because they largely fail to relate closely to the underlying philosophy of regulation.

It seems obvious that the only type of assumption that could be justified in regulation would be an assumption concerning the prevailing social philosophy. All manifest outworkings of social control must be supplemental or complementary to social philosophy. Really no assumption is necessary, save the original one applying the pertinent parts of social philosophy to the specific problems at hand.

The pertinent part of social philosophy here involved is free will, or the right of choice. Unless regulation theory uses choice as a starting point, the results are apt to be vague and confusing, if not

1 This statement is, of course, a serious indictment. Most past treatment of regulation has focused upon the average concept in some form.

2 Social philosophy will be taken to mean the equation of rights and responsibilities within the social structure. Social control is the enforcement of this equality.
contradictory. For with any other starting point regulation theory loses sight of who is being confiscated or what of value is the object of regulation controversy. Free enterprise in our society comprehends above all the right to devote self and property to particular enterprises, subject to certain limitations, which limitations must be known in advance.

The confiscated personality is not a business concern, but an individual. The object of value that regulation theory decides (on the basis of social philosophy) to either protect or not protect, is an expectation of income. No assumption not essentially individualized — apart, thus, from the individual status of the corporation in courts of law — can fail to contradict prevailing philosophy.

Most innovations in the field of fair return— notably in the instances cited in the preceding pages — fail in this regard. It can be stated rather optimistically, however that the current trend

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1 Regulation through averages, for example, makes the problem of confiscation completely impersonal, a result wholly incongruous with our ideas of social justice. Just as law may never coerce an individual except non-arbitrarily, so may it never coerce without regard to individual rights and responsibilities. See Jones, and Bigham, op. cit., pp.278 ff. for a frank recognition of this factor as it relates to fair return.

2 This is a reference to the constitutional prohibition against retroactive legislation. Thus once more the extreme importance of this clause in the Constitution becomes evident.

is toward a better understanding at this point. One outstanding example of improved technique came very close to being incorporated into basic legislation in New York. This latter example will serve somewhat as a guide to further examination of specific possibilities in the direction of individualizing fair return in harmony with social philosophy.

It is the purpose of the remainder of this and the following chapter to outline three steps leading toward more realistic regulation. To a degree these steps depend only upon a limited amount of rethinking on the part of commissions. To some extent, however, these steps hinge upon a further extension of jurisdiction. As fundamental as have been some of the legislative additions to commission powers in the past decade, this latter prospect should not be an alarming one.

Before outlining specific proposals a few summary observations may be helpful to the reader. Fair return is considered here in terms of economic cost, or rights equal to responsibilities. Furthermore it is taken for granted that the principal element in fair return must inevitably

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1 The most recent is Coffman, Paul B., "The Direct Approach to the Fair Return Question," Public Utilities Fortnightly, Volume 30, Number 5, pp. 277 ff; Number 6, pp. 35 ff.


3 See Bonbright, James C., Public Utilities and the National Power Policies. (The Johns Hopkins Press, Baltimore, 1940.)

4 For a rather complete analysis of changes in regulatory authority during the depression see Proceedings, National Association of Railroads and Utilities Commissioners, 1936, pp. 360-402.
be the attraction of capital, or opportunity cost. Difficulty frequently arises from a not unusual attempt to make fair return the entire problem of regulation, instead of holding it to its more limited (residual) sphere. The fact that fair return is an accounting residual makes it almost logical to consider it in terms of every aspect of regulation not otherwise handled. But the attempt is not helpful. Fair return is residual because of its technical nature, not because commissions consider other factors first. Thus every factor considered at its incidence leaves less of a problem at the residual level and results in a much more equitable and convincing process.

In the actual operations of a business, economic rentals may be one of two kinds. They may be either contractual or residual. Contractual rents result from a factor's ability to take advantage of a discontinuity in opportunities, enabling it to reap a surplus reward above opportunity costs. Residual rents are those rents that are technically correlated with capital costs and accrue to individuals unexpectedly as the future unravels itself into the present.

Contractual rewards form an element in individual expectations. That is, they are subject to advance capitalization. Residual rewards do not form an element in expectations in the same way. These latter rents

1 Although the Rate and Research Department of the Federal Communications Commission enumerates various considerations, it does give principal emphasis throughout to the problem of securing capital. Op. cit.
are subject only to speculation in advance. The consequences of this distinction are important. Contractual rents are opposed to the assumptions of pure competition, but not to the philosophy of choice. Residual rents in a regulated industry are opposed to both the assumptions of competition and social philosophy. Contractual rents can be controlled by the establishment of certain specific checks. Residual rents can be controlled only by the general check known in utility regulation as control of fair return.

If residual rents, or profits, served in any way to lower cost of utility service to consumers, it would be less imperative to minimize them. But these rents may be either positive or negative and are just about as likely to be one as another. Since either result causes a change in the over-all expectation surrounding the particular income involved, its effect must be to alter the cost of capital, and thus becomes of vital significance to regulation. Whether positive or negative (since in either case the opposite would have been just as possible) the effect will be to engender a more speculative capitalization than without the particular instability.

1 Residual rents and fair return are not synonymous terms. Rents are simply an element found in return under certain circumstances. See Morgan, Charles S., op. cit.

2 The term speculative capitalization is not used here in its orthodox sense. Graham and Dodd, op. cit., Part II. Here it means that the expectations surrounding a given issue of claims in the market has become more uncertain. This usage is related to that of Graham and Dodd, although not identical.
A positive residual means an under-capitalized probability. A negative residual means an over-capitalized probability. Either, separately or collectively, means that a probability has become less probable, less certain. Since only the certainty contained in a probability can be capitalized, the result of over- or under-capitalization must be to lower the price of the security and raise the capital cost to the utility.

The first step necessary to make regulation conform to these principles of modern economy is to make return the test of reasonableness. This is already a basic canon of regulation, although rarely recognized under present technique. The courts are willing to make return the test of reasonableness on the side of confiscation; it is equally important to have some such gauge on the side of extortion. Within limits, meaning when rates become so high that even the housewife knows she is being robbed, return is reduced when it reaches a certain absolute ceiling. But in the large number of cases where fair return is 1 or 2 per cent lower than the actual return, no one takes the trouble to make complaint. On the other side, however, when actual return falls below fair return, utilities immediately petition for higher rates.

It is probably within the power of the average commission to adopt the suggested standard, if ever and whenever the utility begins to receive more than a fair return, but in actual practice attention is only rarely

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1 Re Los Angeles Gas and Electric Corporation, P.U.R. 1931 A, p.132. Here the Railroad Commission originated an investigation on its own motion because it felt the Company was realizing returns in excess of those considered reasonable. By silence at least the federal courts seemed to approve this technique. 289 U.S. 287.
given to slightly excessive returns. In fact, there may be significant examples where exactly the reverse is the case. California and Massachusetts have long been considered courageous in that they have dared decide rate cases by using historical cost or a slight variation thereof as the rate base. Yet it is commonplace to hear it said that these commissions have been successful in keeping themselves out of the courts by being generous as regards fair return. California gains additional favor with her utilities by adopting an undepreciated rate base for purposes of valuation. Other commissions have similarly leaned over backwards in trying to avoid unfavorable (or merely troublesome) litigation. At present there is no consistent check upon this prejudice to consumer interests. Some states have experimented with a Peoples' Counsel to prosecute in the interest of the public. If, however, some system were inaugurated to make the return actually received prime evidence of rate reasonableness, this legal tool would

1 New York and Pennsylvania, through the accounting divisions of their Public Service Commissions, in 1930 undertook an investigation of the actual returns currently received by the electrical utilities under their jurisdiction. The great majority were receiving returns in excess of 10 per cent, at a time when 8 per cent was the return most commonly allowed by commissions in actual rate cases.

2 See Pegrum, op. cit., and Thompson and Smith, op. cit.

3 For a brief description of the Peoples' Counsel and its work see Thompson and Smith, op. cit., pp. 210-211. See also Prendergast, op. cit., pp. 297-300.
be unnecessary — even granting it a certain usefulness under present conditions.

It has been argued, and convincingly, that the consumer is protected against the above type of encroachment. Chairman Prendergast, of the New York Commission takes this view as indicated by the following:

As a matter of fact, the interests of the users of public utility services are competently defended. In bringing rate cases before the commissions, cities are represented by their corporation counsels and by special counsel if such are deemed necessary. If a case is worth the bringing, certainly a city is justified in engaging competent counsel and competent experts, and certainly it can provide funds to do so.

In part the above is a strong argument. In answer to that part it will only be stated here that in those cases where consumer rights are in no danger of violation, no change in this regard need be enforced.

But on the other hand the above argument seems to partially miss the entire point at issue. The crucial question is really not whether there are theoretical avenues of protection for consumers, but whether in fact regulation does operate so as to best fulfill its prime function—assuring the economical performance by private concerns of public functions; not whether present methods are good, but whether they could be improved.

On this latter point, the evidence seems clearly in favor of some form of the technique here suggested. The experience of the Pennsylvania Commission cited above should be sufficiently revealing as supporting evidence. Consumers have no protection through regulation directly. Chairman Prendergast unequivocally states that he conceives

1 Ibid.
of a regulatory commission as a quasi-judicial body, as distinct
from a "prosecuting agency."

In addition to the fact that regulation tends to be one-sided
in practice, public utility control needs an automatic check for yet
another reason. Rate cases are but spasmodic at best. Commissions are
supposed to set rates for a reasonable time in the future by using
for data the facts of the period just ended. Chairman Prendergast feels
that this period may well be five or six years, but only if prices remain
unchanged. Howard Dozier has expressed this difficulty quite well as
follows:

A rate schedule designed to produce an average
reasonable rate of return at a time when earnings can
be expected to be high is unreasonably low and vice versa.
Failure to give sufficient recognition to this fundamental fact is responsible in no small degree for our ever-
recurring rate cases. In the absence of a working agreement
between the public and the utility, the duty of a rate-
making body is to fix a schedule of rates and keep it
fairly stationary, not to fix a rate of return and keep it
fixed.

Mr. Dozier cites a significant example of the results of present policy
in this regard. In 1922 a commission adopted 7 per cent as the fair
rate of return for a certain utility. As is the custom in such cases
the Commission analyzed probable operating expenses, added 7 per cent


2 Ibid.

3 "Present Reasonable Rate of Return for Public Utilities,"
on fair value to the figure thus obtained, and fixed the rate schedule to produce that gross revenue. During the next three years the rate schedule produced a return of 10 per cent, 17\(\frac{1}{2}\) per cent, and 11 per cent. Apparently "if 7 per cent in 1922 was reasonable, then 17\(\frac{1}{2}\) per cent was reasonable in 1924..." and the "...rate of return applied in 1922 should have been about 3 per cent in order to have resulted in the schedule of rates at which the regulatory body evidently was aiming..."

There is little to be gained by multiplying instances. Examples are legion. If return is to be used only in fixing rates, then consumers must resign themselves to expect rates to be "correct" only once over a period of years, and that as taxpayers they will be involved in expensive litigation whenever the utility feels that return is too low. If on the other hand fair return could be used as a more dynamic tool of regulation, as a test of reasonableness as well as a proof of unreasonableness, utility regulation could be much enhanced in the direction of our over-all philosophy.

The foregoing considerations have been primarily concerned with the economic aspects of the problem posed. However, legal aspects will also repay analysis. In the first place, on what grounds can a consumer, or a municipality as representing consumers in the aggregate, enter a prayer for lower rates except on the claim that the utility is making excessive profits? The answer that will first occur to a thoughtful reader is "value of service." This principle of rate control is as old as judicial review of utility regulation, although for forty years it was scarcely

1 Ibid.

2 Covington & Lexington Turnpike Road Co. v. Sanford, 164 U.S. 578.
mentioned by consumer-conscious commissions. Then in 1929 and the years immediately following "value of service" was eagerly sought as an avenue toward lower rates. The Maryland Commission used this concept as an argument to keep street railway fares low in Baltimore, only to be reversed by the Supreme Court. In 1932 the Wisconsin Commission endeavored to substitute "value of service" for "cost of service" as the proper rule of reasonableness, and met with the same result in the courts, except more emphatically. At present it is genuinely doubtful that the "value of service" principle could stand another court test as a legal injunction in regulation. Its only usefulness is concisely summarized by two authors as follows:

...value of service is no help at all as a primary standard of reasonableness for pricing of utility services...value of service plays an important part in the setting of specific rates...Thus, value of service is distinctly subordinate and supplementary to cost of service as a theory of particular rates and is never acceptable as a general theory of reasonableness of rates.

The obvious conclusion is that "value of service," despite its hopeful origin and ambitious revival, is no legitimate ground for consumer complaint.

The next thought that interposes itself is that of consumer confiscation. It would seem that if one party to a bargain is subject

1 United Railways & Electric Co. v. West, 280 U.S. 234.
3 Thompson and Smith, op. cit., p. 262.
to confiscation, the same principles should apply to the other. In the earliest cases, indeed, the very wording of Supreme Court decisions seems to imply that the public is in fully as acute danger of confiscation as the utility company. For example, consider the following taken from Justice Harlan's opinion in Reagan v. Farmers' Loan and Trust Co.:

"The equal protection of the laws...forbids legislation, in whatever form it may be enacted, by which the property of one individual is, without compensation, wrested from him for the benefit of another, or of the public."

Or consider the majority opinion in Covington & Lexington Turnpike Road Co. v. Sandford: "A state enactment...that will not admit of the carrier earning such compensation as under all the circumstances is just to it and to the public...would therefore be repugnant to the Fourteenth Amendment of the Constitution of the United States." Even in the Nebraska Maximum Rate case the same idea runs as a thread throughout the entire opinion. The following is typical of the language used:

It cannot be assumed that any railroad corporation...ever supposed that it acquired...the power to construct and maintain a public highway simply for its benefit, without regard to the rights of the public. But it is equally true that the corporation performing such public services...have rights that may not be invaded by legislative enactment in disregard of the fundamental guarantees for the protection of property.

1 154 U.S. 362.
2 164 U.S. 578.
3 Emphasis added.
4 169 U.S. 466.
These paragraphs were written many years ago. By now it is well
known that, whatever other significance these statements may have
pertaining to regulation, the Fourteenth Amendment is not the correct
explanation. In short, a public utility consumer cannot be confiscated.
Brutal as it may seem, and though apparently inconsistent with the basic
premises of regulation, the courts and commissions have decreed that
since the customer is not forced to buy (in the way that the utility
is forced to sell) he has no constitutional protection. The latest
available decision on the point was handed down in 1937 by the Alabama
Supreme Court:

It would follow, as a logical result of the theory ad­
vanced by the city, that a subscriber who has no invested
capital at stake, but only a desire for a lower rate, and
dissatisfied by the schedule fixed in the law by his rep­
resentatives in the legislature, could appeal to the courts
to have the law nullified, and a new schedule of rates
established by the judicial branch of our government, and thus
have the courts' judgment in a purely legislative matter sub­
stituted for that of the law-making body.

The position as here presented seems sound. Yet, if utility
regulation is predicated upon the public nature of the business, consumers
must have some recourse. If they cannot claim confiscation, and if
"value of service" is lost to them as a defense, then the suggestion
that return be used as evidence of rate reasonableness is even more in need
of adoption.

1 Bauer and Gold, Public Utility Valuation. (The Macmillan Company,
New York, 1934.) Bryant and Hermann, Elements of Utility Rate Determination.
Principles of Public Service Regulation. (Public Utilities Reports, Inc.,
Washington, 1926.)

2 Birmingham v. Southern Bell Telephone & Telegraph Co.,
176 So. 301.
As early as 1876, in Munn v. Illinois, Chief Justice Waite set the standard for such a procedure.

In countries where the common law prevails, it has been customary from time immemorial for the legislature to declare what shall be a reasonable compensation under such circumstances, or, perhaps more properly speaking, to fix a maximum beyond which any charge made would be unreasonable.

Thus it is not for the courts to point the way. It has been their custom in the past to leave the state legislatures to their own devices as far as innovation is concerned. Possibly legislatures and commissions have been too much concerned about the confusion that the Supreme Court has allegedly made of valuation, and too little concerned over other possible remedies.

However, an opening wedge has been driven. In 1940 the Federal Power Commission ordered the Natural Gas Pipe Line Company of America to reduce its rates, not by a certain amount, but to yield a certain amount of revenue. In 1941 an appeal reached the federal district courts where the Commission was upheld. The court dwelt long on the fact that the return actually received has always been the judicial test of rate reasonableness. A few more decisions by commissions similar to this decision of the Federal Power Commission will go far in the direction of more objective regulatory technique.

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1 94 U.S. 113.


CHAPTER VII

PRACTICAL ASPECTS OF REGULATION (CONTINUED)

The one suggestion thus far advanced would add little to the effectiveness of regulation taken alone. True, control would tend to be more smooth and continuous. But rate changes would be more frequent, forcing the cost of regulation yet higher. The triangular relation between utilities, the public, and commissions would tend to become more strained. Actually this proposal savors strongly of the service-at-cost and sliding-scale techniques, though savoring much more strongly of the disadvantages thereof, than of the advantages. To add stability to the rate structure it is necessary to go further and consider a more comprehensive approach. Thus the second step to be offered here is that the ownership of excess earnings — defined as earnings over and above those considered fair under existing technique — be made to reside in the consumer; not

1 Service-at-cost and sliding-scale methods can be defined in common as any system of regulation that endeavors to establish close correlation between managerial efficiency and the level of utility rates (or profits depending on the viewpoint).

2 The most vital disadvantage is centering attention upon return, rather than allowing full recognition of the significant interrelationships inherent in the utility industry.

3 These can be summarized in brief as insuring that consumers shall pay no more than cost in the accounting sense, not necessarily in the economic sense.

4 A third step, to be outlined later, deals with the specific problem of determining fair return and relates that problem to the two preceding steps. But it is important to emphasize that these two, if inaugurated, could vastly improve utility regulation under any system of return determination.
to be regularly withdrawn necessarily, but to perform an important
function as the elastic element in regulation — a function now being
1 inadequately and erroneously performed by commission generosity.

This second suggestion might at first seem revolutionary.
But logic, at least, will support the view here taken — although the
innovation does seem to be somewhat more dependent upon legislation than
the first proposal. At all events two examples should serve to illustrate
both the economic and legal principles involved.

The first of these examples is the Black River Telephone
2 Company. In 1929 this Company filed new tariff schedules with the New York
Department of Public Service, effecting a general increase in rates. Certain
of the towns affected by the new schedule filed complaints with the
Department. After considering the pertinent facts the New York Commission
allowed, in part, the increase asked by the Company. However, several
significant facts were brought to light in the minority opinion of
Chairman Maltbie and Commissioner Burritt. In 1924 the Company had paid
a stock dividend of 50 per cent. In 1925, 1926, 1927, 1928, and 1929
respectively it paid 10 per cent, 16 per cent, 18 per cent, 18 per cent,
18 per cent cash dividends on its common stock. In addition, in 1929,
it added more than $34,000 to surplus after the payment of dividends and

1 The significance of this elasticity element can be demonstrated
more convincingly later in conjunction with step three.

2 Re Black River Telephone Company, P.E.R., 1931 C 26, New York
Department of Public Service.
all charges upon revenues. At the time of the inquiry the Company
had a corporate surplus equivalent to 20 per cent of its entire
capital. The minority also found that if the revenues actually
received under the new schedule as approved by the majority should be
$11,000 less than anticipated, the Company could meet all charges, pay
18 per cent dividends on outstanding stock, and add $15,000 to corporate
surplus.

The situation above described is not a wholesome one, at least
if it be granted that utility service should reach the consumer as
economically as possible. At the time the Black River Telephone Company
first began to plow back its earnings the New York Commission had ample
authority to initiate action on its own motion to reduce rates to the
proper level. Had the Commission done so year by year the net result
would have been the same as though the ownership of excessive earnings
had rested with the public over the same period, and the legal outlook
could thus be no different. As worked out in this particular case, both
of the principles of regulation thus far mentioned were violated; not

1 Ibid., pp. 51-52.

2 As early as 1914 New York was a pioneer in the modernization
of her regulatory authority. Of course, once the "value" of the
property is enhanced by reinvestment, the present rate-making rule
demands its recognition.

3 If rates were to be set — as one possibility — on the basis
of value minus reinvestment, it is probably not desirable to have too
large a surplus accumulated. Such a process would penalize one genera-
tion of consumers for the benefit of another. The proper criterion as
regards size of surplus might be that necessary for equalization.
only was the rate of return given no significance in determining rate reasonableness, but past overcharges were permitted to become a permanent "value".

The second example is perhaps the more significant of the two, although less spectacular. The amounts involved are larger, and the Commission involved is one that many years ago laid down the general principle that consumers should not be charged high rates because of reinvested earnings, where such earnings were not the result of withheld dividends. The company involved was made the object of a complaint in 1931. Later the Commission instituted proceedings on its own motion as to rates and practices of the utility. This case was the final disposition of the motion of the Commission.

The San Diego Company had had a virtually unbroken dividend record. Its bonds had a Triple A Moody rating. Its financial position had

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1 If surplus is reinvested in necessary utility property, only the consumer who paid the original excess is injured. But if any of the reinvestment finds its way into valuation without being reinvested in useful property, all future consumers will be injured as well. The proposed technique would be principally useful in obviating the necessity of making such costly determinations at the expense of the taxpayer.

2 The California Railroad Commission. See Pegrum, op. cit.


4 Ibid.
never been questioned. And, particularly, it had been adding to its earned surplus account by upward of $100,000 annually for well over a dozen years, the total account amounting to roughly 5 per cent of total assets. In the proceeding under discussion the commission allowed an undepreciated rate-base, as is its custom, depreciation reserve amounting at this time to about $7,500,000, or about 15 per cent of total assets. Thus, approximately 20 per cent of the total valuation consisted of depreciation reserve and surplus. If, under such circumstances, a commission concentrates rigidly upon cost requirements in deciding upon the amount of return required (as the California Railroad Commission claims frequently to do) no serious error could result. But in view of the fact that preceding and during the depression the company found it possible to make annual and substantial additions to its surplus, the

1 Although the earned surplus account is often only an omnibus term for all surplus and many reserves, the San Diego Company keeps its accounts in accordance with rules laid down by the California Commission.

2 Like all valuations of the California Railroad Commission this one closely approximated original cost.

3 It is not necessary here to give a detailed account of the theory behind an undepreciated rate-base coupled with the sinking-fund method of accruing depreciation. Suffice it to say that the method assumes that a close enough adjustment has been made in rates to give consumers annually the benefit of the lower depreciation charge. If such an adjustment has in fact not been made, the consumer is doubly the loser. The advantages of the method are clear in theory, but it does place upon regulatory bodies a precarious responsibility.

4 Pegrum, op. cit.
facts of the case seem to indicate that the attempt was ill-adapted
to the desired end. This fact is driven home even more sharply to the
observer when it is recalled that the company in 1934 had been under the
direct surveillance of the commission six times in the preceding eight
1
years. Thus, again, both of the regulatory canons have been imperfectly
observed at best.

If these two items were merely isolated instances they would
cause no legitimate concern. But analogous situations are common-
place. In the telephone industry 8 per cent of total assets is represented
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by "unappropriated" surplus. In the traction industry almost 8 per cent
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of total equities consisted of surplus and reserves. While in the
electric light and power and gas industries about 5 per cent of total
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equities represent surplus and reserves. These figures may seem immaterial
when taken as bare percentages. But remembering that these same equities
are the data of public utility valuations, 5 per cent can add substantially
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to utility service bills. In addition, the above figures are averages,

1 7 P.U.R. (N.S.) 443.

2 Moody's, Public Utilities, 1940. The Federal Communications
Commission alone among the Federal regulatory agencies, under whose
supervision most of the telephone industry keeps its accounts, permits a
generalized surplus account. But it is well known that earned surplus is
an important item in this industry. See 292 U.S. 15.

3 The Sources of Public Utility Capital, Bulletin No. 20 Bureau of
Business Research, University of Illinois Press, Urbana, 1928.

4 Unfortunately these figures are not broken down for close scrutiny.
It is not even stated whether or not the "reserve" item includes depreciation
reserve. Logie would say not. The percentages are given with that
assumption.

5 Bureau of Business Research, op. cit.
taken from a group of utilities at random, many of them having deficits which were deducted. Recognizing these as somewhat unnatural situations, the true picture might be drawn more strongly. In addition many valuations have been tempered by considerations of reproduction cost, and in view of the fact that reproduction cost (when used for valuation purposes) is always higher than original cost, the percentages quoted appear even more conservative.

In this, as before, the legal perspective is a prominent consideration. In all the annals of corporation law in general it has been assumed that whatever found its way legitimately into the hands of the corporation could legally be used for any proper purpose. In the public service corporation, however, there arises an initial doubt as to the propriety of the automatic relinquishment of funds as soon as they are clutched in corporate fingers. This doubt has occasionally found its way into courts as the "doctrine of implied trust." As such it has had an interesting and confusing history.

It must be recognized at the outset that there are many different kinds of surplus, or stated more accurately, surpluses from many different sources. Some of the major sources of surplus are as

1 This factor for the past fifteen years has been much less of a factor than commonly supposed. The typical method, revealed by an examination of decisions of commissions, is to use some previous valuation with subsequent additions at cost.

2 For a complete discussion of implied trust from the standpoint of the Interstate Commerce Commission, see Locklin, D.P. Regulation of Security Issues by the Interstate Commerce Commission. (University of Illinois, Urbana, 1926.)
follows, together with the attitude of the Interstate Commerce
Commission toward their capitalization as reported by Professor
Locklin:

1) The writing up of assets to correspond to a higher
reproduction cost. The Commission properly, although not
invariably, allows such surplus to be capitalized if
capitalization does not thereby become greater than fair
value.

2) The inclusion among fixed assets of intangible values,
such as good will or going value. The I.C.C. apparently
disapproves the capitalization of this surplus.

3) The writing up of the accounts due to appreciation
in land values. The Commission emphatically frowns upon
the capitalization of such a surplus.

4) The inclusion of depreciation or other reserves in the
surplus account. Obviously such a surplus should not exist,
let alone be subject to capitalization.

5) The reinvestment of earnings. The Commission has given
little attention to this problem, and has never commented at
length. In general the capitalization of such surplus is
permitted.

While important questions of policy hinge about each of the
above possibilities, the legal doctrine of implied trust applies only
to the last, and then only in the case of public utilities. At best
it is a delicate situation, for reinvested earnings may be the result
of excessive rates or non-payment of dividends. Certainly there is no
legal or ethical justification for denying to the corporation owner­
ship of the latter. In fact utility services could be rendered much
more cheaply if there were no such thing as non-payment of dividends.

But with reference to the surpluses created by excessive rates, as noted previously, doubt arises. Regulation seems to be in the anomalous position of being legally able to prevent such a surplus from arising, but with no power over it once formed.

Very early in the history of regulation in Massachusetts, the Board of Gas and Electric Light Commission endeavored to insert implied trust into its scheme of control. But the Board was promptly short-circuited by the Massachusetts Supreme Court which held that the Company might capitalize the cost of all additions to plant without regard to the source of the funds used. The general policy of regulation in Massachusetts at present is to maintain equivalence between capitalization and investment, which would imply permission to capitalize reinvested earnings.

Pennsylvania has had a similar experience. At present the only pertinent stipulation regarding stock dividends contained in the Pennsylvania laws is that a part of the surplus must remain capitalized.

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1 By way of definition implied trust may be said to be the principle that all revenues in excess of a fair return on fair value are held by the utility only in trust for rightful owners—in this case the consuming public.


3 Barnes, op. cit., p. 127. However, see Re Lowell Gas and Light Company, P.U.R. 1933 A, 460.

In New York the issuance of a stock dividend by a public service corporation under the jurisdiction of the state commission is not legal, but apparently this rule is not directly related to the doctrine of implied trust. And it appears that the doctrine does not figure in the regulatory laws of Illinois or Maryland. Thus only California, among the stronger of the utility commissions, has made an effort to follow an implied trust policy. This rule was laid down by the California Railroad Commission in the first published volume of its reports to the effect that no return was to be allowed on property

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4 Wisconsin can of course not be omitted in any discussion of the stronger utility commissions. The Wisconsin rule as to the purposes of security issues, as in many states, is that stocks or bonds may be issued to reimburse the corporate treasury for improvements secured from earnings.

5 Geo. A Legg v. the Nevada County Narrow Gauge Railroad and the Southern Pacific Railroad Company, 1 C.R.C. 11. See also 3 C.R.C. 1212, and 4 C.R.C. 570.
built by revenues from excessive rates. It has been noted earlier that the policy of the California Commission may not be so sound in practice as it appears in theory. However, this policy has never been overruled by the courts.

The entire legal question of implied trust must be considered unsatisfactorily settled at best. But the economic question is certainly not so simply disposed of as the following statement implies: "The regulatory commissions are justified in refusing permission to issue stock dividends to capitalize an earned surplus only if the property acquired therewith does not increase the Company's earning power."

Indeed, as long as such a treatment is accepted as true, the problems of regulation will remain just that far from solution.

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1 This policy does not exactly vest in consumers ownership of such property, but it does have the same general effect.

2 The lower federal courts have made the specific decisions unanimous in the negative. See Garden City v. Garden City Telephone, Light & Manufacturing Company, 236 Fed. Rep. 693. The Supreme Court has never ruled on the point.


4 Note the following statement by Joseph B. Eastman of the Interstate Commerce Commission 67 I.C.C. 156: "It is not a sufficient answer to this doctrine to say that the property acquired from surplus is owned by the carrier, for the rights of ownership are not absolute, but limited by the dedication of the property to public use and the circumstances of such dedications. Nor is it enough to say that the surplus might have been distributed to the stockholders at the time it was earned, for the public might well have declined to acquiesce in rates producing excess income if that income had not been used for the improvement of the property."

R.H. Whitten in his Valuation of Public Service Corporations (as enlarged and revised by D.F. Wilcox, 2nd Edition, Banks Law Publishing Company, 1928) takes the view that it is impossible to return excess
The preceding analysis has not been predicated upon the assumption that consumer ownership of surplus (over and above a fair return) is an innovation impossible of achievement. What has been predicated is that whatever steps are taken in this direction probably must come through legislation, rather than from a more firm and definite stand on the part of commissions.

Actually there is a quite conclusive precedent for legislation of this nature. The most significant body of this precedent is to be found in relation to the recapture clause of the Transportation Act of 1920, and the Supreme Court opinion pertaining thereto. The recapture clause, it will be recalled, permitted the Interstate Commerce Commission to fix a proper fair return for carriers as a whole. Whatever any one carrier received above this fair return was to be divided one-half to the carrier and one-half to a commission revolving fund, to be available for loans to other carriers. That part of the excess retained by the earnings to those who actually paid them. Such an argument begs the entire question. To permit a small injury to stand in the way of correcting a large one is certainly not objective. The built-up surplus, regardless of ownership, would benefit all consumers — past and present. The only other way such a surplus could be accumulated (other than by consumer contributions) would be by assessment of stockholders. Such a policy has its points but it is an entirely different question.

1 Section 15 A, 41 Stat. La. 4881.
3 Originally 6 per cent — later 5 3/4 per cent.
carrier was to be kept in a reserve until it should amount to
5 per cent of the value of the carrier's property, after which the
1 carrier was authorized to use its share for any lawful purpose. But
most significant of all its provisions is the declaration by the act,
even as approved by the Supreme Court, that the carriers only acted as
trustees for the public as regards all revenues exceeding fair return.
The Court reserved the right to decide when a specific prayer could be
brought as to whether the shipper or the general public should be the
beneficiary of the trust. The full implication of this decision
probably lies in the fact that if the ruling authority may legally take
one-half of excess earnings, if — in truth — excess is a public trust,
there can be no constitutional bar to the declaration of a 100 per cent
trust.

Such a step was in fact taken by the city of Laredo, Texas. On December 15, 1931, this city enacted an ordinance fixing gas rates for
the city, and provided as a condition of the bond posted by the company

1 Paragraph 18 of Section 15A.
2 262 U.S. 456.
3 Loc. cit.
4 Ibid.
5 This is not a defense of the particular aptitude of the re-
capture clause for carrying out its purposes. Details of regulation
will naturally be altered as experience points new ways.
involved, that the Company should refund to the city for the benefit of consumers any excess of rates collected "over and above the rates and charges that shall be finally determined to be a fair and reasonable return upon the value of its property used and useful in supplying natural gas and natural gas service to the City of Laredo." When the company later appealed its case to the courts, the issue of recapture was not raised.

It would appear that the real problem is not one of forcing courts to recognize the validity of an implied trust, but to urge legislatures to recognize the advantages of creating a statutory trust to serve the same purpose. It may at first seem strange that the court system stands ready to approve legislation on this subject but will not tolerate direct action by a commission. In theory, however, the position of the judiciary is perfectly sound.

It is a basic fact in capitalistic organization that an investor cannot be confiscated if he knows the rules of the game before

1 For details of the franchise see United Gas Public Service Co. v. Texas, 303 U.S. 123.
2 Ibid.
3 Thompson and Smith, op. cit., pp. 377-378, cite Board of Public Utility Commissioners v. New York Telephone Company, 271 U.S. 23, as an effective bar to the "streamlined" regulation here suggested. Perhaps they are right in concluding that the New Jersey body was urging a more defensible economic position than the court. But there is a great deal of difference between "confiscatory" rates to absorb an excessive depreciation reserve, and the recapture of excess earnings. Economically the latter offers a much more basic (economic) approach, although the former is an important problem.
he makes a commitment. These rules apply to the specific facts surrounding particular investments. If one of those facts is a maximum return of 2 per cent on original cost of plant, the over-all expectation will simply dictate a lower value for the investment. If one fact is a statutory trust imposed by a legislature, that fact will be incorporated into the general expectations of investors, and investment value will be affected accordingly.

The situation is otherwise if a trust is created by Commission action. Such an act confronts an investor with a circumstance he had no reason to anticipate. It is productive of a situation in which an individual finds himself possessed of an investment value procured according to terms that would not have been satisfactory had all the facts been known. Briefly, such action taken by a commission directly abrogates choice by obstructing the operation of free will. Such a result is confiscation in our society. Thus the courts have reason to distinguish between legislation and administrative decision in this regard.

The third and final step to be suggested here, by way of conforming commission procedure to the necessities dictated by the modern

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1 Note that both the recapture clause and the Laredo case represented specific legislative action. Of course a consistent commission policy can be anticipated by an investor, but there is always the initial confiscation when the policy is first inaugurated.

economy is the most extreme of all. What is more to the point, perhaps, this suggestion is the most important. It involves a "formula" for the automatic determination of return.

Immediately it will be urged that a "formula" for calculating fair return is prima facie unconstitutional. As authority for such an objection, West v. Chesapeake & Potomac Telephone Company will be cited. There is, however, a vast difference between a rate-fixing formula, as a general proposition, and the use of a peculiarly weighted group of index numbers for calculating valuation. In the first place, the theory behind the Maryland Commission's system was quite dubious, and, what is most pertinent for our study, the court did not object to the formula as such, but only to its results in the particular case. In fact the court considered the greatest defect in the method of valuation used to be the fact that it permitted the utility "to claim to the last dollar an increased value consequent upon a sudden and precipitate rise in spot prices of materials and labor." In that connection the court pointed out that the owner of public utility property may not "pass on to the public the risk involved in a general decline in values." In short, the judiciary did

1 295 U.S. 662. In this litigation the Supreme Court disapproved a valuation based on a series of index numbers. Most of the remarks of the court were directed against the use of these index numbers as a "rate-making formula."

2Localization.

3Localization. The court obviously recognized that this rate determination would have to do for a number of years, and therefore must be better than a guess.
not frowned upon the Commission's method -- as such. It merely opined that this method had neglected certain important factors. It thus can not be conclusively stated that the court will reject formulas on principle, even though it did reject a formula in 1933.

The reasoning of the Maryland Commission in reducing valuation to a weighting of price indices is so important to our general topic that it must be further analyzed. The aim of the Commission was "to give to investors an investment dollar of constant purchasing power; that is, exchangeable dollars invested in place of present exchangeable dollars."

To thus assume that valuation, or any other single factor in rate regulation, can or should be held responsible for the basic problem of price fluctuations in regulated industries is to miss the point of regulation theory. Control has an over-all purpose to minimize the cost of utility service to consumers. Any policy contributory to this end has an initial justification. Any policy not contributory to this end has no

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1 In a strong dissent Justice Stone interprets the decision as not facing the substantive problem of confiscation, but concentrating on the procedural problem of method. The Commission had allowed a set of rates that would have produced somewhat more than 5 per cent on the valuation of the district court. The court had specified 6 per cent as the minimum return that would avoid confiscation. Clearly, then, the majority had faced the substantive issue even though the point was not stressed. Whether 5 per cent was or was not confiscatory is not to be determined here.

2 See Virginia Law Review, November, 1935, pp. 73-83; and Harvard Law Review, March, 1938, pp. 835-893. Perhaps the controversy on this point can only be dissolved by another case. It is unfortunate that the Supreme Court is frequently ambiguous on some really important points.

3 295 U.S. 662.
such initial justification. This fact the Court wisely recognized in outlining the defects of the Commission's procedure.

It could probably be demonstrated that a rate-making formula is both desirable and inevitable. Obviously rate-fixing must follow a set of principles if it is to be accurate and just. Principles, by very nature, set forth the reasons for making one type of determination as against another type. These reasons are by definition formulae, though they may not be embellished with all the precision of mathematical calculation. Almost by definition a formula means the application of a reason, while no formula means arbitrary regulation.

In addition to being inevitable a formula for purposes of fixing rates in regulated industries is also desirable. Definiteness of approach not only gives regulators a staff to lean upon, but it furnishes the public utility investor with a basis for his calculations. Economy as to fair return necessitates securing capital on as favorable terms as possible. Thus the investor must be approached with terms he is in a position to appreciate. The most basic of these terms is knowledge of the

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1 Loc. cit. All this is further explanation of the substantive nature of the approach of the majority. The fact of confiscation is not without time dimension, although the immediate result is an important item.

2 "In fact, it is quite impossible for those concerned with so difficult a problem as rate making to avoid the use of a more or less definite formula." Bernstein, op. cit., p. 121.
rules of the game. With these clearly stated, capital can be obtained much more easily than otherwise. In fact there is very little more, along lines involving fair return, that a commission can do to assure the economical acquisition of capital.

The element of uncertainty surrounding a public utility security has two sources: first, the normal uncertainty that troubles every economic organization in a dynamic society; second, the uncertainty that accompanies the possibility of adverse commission decisions lowering net returns. From whichever cause, uncertainty is the basic fact that raises the cost of capital to a utility enterprise. It is a long-recognized fact, by commissions and courts alike, that the second type of uncertainty should be avoided by prohibiting what is known as "arbitrary" action by commissions. But it has not been universally agreed as to the

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1 "One of the prime requisites of a flourishing economic development is that those who take initiative and assume responsible leadership shall know what to expect, and shall be able to count on the consequence of their own acts and those of other persons with whom they have dealings." Clark, op. cit., p. 143.

2 Unexpected high returns and unexpected low returns affect the capitalized worth of an investment by making it speculative. Speculative capital invariably is more expensive to the utility than non-speculative capital.

3 This follows from the legal principle that no individual is to be treated except as a member of a class. If regulation follows a pattern, thus, the investor (theoretically) can apply the principles involved to his own case.
role regulation should play in avoiding (or permitting) natural
uncertainties that tend to disrupt investor calculations. It is in
this sphere that it is thought a formula can be of greatest value.

It has been urged of late with increasing frequency that the
basic investment uncertainty resides in the residuality of net income —
particularly common stock income. Thus the common stock contract would
be a logical beginning for an attempt to minimize uncertainty.

The common stock contract customarily carries neither maxi­

mum nor minimum return. Thus almost all uncertainty inherent in the
enterprise rests with the common stock investment as residual. This
uncertainty is present within the limits of zero per cent and infinity
in the abstract situation, and between zero per cent and, say, 30 per cent
in the concrete utility world. If this uncertainty could be concentrated
into a smaller range, utility capital could be secured for less over-all

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cost.

The specific regulatory innovation to complete the list
of three offered is that all contracts for capital be made to carry a

1 Jones and Bigham, op. cit.; Morgan, op. cit.; Prudent
Investment Bill, op. cit.

2 "...But this factor of uncertainty must be eliminated for
the future if we are to exercise workable rate regulation. The rate of
return must be equally definite with the rate base for effective public
control." Bauer, op. cit., p. 255.
maximum rate of return. It is probably unnecessary to outline the mechanical details of such a proposition. As to such details the writer will accept the procedure suggested in New York's Prudent Investment Bill of 1930.

In equating rights and responsibilities, cost and prices must be matched. Ultimately this requirement means that economic rents are not to be collected by the factors of production. In the capital market investment valuation is a process of equating expectations to changing market conditions. The problem of fair return centers on preventing this process from bringing to persons economic advantages apart from legitimate expectations. "In the issuance of all such securities, there are always fairly certain assumptions on the basis of which investors contribute capital to public service. The natural basis of determining the return would be according to the expectations of the investors at the time they bought the securities. In no other way can factor sacrifice be equitably adjusted to consumer sacrifice."

1 Of course, a minimum rate of return could not be fixed unless accompanied by an outright guarantee. The residual claims must have some element of residuality, with which to buffer altered circumstances. Guarantee of common stock dividends is not contemplated here.


Present procedure largely follows the above outline only as to bonds and preferred stock. In the common stock field, however, a new issue requires, not only that the expectations of new investors be satisfied to meet the requirements of a competitive capital market, but that existing holders must also be allowed to participate in existing expectations. In terms of return requirement the present proposal of a maximum return to common stock would operate in favor of consumers in times of rising expectations, and against consumers in times of falling expectations. But in terms of reducing uncertainty, the plan would operate in favor of consumers at all times.

The consequence of current technique may be summarily illustrated. Consider a utility corporation with $1,000,000 common stock outstanding, issued at a time when investment value was calculated at ten times average annual dividends (yield of 10 per cent). Now the company finds it necessary to raise more capital and discovers that, all things considered, the common stock medium is the most efficient method of raising additional capital. However, the management finds that the general level of expectations is now 11 per cent rather than the 10 per cent

1 Jones and Bigham, op. cit. pp. 278 ff. This selection also contains a criticism of the Bauer proposal, which is not fundamentally different.

2 See Brandeis' separate opinion in Southwestern Bell Telephone Company v. Public Service Commission of Missouri, 262 U.S. 276, for an excellent critical background for these statements.
accompanying the original issue.

Were this an issue of bonds, or even preferred stock, no concession would be necessary with reference to original holders. But with common stock the usual practice is to simply reduce the amount of "unissued capital stock," and increase the amount of "capital stock outstanding." In all such cases the old participates on exactly the same basis as the new.

The proposed plan would operate differently. The original holder would be left with his original expectations (in so far as earnings were adequate). The new holder would participate in the new expectations. Neither would be confiscated. Neither would receive any factor rentals (positive or negative) as a part of return.

It is clear that the above is not passive regulation. However, today's capitalism is beyond the point where we can be assured that charges to consumers can be reduced by determining a per cent as fair return. It would be necessary to regularize and cumulate dividends on common stock. Reinvestment of earnings would probably have to take the form of stock dividends, and made never to exceed the accumulated dividend coming to stockholders.

1 "For the future, we should be perfectly clear that we cannot escape the market requirements in obtaining capital. We must pay the interest or rate of return that will be required. But, let it be equally clear that this does not require, at any point, a readjustment of return on past investments. It applies only at the time the funds are obtained." Bauer, op. cit., p. 250.

2 In many cases, of course, the old holder and the new are identical persons. The current technique, however, is no more defensible because of this fact.

3 Jones and Bigham, op. cit. See also Prudent Investment Bill, op. cit.
The outline of fair return here set forth does not provide an incentive for better entrepreneurship. But that does not mean that there can be no incentive. To let return be flexible to the extent of rewarding good management is to take the position that common stock dividends are wages rather than a return to capital. Suppose, for example, that the president of a utility owns 5 per cent of the common stock of his company. Why should the other 95 per cent of the stock receive 1 per cent higher dividends merely because the company wishes to express appreciation for good entrepreneurship? A company that has a good president should pay him extra, not the common stockholders.

Actually regulation is endeavoring to get away from executive control over the stock of corporations. It has been found that executive manipulations of capital structure have been a frequent result. Regulators should examine very carefully any technique that divorces the executive from capital structure. There is no good reason why an executive should look upon dividends as his remuneration for efficiency.

There are other and more legitimate incentives for good management. There is, for example, the incentive of comparative workmanship.

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1 Incentives are excellently treated in Morgan, op. cit. The view here presented is similar to the one outlined by the above author. Above all Morgan feels that profit should not be the criteria of efficiency in a public utility industry.

2 Part of the task of the S.E.C. in regulating security issuance is the elimination of these cases.
An executive knows, and he knows that certain other people know, whether or not he is doing a good job. With a set of comparative statistics regulatory commissions themselves can determine this within fairly definite limits. There are many entrepreneurs who take a genuine pride in their accomplishments. It is far too narrow a view of entrepreneurs in general — and one warranted only in part — that they are motivated only by monetary rewards.

In addition to the above, executives move within a highly competitive environment, and stand in a very favorable competitive position. The more clear-cut the competitive position, the more obvious are opportunity costs in a given case. And the more obvious are opportunity costs, the more clearly visible are economic rents when they appear.

If an entrepreneur feels himself to be abused, he may offer himself to another group of stockholders. In many cases it will be to the interest of utility customers to prevent this transfer of employment. In such a case his salary will need to be raised to remove the temptation to quit present employment. If he feels he should be allowed to

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1 This is a comparatively new field of regulation. The Federal Power Commission, the Civil Aeronautics Board, the Interstate Commerce Commission, the Federal Communications Commission, and the Securities and Exchange Commission are all actively interested in this phase of social control.

2 Thorstein Veblen, op. cit., did much to popularize this point of view. More recently, however, the struggle for power has been given greater weight as entrepreneurial incentive. Burnham, James, The Managerial Revolution. (The John Day Co., Inc., New York, 1941.)
participate in profits, he may move to a non-regulated industry. Here again his salary can be raised to remove temptation. The fact that rents occur in other industries is no argument for their allowance in public service industries. This is not, of course, the same as saying that other-industry-rents do not affect "necessary" costs in regulated industries.

In short, there is no cost coming under the heading of necessary that cannot be provided for better than by a deliberate flexible return. Fair return is residual as the legal equivalent of an economic fact and is therefore not a "catchall". A direct charge is always to be preferred to an indirect one.

The idea of an average return is not new in regulation theory. Most writers of repute recognize this need.

There is an important relationship between average return and the present suggestion of limiting dividends on common (and preferred if necessary) stock. Under present technique, an excess revenue above fair return can be paid out of dividends. These surplus dividends have the effect of causing speculative flurries in capitalized expectations. These flurries, as indicated earlier, cannot result in lower capital costs, but always in higher capital costs.

It should be clear, then, that expectational-time-dimension can only be enforced through dividend controls. It is scarcely an

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1 The best presentation can be found in the Prudent Investment Bill cited above.
argument that many concerns do make a more or less consistent effort to regularize dividend payments. Such concerns would not be injured by the contemplated regulations, while consumers and investors of other concerns would be positively aided. In this way a final step could be taken in the direction of making regulation conform more nearly to the regulatory ideal despite the environmental changes making precise control more difficult.

The legal aspects of this third and last suggestion for "streamlining" regulation are both interesting and instructive. Casual thought would seem to dictate that a maximum dividend on common stock would be contrary to the governing rules of the day. Two factors contribute to this thought. First, the present opposite practice is widespread and firmly entrenched. Second, it is manifest nonsense that a law would punish a corporation for not making a profit, which would follow if maximum dividends were treated in the same way as bond interest.

However, the legality of a certain activity must begin with an examination of the sovereign power that sponsors the particular activity under consideration. "It is universally recognized in this country that legislative authority is essential to the creation of a corporation." Thus we must look to the law of the land to discover

the details of this creation. For if a corporation must look to a law for its very right to be, it must assuredly look to this same law for its subsidiary right to be one thing as contrasted with another.

Perhaps the best approach to the indicated analysis would be the analogy of the preferred stock. Although a legal distinction can be made between bonds and stocks in this regard, the case for a distinction between two stocks is much less clear. A bond is the collection of legal rights and duties. Likewise a stock is a collection of legal rights and duties. But the two sets of rights and duties are sufficiently different to justify distinction.

The next question is not so easily settled. It has reference to the distinction between preferred stock and common stock. True, each of these is a collection of legal rights and duties. These rights and duties have a source or sources from which they spring. If the source is the same in the two cases, there is no reason why legislation could not legally fuse the two in the way indicated.

Stocks receive their basic sanction from common law. Bonds do likewise. But the common law does not make a stock a preferred or a

1 Chief Justice Marshall, Dartmouth College Case. "Being the mere creature of law, it (the corporation) possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence." 4 Wheat. 518.

2 A bond stems from the old common law of debtor-creditor relationships. A stock has origin in the common law of ownership. That is why present legal-residual technique is rooted much too deeply to be casually altered. It is most significant to note, however, that the above distinction has nothing to do with incorporation as such.
common stock. It makes these simply stocks. What, then, makes a stock
a preferred or a common one? The answer to this question is given most
clearly by William T. Granger: "It should be emphasized that the
preferred stockholder will get no special right or privilege unless it is
written into the charter, and, on the other hand, he will not be excluded
from any of the rights enjoyed by a common stockholder, unless it is so
provided."

Now if a stock becomes a preferred stock only through a
charter, and if charters are obtained only through the exercise of the
sovereignty of the state, it must follow that a common stock is turned
into a preferred stock by a grant of the state. If, then, a state can
turn some stock into preferred stock, it can do the same with all stock.

Our question has now basically delimited itself. We began
by asking if the prevailing legal system could enforce maximum dividends
upon common stock. It now seems that this could result from legislation
differing only slightly from that now in operation.

1 Corporation Law for Officers and Directors. (The Ronald Press

2 A common stock is a common law certificate of ownership. A
preferred stock is similarly a certificate of ownership but dressed in a
modern garb.

3 A corollary of this is that, obviously, by merely changing the
name of a circulating claim, one cannot alter its substantive content. All
of the stock of the Great Northern Railway Company is preferred stock. Yet
it has all the residuality that normally accompanies common stock.
Fundamentally and realistically the corporations themselves could act. "Where corporations are not restrained by their charters they may adopt all reasonable modes in the execution of their business which a natural person might adopt in the exercise of similar powers". It does not follow that legislation may enforce any arrangement that may be entered into voluntarily by the parties concerned. In this case, however, the arrangement contemplated lies wholly within the sovereign authority. Such a situation is an open door to legislation if and when a legislature decides to act. Thus the law need not depend upon voluntary action.

The author is under no illusions about destroying residuality by the simple expedient of changing the law. Residuality is an economic phenomenon that has no connection with legal technicalities. The thought here is, and this thought can well be re-emphasized, that the three suggestions offered here, taken in conjunction with each other, can serve to reduce the effects of the inevitable residuality of modern business organization, and minimize the confiscation inevitable in regulation of this organization.

It seems pertinent at this point to draw together the thread of discussion of which the past three chapters are only a part. This analysis of ways in which regulation could be modernized is, after all, only intended as a point of departure for a contrast to the actual

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1 Supreme Court of Missouri, 47 Mo. 425.
Regulation of return is the residual regulatory act. It is residual for precisely the same reason that fair return itself (capital cost) is residual. The control problem is to make the legal facts consistent with the pertinent economic facts. This is the focal point of regulation.

The choice that a government makes in deciding the extent of regulations to impose upon a utility is not "to confiscate" or "not to confiscate", but how to confiscate. Any correction of a past injustice (failure to equate rights and responsibilities) can be made only through the process of taking away that which was gained unjustly. This type of control is confiscation because it cuts across the lines of choice, or violates the free will upon which the society is predicated. This is an important problem of regulation, although it is not the problem of fair return.

The problem of fair return grows out of the necessity of confiscation in the regulatory process. Starting with the assumption that confiscation is undesirable, fair return control is principally dedicated to the minimization of confiscation, making it as little necessary as possible, and making its incidence as little felt as possible. Minor confiscations, ill-chosen, can be as violative of philosophy as major confiscations, carefully selected. Unnecessary confiscations (in the sense that a similar result could be obtained otherwise) are still worse. Thus the problem of fair return is to keep confiscation to a bare minimum (necessary), and to apportion necessary confiscation in an equitable manner.
The present technique of regulation is to utilize an arbitrary percentage of value as fair return, without relating it in absolute amount to investor expectations. Such an approach would not be serious but for the fact that if the return allowed is greater or less than an economic fair return, the difference is capitalized as negative or positive rent against the consumer. This is precisely what regulation aims to avoid.

To better the over-all approach to fair return, suggestions were made. The first involved making fair return the test of reasonableness. Standing alone this technique would serve only to keep rates fluctuating up or down according to whether the utility was earning less or more than a fair return. It would, however, prevent over- and under-returns from being capitalized against the consumer.

The second suggestion is intended to make the first more concrete and practicable. Specifically it is to provide that all excess earnings be held in trust for consumers. Carrying out this suggestion would provide a basic automaticity in rate regulation. The net result of this automaticity would be to provide for the operation of the first suggestion over a longer period of time. In short, it would allow the advantages of making fair return a test of reasonableness, but would operate against rate instability.

The third suggestion strikes much more at the heart of private enterprise than either of the first two. It provides for a limitation of capital return through maximum dividends. From this point regulation would permit a very wide executive discretion in fixing rates
on the basis of actual economic condition, while at the same time
predicating control upon the exacting time-dimension business sphere
into which the economy has evolved.
CHAPTER VIII

THE MODIFICATION OF REGULATION

The chapters immediately preceding have outlined one of the directions regulation might have taken in an attempt to make the actual more nearly commensurate with the ideal. Although it was indicated that sporadic gestures have been made in this direction, it is well known by students of utilities that this adjustment was not attempted on any large or concerted scale. Actually the mode of adjustment to the new environment that was adopted was a compromise of the earlier pattern of regulation rather than its intensification in terms of developments throughout the environment. This compromise mode it is the purpose of this chapter to briefly explore.

The two basic accompaniments of developing capitalism discussed in two earlier chapters — inelasticity and capitalization — have produced compromise in two ways. In the first place they have tended to make the original regulatory adjustment impossible; while in the second place they have tended to make this adjustment illogical.

Economic inelasticity contributed to this impossibility and illogic as follows. As the asset inflows of enterprise concentrated into larger and larger indivisible units, the task of isolating the particular part of a given inflow producing a specific outflow became more and more difficult. Thus the matter of pricing utility services to the various classes of customers tended to become arbitrary even under regulation. Some class of customers, obviously, needed to pay only marginal costs, and
it was somewhat arbitrary in actual cases which group would be so
designated. The degree of arbitrariness that developed provided a
rough measure of the degree to which rights and responsibilities
could not be equated through the simple technique first enunciated
by the courts.

In regard to the scope of regulation as well, inelasticity
made the sharp line of demarcation less clear. Inelasticity is a
phenomenon attaching to a greater or lesser extent to all business rather
than being limited in effect to a few industries. Fixed cost and
tendency to monopoly — the two principal inelasticities — and a
consequent 'unequal' relationship to the public is characteristic of the
steel industry or the automobile industry in the same way (if not to the
same extent) as of the utility industries. Even within the utility
category itself the influence of this fact has been felt in that today
there is much less homogeneity than fifty years ago. There is very
little, for example, that is common between the distribution of milk and
the distribution of electric light and power. Yet both industries are
classified as utilities before the law.

The development of capitalization, too, contributed its
share to both the illogic and the impossibility of the original adjustment.
With respect to the extent of regulation the intention behind the concept
of confiscation was that whereas utilities could legitimately be regulated
intensively yet a limit was to be imposed. Hence a certain operating
result was postulated as representing an exact equation of rights and
responsibilities. As an economic formulation predicated upon a somewhat outdated conception of property, the regulatory tool fashioned to produce the required result — fair return on a fair value — was reasonable.

With a high degree of development in capital markets and a redefinition of property, the strictures against confiscation lost much of their effectiveness in protecting regulated industries from an excess of control. As a consequence regulation was found in need of modification.

As regards the scope of regulation, capitalization had widespread effects. With the realization that once intensive regulation was legitimized business organization was to a degree at the mercy of society the classification of an industry as a public utility became a matter of grave concern. No longer could confiscation be defined as a given level of inflow. Rather it became a reduction in the level of inflow to a person or a concern. Since one of the primary purposes of regulation was to correct for the future an undesirable situation that had arisen from the past, extreme hesitancy necessarily characterized the actual designation of an industry as a utility. At the same time, interpreted in terms of the entire pattern of change involved here, much of the significance of the utility category in regulation disappeared.

This summary of the impossibilities and illogic introduced into the social control picture by two basic environmental developments has not endeavored to isolate the ramifications contributing to impossibility from those contributing to illogic. This has been deliberate. It could not be too strongly emphasized that these are two interrelated ways of
viewing the same thing. Social philosophy is built within a framework bounded by both the undesirable and the impossible. Thus society as a whole and individuals in particular are oriented to the desirable as partially defined by the possible, and to the possible as partially defined by the desirable. This suggests and again emphasizes the very significant fact that social philosophy is both cause and effect. In the present context philosophy as cause dictated an adjustment that was possible and desirable. As effect philosophy developed into a somewhat different mold as various social changes made the indicated adjustment less possible and less desirable.

To this point attention has been focused upon philosophy as cause, and upon modifications of the economic environment. Equally important now is the problem of translating these modifications into philosophy as effect.

Basically philosophy as effect has been altered in two ways. First, modifications have been instituted in what may be called negative regulation, both as to scope and extent; while at the same time there has developed what may be termed positive regulation. In the following discussion of these modifications in philosophy the greatest detail will be reserved for treatment of changes in negative extent of regulation, since it is at this point that utilities as such are principally involved. The development of positive control will be discussed in outline only.
It will be remembered that the function intended for the
public utility concept was to separate through use of a reasonable
principle those businesses that could be intensively regulated and those
that could not. The principle used in making this determination was the
public interest. Industries in such a position with respect to the
public that they could substantially alter consumer alternatives (monopoly
price and discrimination) are to be regulated. Others are not.

After a certain amount of experience with this adjustment,
however, it became evident that the symptoms contributing to the need for
regulation were possessed by utilities to the exclusion of other industries
only in degree. Many industries to some extent began to show a tendency
to monopoly and joint cost very similar to that shown by the utilities.
Since it was unthinkable that the utility category be materially
broadened in the face of an underlying bias against regulation, some way
had to be found to close this growing gap between the intended results
and the actual results.

The search for a compromise approach was, of course,
directed in large part by social philosophy. The ideal economic
organization contemplated by philosophy was free competition precisely
equating rights and responsibilities. The problem posed, thus, was that
of fostering the competitive norm for non-utilities without intensive
regulation. The solution decided upon was the enforcement of competition through
legislation such as the Sherman and Clayton acts, and through numerous
less comprehensive controls imposed by both the Federal Government and by
the several States.
Enforcement of competition, although reducible to a single pattern as to purpose and method, takes three distinct forms. Each form is designed for a specific type of violation of the competitive norm, and endeavors to restore the norm in a manner commensurate with the departure from the norm.

The first type of violation is that of expansion by a single concern until it is sufficiently large to control significantly the output of an entire industry and hence to control prices to the public. Such a concern is able to exert a larger degree of power over its environment than can be reciprocated by the environment. The resultant inequality society endeavors to formally correct by the expediency of 'breaking up' the concern into several operating units and thus increasing the degree of competition.

So obvious is this type of violation that business men normally sought to organize with a greater degree of subterfuge. Thus a more typical case is the concentration of power through agreement rather than through outright monopoly by a single firm. This procedure is commonly referred to as 'combination in restraint of trade', and the defense by formal society is to be alert to simultaneous action by ostensible competitors and to prevent a recurrence of such action by appropriate measures.

While philosophy does act to limit activities in the above two directions, it at the same time recognizes that such limitations can be carried too far. A large part of individualism, for example, has come to be concretely associated with high production and low cost. To a
certain extent largeness in industry assures this result. Too much breaking up of large concerns, therefore, would be in itself a violation of the mass-production principle. And, as can be readily perceived, achievement of a golden mean in this case must be extremely difficult. A large part of individualism has likewise come to be associated with stability in industry, for poverty and inequities occur from economic fluctuations. It is quite generally agreed that to a certain extent combination, by avoiding destructive competition and consequent bankruptcy, may help to prevent the extreme degrees of fluctuations. Here too an excess of control is itself a violation, and the entire situation is too complex to permit of the easy establishment of a mean.

The third type of violation of the competitive norm is through a technique commonly referred to as unfair competition. Here unreciprocated power develops not by too little competition but through the use of a variety of competition that is deemed by the philosophy to be 'unfair'. Thus an individual may not tell exaggerated falsehoods about his competitors' product, although he may refer to his own product as superior to the entire class of competing products. Likewise an individual may not make preposterous claims for his own product, although he is permitted a certain amount of 'puffing' of his product. Finally, an individual may not use violence or coercion in any way to destroy a competitor's business or build up his own.

It is clear from the above that in extending regulation to the non-utilities both the direction taken and the restraint exercised
by control were carefully dictated by social philosophy. This double action by philosophy is essential to the creation of a reasonably integrated adjustment. Unless integration is achieved in large part disturbing contradictions arise that gradually wear away the substance of community.

Despite this obvious struggle for integration, the extension of the scope of regulation does result in a large element of inconsistency. As control is expanded the freedom dimension of social philosophy is correspondingly sacrificed. It is true, of course, that the sacrifice of freedom is rather directly in the interest of the equality dimension of individualism. However, the existence of inconsistency is an important fact, further reference to which will be made in greater detail at a later point.

It follows from the above analysis that the principal modification of the scope of regulation had to do with the extension of control to non-utilities. This development would itself have destroyed much of the significance of the utility category. Another development paralleled this one, however, and contributed to the same result. As the consequences of control — confiscation — became more apparent there appeared a greater reluctance on the part of society to thus classify an industry. This reluctance stemmed in part from the logic of the situation, and in part from the resistance of vested interests to the extremes of control. Due to this reluctance semi-utility controls were placed upon certain industries as a substitute for placing them in the utility category. As a consequence this category tended to lose even more real social meaning.
Utility regulation as such was much more directly affected by modifications in the extent of regulation than by modifications in the scope of regulation. These industries were, after all, the industries which had felt regulatory restraint in the greatest degree. Therefore changes having to do with extending the scope of regulation could not but affect such industries only slightly. Adjustments having to do with the extent of regulation, on the other hand, necessarily had to be in the nature of retreat. For this reason the utilities themselves were most intimately concerned with these adjustments.

Modifications in the extent of regulation took two primary directions. In the first place, the precise approach contemplated for controlling the rate level was modified; and in the second place, the equally precise approach contemplated for controlling the rate structure was modified.

To properly equate rights and responsibilities in terms of the rate level it is essential that: (1) the total entity representing the business be capable of precise definition; (2) that the flow of rights to the business regulated be capable of precise comparison with the competitive norm; and (3) that only conditions identical with those defined be actually allowed. The principal tool developed to accomplish these three interlocking ends was 'fair return on a fair value'.

Of the two sides to this concept the fair value side has received by far the greatest amount of attention. Had it been the universal disposition of regulators to follow regulation through to its ultimate
conclusions, this disproportionate emphasis might have contributed serious results. Actually, of course, granting the above disposition, a disproportionate emphasis would have been impossible. However, since the disposition of regulators was not to universally pursue the ultimate consequences of control the result can not be said to be serious. Assuming rather a disposition to compromise, as is the basic thesis of this dissertation, and the emphasis upon fair value simply stems from that fact. The same general compromise results could have been attained through elasticity of either fair return or fair value. It happens that the one selected as the primary source of elasticity was fair value. A reasonable hypothesis as to why this is so would seem to be that fair value is the more vague of the two terms and hence the one most strenuously called into question by interests opposing regulation.

Throughout the history of modification of regulation fair value has represented some value between polar approaches — reproduction cost and historical cost. The academic defense of reproduction cost largely hinges around what has been called the competitive analogy. Thus it is argued that in good times if business in general is earning a high return so also should utilities, and vice versa. The academic defense of historical cost maintains on the other hand that consistency and continuity in regulation demand that a fixed value be adopted, and that the only proper fixed base is historical cost.

It is interesting and significant to note that no large group in our society has been consistent in its interpretation of fair value.
Property interests defend historical cost when values are low and reproduction cost when values are high. Consumer interests, on the other hand, defend historical cost when values are high and reproduction cost when values are low. Even the Supreme Court, which fact should really cause surprise, has vacillated considerably, giving more weight to reproduction cost in times of high values and more weight to historical cost in times of low values. The only conclusion, it would seem, that could validly be drawn from this pattern of inconsistency is that fair value is a fulcrum for use in adjusting social philosophy to conform with existing conditions. The means by which it is so used is through polar definitions by opposing parties, within a sphere wherein philosophy as currently applied is producing a basic inconsistency, the resultant compromise being in lieu of open conflict.

Fair return, although never as important a factor in regulation as fair value, has had a similar history. It, too, has been used much more to furnish an elasticity to regulation (with a pretense in the direction of objectivity) than to add precision.

The forces operating to produce flexibility and compromise in the treatment of fair return are again the property owner on the one hand and the consumer on the other. Property owners plead for a high rate in prosperous years, while consumers plead for a low rate in prosperous years. Property owners advance the thesis that fair return should fluctuate, while consumers believe it should be stable. With these two forces in operation it is not at all surprising that actual practice is
somewhere between the variability that would characterize the utility without regulation and the inflexibility that would be characteristic of regulation if the earlier adjustment had been rigidly adhered to.

In that original formulation by the courts, it will be remembered, there was contemplated a single degree of economic power over others and a situation in which rights were known in advance. On both of these counts and disregarding the operation of the business cycle the philosophy probably demanded a fixed rate of return as well as a fixed valuation. That this was a reasonable demand is more or less attested to by the fact that prior to 1900 the business cycle was much less of an all-pervasive feature of our economy than today.

However, with the development of cyclical fluctuation as an economic problem of the first magnitude, the fair return adjustment became immediately more complex, and the forces on both sides became commensurately more insistent. The situation for regulation was a difficult one. On the one hand technical adherence to the philosophy would have still demanded an inflexible return. This is true since the capitalization process had developed to a point where it was quite capable of adjusting actual dollar returns to the state of the market. On the other hand, regulation could not place itself in the position of seeming to confiscate by denying the existence of the business cycle phenomenon.

Stated in terms of previous analysis, the crux of the development of the cycle as a major factor in economic life was the growth of a much greater degree of dynamism than assumed by the philosophy, coupled
with a lesser degree of business adaptability to dynamic conditions.

It follows that a degree of inelasticity developed that the philosophy could not cope with except by itself giving away somewhat in the process. This the philosophy did do through compromise and through a lesser degree of control than was originally contemplated.

It perhaps needs reemphasis at this point that the principal compromise in rate level was fair value rather than fair return. Despite this fact, however, control of fair return does exhibit interesting and revealing uses in the interest of elasticity in regulation. Pennsylvania, through her regulatory commission, adopted 7 per cent as a fair return for all classes of utilities under all types of circumstances for a period of more than twenty years following the first World War. During this period there were numbers of cases of Pennsylvania utilities earning far more than 7 per cent. The California Commission, long recognized as one of the stronger of the State Commissions, has been upheld in historical cost valuations because of a deliberate policy of liberality in fair return allowances. Many other regulatory bodies through sheer inactivity implicitly provide for returns amounting virtually to whatever a utility can earn for long periods of time.

The Supreme Court has contributed to this tendency in regulation by frequently referring to a 'zone of reasonableness'. Thus a situation as in the diagram below is approximated. What the court possibly

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\begin{center}
\begin{tikzpicture}
\draw[->] (0,0) -- (4,0) node[midway, above] {Extortionate Return};
\draw[->] (0,-2) -- (4,-2) node[midway, above] {Confiscatory Return};
\draw[->] (0,-1) -- (0,-0.5) node[midway, above] {Zone};
\end{tikzpicture}
\end{center}
```
has in mind in adhering to this 'zone' is that the real problem of defining return is legislative. Following from this the courts will not substitute their judgment within the limits indicated. However, regulators, confronted by a complex situation and conflicting forces they can resolve in no other way, have tended to seize upon this device as justification for a policy that is not at all precisely worked out in terms of the earlier applications of philosophy.

A final way in which control over the rate level has been modified is in the direction of what has been called 'paternalism' in regulation, or the demand for special consideration by the utilities in times of economic depression. This demand began with a simple endeavor to solve the problem of an average return for regulated industries in the face of violent ups and downs in business fortunes. As regulation expanded in extent, the need for an average return was intensified, and the claim became virtually one for a guaranteed return. This last, of course, was never contemplated by the ideal, and compromise on this score evolved because of the same general changes in the environment that resulted in the various other modifications of the earlier approach.

This semi-paternalism — typified in railroad regulation by specific legislation requesting the Interstate Commerce Commission to consider the revenue needs of the carriers in determining rate levels — indicates a somewhat new emphasis in control. From a pattern of restricting property in the interest of the public, the environment has evolved until the obverse technique is required in some instances of protecting property in the public interest. This technique is dictated by the equality
It has been emphasized that return can not be actually guaranteed through regulation as long as the competitive norm is used as a guide. But if the utilities are by definition so important to the public that they must be controlled, it follows that they are important enough to be kept operative even under adverse economic circumstances. At this point negative control begins to merge into positive regulation. This merger and some of its major consequences will be discussed at a later point in this chapter.

Attention is frequently called to the fact that in the prowess of adjusting regulation to the facts of the environment compromise has typically operated in favor of property. Technically, of course, this result, would not be compromise. However, this appearance of greater power in the hands of property is the result of the technical organization of society in America in greater degree than from a substantive difference in power. The original bias of social philosophy in America in favor of property dictated that property interests would become the status quo, or the vested interests. Emphasis upon equality — as the growth of property inelasticities produced inequality — resulted primarily in taking away a portion of the freedom dimension of philosophy interpreted in terms of property rights. Thus it happens that the forces of equality endeavor to restrain the forces of freedom, while the forces of freedom resist restraint. The power of the forces of equality is demonstrated by the fact of regulation and measured by the degree of regulation. The power of the forces of freedom is demonstrated by the fact of compromise and measured
by the degree of compromise. Therefore the fact that compromise favors property is no more significant in assessing the forces operating than the fact that regulation is typically in the interest of non-property interests.

It was emphasized earlier that in the process of adjusting to the demands of the present environment alterations in the scope of regulation resulted in a loss of freedom through bringing into the sphere of control certain (aspects of) non-utility industries. It is now clear that this loss of freedom is paralleled by the attainment of a lesser degree of equality than might have occurred through a process of altering the extent of regulation. These two developments are doubly parallel in that both stem from the same necessity of modifying the application of social philosophy and both types of modification are equally consistent with both the older ideal philosophy and the current philosophy as modified. In short both are caused by a change in philosophy and result in further changes in philosophy.

No specific mention has been made to this point of the concrete nature of modifications in the rate structure. Before doing so it might be helpful to emphasize once more that the issue here is not nearly so fundamental as in the case of the rate level. It is of much less significance to a utility whether or not it is allowed to practice a degree of favoritism among its customers than whether or not its total return is equal to competitive returns. Contrariwise, although the matter of
favoritism is of importance to consumers, they have never organized them- selves to the task of pressing any precise demands. In addition, if favoritism is held to narrow limits the difference that a few cents a month more or less will make to the average consumer is relatively slight. Thus the lack of precision in rate structure, although not contemplated by the original adjustment, is of lesser importance to society at large.

The principal modification of the ideal in so far as rate structure is concerned stems directly from the technical difficulty of accurately separating indivisible asset inflows into particular outflows and the consequent larger expenditures for regulation that would be required to do so. Since fixed cost is by definition such an important characteristic of public utilities it was thought most appropriate to set forth a few relatively simple rules of consumer classification rather than to attempt an elaborate assessment of rights and responsibilities for each customer.

The most typical tool, through the use of which this failure to measure inflow and outflow with all accuracy was justified, was the 'value of service' concept. Thus value of service and cost of service provided supplementary approaches to the problem of fixing a scale of rates. This technique can be exemplified by reference to the structure of taxi fares in Washington, D.C. A single person riding from point A to point B will pay, say, 30 cents. Two persons riding between the same two points will pay 20 cents each, or 40 cents. For all practical purposes the cost is identical in the case of both trips. Yet if receipts for both trips exactly equal the total cost of both the single passenger has been charged less than cost while the two passengers have been charged more than cost. Even so the system does provide the elementary justice that, on the one hand, a single individual should pay less than two, and, on the other hand, it does not cost twice
as much to carry the two. In utility regulation as long as (figuratively speaking) every single passenger is charged the same amount and every group of two passengers is charged the same amount greater precision is not required. Indeed, in many cases, a far lesser degree of accuracy is deemed satisfactory.

Apart from the technical difficulty of actually tracing costs to consumers, however, the value of service modification plus commission inactivity does contribute to an additional understanding of the current compromise. In the first place in the regulatory activity required for real precision in rate structure there would be entailed a degree of interference with private enterprise that it has been in the interest of property interests to resist. Since the facts of the case were such that the interference might very possibly be disproportionately great in view of the results, this resistance has been effective. As a consequence regulation simply shrugs its shoulders if some few, on the basis of value of service, pay more than cost for service received.

In the second place, public policy sometimes uses the value of service principle to further its own ends. For certain groups of the underprivileged society frequently requires the furnishing of essential service at less than cost. If, in other words, this group would forego purchasing an item if cost is charged, society will charge less than cost, if it is in the public interest (as determined by social philosophy) that the service be furnished. Thus water supply is frequently city-owned in order that health in the community may be protected. This type of activity, of course, merges quickly into positive regulation, which subject will be presented in some detail shortly.
This concludes discussion of the two phases of modification of the negative type of community action — restraint or formal control. The scope of regulation was modified to permit control of non-utility activities. Simultaneously the extent of regulation was modified to demand a lesser intensity of control. The first of these developments resulted in lesser freedom in the interest of greater equality, while the second resulted in lesser equality in the interest of greater freedom. Thus, contrary to the earlier philosophy which assumed identity between these two dimensions of individualism, a newer philosophy developed from the first in terms of which these two dimensions were assumed to be in the main consistent — although no longer identical. Formal control was altered to conform with this new philosophy, the direction of the control and its specific content taking the form of a compromise between the two dimensions at their periphera. In consequence the norms used for control purposes continued to be basically the pre-compromise norms of free competition.

In addition to modification of negative control, however, a second great development followed close behind. This was the growth of positive control, or the exercise of positive responsibility through the instrumentalities of social control.

One of the most important ramifications of social organization is that, under normal circumstances, the predicates of the organization are such that the power of the group need be exercised only against a peripheral few who seem to develop anti-community tendencies. Within the framework set and with this degree of protection it is presumed that the individual can live his own life
in the community. In a society such as ours, where great emphasis is
placed upon free choice, spontaneous social organization would implicitly
assume that the individual can and will make proper choices if the
peripheral few that would restrain choice are controlled by the organized
might of the group.

The basic prerequisite to spontaneous free choice is the
existence of good, available alternatives from which to choose. Thus for
free choice to operate in the direction assumed it would have required an
essentially neutral environment for each individual — an environment in
terms of which every individual would have equal opportunity. It is not
necessary for the working out of this principle that every individual have
equal capacity, only that virtually every individual have sufficient
capacity to make favorable choices in a non-coerced (neutral) situation.
In terms of modern capitalism a neutral environment would be one in which,
to state only a few of the more obvious requirements, no individual would
be involuntarily employed at less than a living wage, one in which no
individual would be unduly under the economic influence of another due to
concentration of wealth in the hands of the latter, and one in which the
social situation would permit a 'full' life for every individual. Under
these circumstances, of course, the individual could make choices consistent
with the ideal.

John R. Commons had discussed this aspect of individualism
and developed what he has termed 'the empty concept of the will formulated
by John Locke.' Thus when the Supreme Court was insisting that the will of
a corporation and the will of an individual were equivalent Professor Commons
explains that the empty concept of the will has been carried to its extreme point. In one sense this analysis is incisive and revealing. It would probably be more practical for present purposes, however, to think of the will according to Locke as a quantitative will in a quantitative or neutral environment, and the will according to earlier Court decisions as a quantitative will in a qualitative (non-neutral) environment. Thus what Professor Commons calls an empty concept is really the failure to adapt the older usage to the newer situation. Such adaptations take time. By 1900 the United States had made only a beginning toward this end.

The extreme to which the older usage was carried can best be illustrated by reference to employer's liability cases. The courts insisted that an individual decided for himself whether or not to work in a dangerous occupation. Therefore if he were injured it was as a result of exercising his free will. As a consequence the corporation could not be held responsible for damages. It made no difference, of course, if the individual could find employment nowhere else.

Not only does reference to this situation illustrate the use of a quantitative concept of the will in a qualitative situation, it illustrates also how qualitative the environment had become. With the development of the huge corporation and the branding of it as an individual; with the increasing concentration of wealth and power in fewer hands; and with the growth in scale and intensity of business depressions, the economic environment in the United States ceased to be neutral and the concept of the will in use was necessarily modified.
When the environment became non-neutral society could no longer be predicated upon the proposition that with specific restraints for the anti-community few, individual free choice would result in a society approaching the ideal. In addition to specific restraints for the particular few, it became necessary for society to guarantee in a general way minimum conditions of life. Positive control was thus added to negative regulation to assure that no individual would be forced by the environment to 'choose' a sub-minimum condition. In short, when negative regulation failed to keep the free choice environment neutral, positive control was inaugurated to add the organized power of the group to the power of the weaker elements within the group.

The specific focus that positive control has taken in America need not be elaborated in detail. A few steps will be mentioned, however. Measures to control the business cycle, collective bargaining legislation, government assistance to home owners, wages and hours laws, etc., are some of the major aspects of this development.

It has been emphasized earlier that the growth of negative regulation was the result of, and that it was characterized by, a spirit of compromise. It must be emphasized now that the growth of positive control results from and is characterized by a tendency toward the exercise of power beyond the point where compromise is the only factor. Some of the ramifications of this thesis are important enough in terms of the general theme of this dissertation to warrant brief discussion.

In the first place, where basic conditions of life are guaranteed by the organized group through force the underlying norms of
the social philosophy lose some of their significance in terms of the total group. Instead of norms typically predicated upon the broad base of the entire society, norms tend to be predicated upon the narrow base of the class in power, and as such are very possibly unsatisfactory to the group not in power. This is not, of course, to rule out completely the element of compromise in control. Rather it is only to superimpose another element upon the element of compromise to assist in an understanding of certain conditions in current society.

This shift from society-wide norms to single group norms can easily be illustrated. The norm for utility regulation has always been 'fair return on a fair value' defined in the average case as the competitive return, or the socially approved return. Now when regulation by government extends beyond the periphery of industry, the return under competition — as a norm — is much less helpful. In the extreme case the government could so act that the norm in use would be far different from the competitive norm.

For example, as a part of the program to guarantee basic conditions of life, the government has entered the capital market. A prospective owner of a home may borrow from the government at a rate of, for example, 3 per cent rather than from a private company at a much higher rate. This entrance of the government naturally affects the private capital market directly. In addition, however, there is some reason behind the selection of 3 per cent as the government rate. If that reason is a belief on the part of the group in power that 3 per cent is the socially acceptable rate of return (and it will no doubt have some such basis) there is nothing
to prevent this rate from being made the 'fair return' for regulated enterprise — nothing, that is, except whatever spirit of compromise exists, and the resistance of the opposition.

The second significant ramification of the tendency for norms to shift where power is the rule is that these shifting norms are the concrete framework of social change. This framework may be the framework of either evolutionary or revolutionary change, depending upon numerous internal, external, and historical factors affecting a particular society.

Norms may quite conveniently be termed conservative norms (status quo) and liberal norms. The line-up behind these norms will be, obviously enough, the vested interests favoring conservative norms and those dissatisfied with the status quo favoring liberal norms. The dissatisfied seek to educate the group in terms of the new norms while the vested interests endeavor to educate the group in terms of retention of old norms. In addition, both groups exert as much pressure on the side of their respective norms as can be justified by the current state of compromise. In this contest situation the vested interests has the advantage of inertia, while the dissatisfied have the advantage of dynamism.

Any such struggle as this between two basic factions within a group will normally proceed through a giving way in part of the status quo. If this giving away proceeds with nearly as great a rapidity as the pressure of dissatisfaction grows peaceful change results. Most social change is of this variety. Particularly does this result seem to characterize social change in America.

In the American scene conservative norms are the protection of property, property rights, free enterprise, freedom. Liberal norms, on
the other hand are the guarantee of good alternatives, economic security. Since approximately 1900, and especially since 1930, conservative norms have been giving away before the increasing pressure of liberal norms. If this trend continues without too extensive a complication from world affairs, peaceful change based upon (although not wholly characterized by) compromise will continue to be the rule. External pressure in the present 'one world' environment can have serious internal manifestations.

It is important to emphasize here that social change is not a smoothly continuous process. Thus development will be characterized by spurts and reactions on the one hand and a sort of secular trend on the other. At any given moment of time the status of change can be roughly determined by a compromise of current norms with historic norms and with the trend in norm evolution. Utilizing this tool for analysis of the status of change in America it seems likely that the immediate future will witness a slight reaction from the spurt of liberal norms between 1930 and 1940, and that the trend toward security will continue.

One final ramification of the development of positive control will be briefly discussed. This type of evolution is an important symptom of the disappearance of basic community. And, what is most significant, as community begins to break down the stage is set for still further disintegration.

In a society fundamentally characterized by common values, individual and group acts are universally comprehensible and universally approved. In a society, however, where there exist side by side so to speak two sets of values, individual and group acts have a large measure
both of comprehensibility and approval. Even compromise adjustments are more readily understood than when two struggling factions produce a power adjustment that satisfies no one. In cases where acts are not understood they are interpreted as merely vicious by a large segment of society. Thus at times antagonism may be aroused even where there is no real issue involved. In this way conflict breeds conflict, and power tends to result in a still further exercise of power.

It is in this kind of a situation that politics is elevated to a position of increasing prominence. With only, say, half of the population to choose from group leaders have a greater difficulty selecting assistants on the basis of both ability and value orientation. Where stakes are high, of course, it frequently is necessary to forego the ability standards to a large extent. Obversely, too, the group not in power interprets acts of officials as acts of incompetence even when the difference of opinion is basically one of values. In this way the illusion of politics proceeds equally with the practice of politics, and community is correspondingly weakened.

With this discussion the presentation of the structure of regulation modification can be considered complete. In the next and concluding chapter an outline of the entire history of control in America will be presented together with a brief statement of the consequences for community of the present status of the regulation pattern.
CHAPTER IX

THE PHILOSOPHY OF REGULATION IN AMERICA

Social philosophy consists in essence of two things — a principle and an application of principle to actual cases. Utility regulation in America is built around the principle of individualism. This principle has two basic dimensions as applied to cases—freedom of choice and equality of opportunity.

As individualism was originally conceived both of its dimensions were considered identical in scope and connotation. In addition both were believed to be a part of the natural state of man. Thus regulation was logically placed on the defensive in American life, where it remained until quite recently.

A very short experience with individualism, however, demonstrated the impracticability of its extreme form. The economic system was seen to clearly operate in the direction of coerced choices and inequality of opportunity. In order to maintain the desired balance within the group formal control was brought into play.

In formulating the principles of formal control two things were necessary. First, rules laid down by law had to be definite in order to preserve free choices. Second, these rules had to be so framed that regulation would be minimized in order to preserve the equality that did exist. Both of these were strictly demanded by the philosophy of individualism; and both were faithfully insisted upon.

As evidence of the strong bias of individualism against formal control, the bible of individualism — the Constitution — was
found to contain no specific provision for regulation. A number of provisions were found, on the other hand, that limited such activities by government. One of these — the no-retroactive-legislation provision — was designed to protect choice. Another — the due-process clause — was designed to prevent inequality resulting from action by government. However, since at this early date there could be said to be no real distinction between the two components of individualism, it would perhaps be most proper to say that both of these provisions had originally an identical connotation in the direction of rigidly protecting the individual citizen from the government and preserving the status quo.

But regulation necessitates changes in the status quo and restraint for individual citizens. For this purpose it was necessary to go outside the Constitution itself and bring in the extraneous principle of the police power, or the common law right of a government to control individual action in the interest of the public health, safety, and morals.

The primary responsibility for steering the proper course between due process and police power — between protection and restraint — rested with the Supreme Court. In developing a compromise the court was guided, not by specific standards already existing and in use, but rather only by its application of the prevailing community spirit. This does not mean, of course, that the Supreme Court in any sense dictated the regulatory adjustment. The court do doubt represented the prevailing
spirit quite accurately. The emphasis intended is simply that the adjustment was made without objective standards and that it was made in large part by the Supreme Court.

The process of charting this course seems simple in retrospect. A description of it takes two directions that we will here call the horizontal and the vertical. Horizontally, the permissible scope of regulation was defined by dividing the police power into two parts and by classifying businesses into two categories. General police power was developed as an incidental restraint of non-utility businesses violating community values only in widely separated instances. Price control police power, however, was developed as an over-all restraint of utility businesses the totality of whose relationship to the public was considered to be a potential threat to the community.

Vertically, the permissible extent of regulation was defined in terms of the same classifications. In the case of incidental control of isolated activity the Supreme Court provided no protection from the restraint of law. The classification itself was presumed to be adequate protection. In the case of price control for public utilities, however, due process (fair return on fair value) was instituted as a definition of the limitations of government regulation.

These two dimensions of regulation — scope and extent — fit into the dimensions of American social philosophy as follows. Freedom of choice was assured by classifying industries in such a way that only a small percentage could actually be regulated as public utilities. The
basis of the classification in turn was the actual or potential relationship between the business and the freedom of choice of consumers. Thus the government undertook to interfere with the basic choices of industry when and only when industry was in a position to interfere with the basic choices of individuals.

The regulatory adjustment similarly operated to assure equality of opportunity. The restraint of government by itself in the interest of equality was demanded at an early date. The process through which the government restrains is called just compensation and is based upon 'fair return on a fair value.' Here the government says in effect that if a business is placed under strict control it is entitled to earn the return it would have earned if it had been faced with a reasonable amount of competition. Since most business was presumed by the philosophy to be competitive the norm used by regulation was naturally the rest of the economy. The result of this aspect of the adjustment was a situation in which regulated businesses were allowed residual income (rights) equal to that currently being received by other businesses.

In all of this it is important to recall that the entire adjustment represented a compromise between the common law and the Constitution. The conflict between these two sources of control principles was resolved primarily in the minds of Supreme Court justices over a period of one hundred years. The fact that a succession of justices drawn from every corner of American life outlined a substantially consistent approach to this problem in the face of the opposing concepts of police power and due process without the aid of objective standards is strong evidence that the real
source of decisions could only have been the social philosophy of the day.

It might be helpful to the reader to see the regulatory adjustment schematically arranged.
It will be recalled from the analysis in Chapter 1 that in the philosophy of individualism equality and freedom were treated as identical in connotation and meaning. However, as can be seen from the above discussion, with the first application of these two dimensions of philosophy — this application will here be referred to as phase one in the history of regulation — this identity began to disappear. In consequence equality and freedom became merely consistent with one another rather than identical.

Neither principles nor the application of principles is ever static. After a principle has been adopted it immediately begins to evolve in a manner commensurate with the problems that arise in actual application. Out of this evolution arises a new principle and so on ad infinitum. In this way principles and their applications merge into and become one another, while at the same time evolving into something else.

After phase one in the history of regulation was well along in development— after, in short, the above categories of control had been rather completely and precisely set forth — America had to do a considerable amount of "living with" the principles thus outlined. During this period these principles had to undergo a rigid application that resulted in what will here be called phase two of the regulatory adjustment and which will be described later.

The principal direction taken in the process of evolution was a gradual dilution of the categories of regulation. Thus the line of demarcation between a public utility and a private business on the one
hand, and the line of demarcation between confiscation and non-confiscation on the other hand tended to break down under the pressures to which they were submitted. It is these pressures and the resultant breakdown of the precise pattern of regulation originally outlined that provide background for understanding the current compromises in regulation.

In the first place it should be noted that broad social principles are always vulnerable to attack. In any attempt to set up pure-type categories there must always be a territory between that may be conveniently called a penumbra of uncertain classification. When cases come up for application of principles there are always ramifications of decisions not wholly integrated into basic philosophy. Frequently one or more of these ramifications has the effect of moving a part of the penumbra into the area of solid classification. The result of this is a shifting of the area of doubt. The typical evolution of this kind, thus, is the enlargement of one category at the expense of the others.

The penumbra itself would not be as certain to lead to evolution were it not for a large amount of supplementation by a second factor. Unless men in society have all values in common and in hierarchies of equal proportionate intensity there will exist in some degree conflicting interests. Since social principles provide an outline of the conditions of individual action, interests attach to every phase of a classification made by a social principle. Some of this attachment of interest is positive in the sense that it depends upon a continuation of the classification. On the other hand some of it is negative in the sense that the interest is in the breakdown
of the classification. The negative interest toward group principles is a measure of the lack of integration in the community.

It need scarcely be added, of course, that a negative interest will fix its attention upon the penumbra rather than the solid classification. The latter would be a direct attack upon the community itself and would be dealt with accordingly. Once the attention of a negative interest is focused upon the penumbra it is only a matter of time until the lines begin to give a little. Particularly will this be the result if a Supreme Court judge has a bias in the direction of breakdown.

The above two factors can be simply summarized. Principles of social action exist primarily as emotions and only secondarily as rational purposes. Whenever a classification begins to lose the support of the emotions, rational minds will begin to find a way to destroy it. And the process is cumulative. As lines of demarcation shift the delicate balance between interests is further disrupted and negative interest tends to grow. Thus, simultaneously, the classification became more vulnerable and interest in its breakdown became more powerful.

However, these factors are only structural. The regulatory adjustment here under discussion became vulnerable for specific reasons as well. These reasons are intimately related to the maturation of the business process. The first resulted from an increased inelasticity in economic society, while a second resulted from the development of claims as a basic property type. Both of these consequences of maturing capitalism helped to make modifications in regulation logical and necessary.
Among the basic accompaniments of the development of capitalist institutions has been the accumulation of large aggregations of fixed and specialized capital, and the increasing specialization of human beings. Both of these together have contributed not only to a more dynamic economic situation but even more to an inability on the part of economic units to effectively meet dynamics. The resulting inelasticities produce economic inequalities, or economic rents. And, although regulation was first extended to the utility industries because inelasticities became flagrant at that point in the economy before they did at other points, this inelasticity has extended itself in greater or lesser degree to all businesses. Thus the 100 percent extreme to which the courts originally took the industry classification process was necessarily weakened. Thus the utility category itself became less homogeneous, and semi-utility controls were exercised in connection with non-utilities.

A second environmental change has contributed to the specific vulnerability of the early adjustment outlined in phase one in the history of regulation. As long as private property was defined as holding for use, it was logical to define confiscation in terms of the negative of just compensation. In such a case, if an individual used property for non-community purposes the government could discharge its obligations to the individual in taking the property by paying the monetary equivalent therefor. But when private property came to be defined as withholding for exchange, and value came to be determined through a process of capitalization, it became
much less logical to define confiscation in terms of the negative of 'fair return'. Application of this definition frequently results in taking value (property) from individuals not involved in the non-community activity at all, while those really involved are not touched by the preventive or retributive measures taken.

The above discussion furnishes a background for an understanding of the evolution of the categories of regulation and also suggests the generalized outline of the directions taken by that evolution. Before attempting to describe specific directions, however, it would perhaps be desirable to present the adjustments in regulation that could have been made in conforming to environmental change without disturbing greatly the original pattern. In this way a basis for comparison with the actual adjustment will be available.

First and foremost, we would have retained the rather rigid classification of industry into public utilities and non-public utilities. In this way the coverage of regulation would have been minimized and a maximum of spontaneous freedom allowed. At the same time we would have maintained the difficult distinction between price control and incidental control to implement the industry classification.

Second, we would have faced squarely the implications of competitive return in regulation despite an evolving set of capital relationships. This could have been done through the steps outlined in Chapters 6 and 7 consisting of: (1) making fair return the test of reasonableness of rates rather than adjusting the two only at a given moment of time; (2) establishing a statutory trust for consumers and owners to avoid the payment of
dividends out of excess earnings and to help pay dividends in years when earnings were too low; and (3) providing a maximum return for each element of the capital contract.

The effect of these steps, with the industry classification, would have been a rather complete limitation of spontaneous freedom in public utility industries. Had the classification itself been abstractly accurate there would have resulted a situation of equal residual rights throughout the entire structure with informal control for non-utilities just equaling formal control for utilities. But as has been emphasized, the classification was in part artificial rather than abstractly accurate. In addition spontaneous freedom was believed preferable to the extreme of formal control. With this last providing the motive and the former providing the logic property interests began to organize a concerted attack upon the penumbra of the framework of control.

As a result of this battle the actual regulatory adjustment was substantially different from the adjustment just outlined. In the first place, the classification itself in part broke down. This breakdown is particularly evident in regulation by the federal government, which regulation has taken a more and more important role in the regulatory scheme of things. To an ever greater extent regulation extension is being justified by general reference to specific evils of the status quo rather than by a painstaking decision on whether a particular business is or is not a public utility. It is precisely this breakdown in regulatory classification that makes it increasingly difficult to selectively define a public utility.
The result of this breakdown in the classification was that general police power moved up in the control scale, while price control moved down the scale. Thus regulation in the former instance became more pronounced than incidental; while in the latter instance price control became less rigid than it would justifiably have been made.

In the second place, the application of the confiscation concept was substantially modified. One process through which this modification took place was that of defining fair value. Although the content of fair return has not substantially altered in the period in which it has been in use, fair value has been given alternative definitions by means of which justice in regulation has become quite elastic. Thus even if the implications of competitive return as such were rigidly applied there would still exist a large modification of the pattern of control originally promulgated to carry out the mandate of equal residual rights.

A second process through which the confiscation concept was modified in application was the use of a 'zone of reasonableness' that effectively assisted in whittling down the extreme result of the rigid maintenance of the original categories. In fostering the 'zone' concept, regulators have accomplished two related purposes. By permitting a leeway they have avoided much of the responsibility to which they would have fallen heir had inelastic classifications been maintained. Also, however, by deliberately allowing a penumbra in the categories they have made it easier for negative interests to stop the regulatory adjustment somewhat short of its most extreme consequences.
All of the above modifications took place with reference to the rate level of regulated business. A similar development is in evidence with respect to the rate structure. The theory of regulation demands cost-of-service pricing. If interpreted consistently in terms of residual rights cost-of-service pricing would leave the regulated business little or no room for free bargaining. At the same time the industry classification— if followed — would exempt non-utilities from price structure control. The modification of such extreme applications took place in two directions. First, by a set of rather extensive regulations aimed to foster fair competition the price structure of non-utilities was in part brought under control. Second, the concept 'value of service' was introduced, tolerated, and even furthered by the courts, providing a means by which utilities were saved from the consequences of the original categories. It should be added, of course, that this last was very easy to justify since the fixed cost structure of modern capitalism — particularly and significantly public utilities — makes cost-of-service largely indeterminate.

Furthermore, as an additional variable in the direction of bargaining rather than rigid price structure, the Supreme Court very early introduced the principle that a regulated industry was entitled to a fair return on its entire operations although not necessarily on each phase of its operations. This modification operated in two directions: first, it provided for adjustments in cases where the public interest seemed to dictate service at less than full cost; and second, it enabled
the regulated business to more successfully meet the challenge of capital­
istic enterprise. Both directions represented a clear compromise with
earlier principles.

The thesis advanced here with respect to the above
modifications of phase one in the history of regulation is that in part
they represent a normal reconciliation of a principle to the technical
factors encountered by the principle, and that in part they represent the
use of technical facts by interest groups to effect a substantial realignment
of the forces behind the development of formal control in this country.
This realignment of forces provides the setting for an understanding of
phase two in this history. To a brief discussion of this phase we will now
turn our attention.

Individualism, it will be recalled, is built around equality
and freedom as the natural state of man. It followed that a condition of
government — spontaneous freedom — was the ideal social adjustment. But
spontaneous freedom in the environment it produced tipped the scales against
equality. This development aroused the forces favoring equality — forces
that could not but have remained merely latent if spontaneous equality had
remained coincident with spontaneous freedom.

At first the assault upon freedom in favor of equality aroused
few opposing forces. Gradually, however, as the threat grew larger the
forces favoring freedom were actively aroused in defense. Eventually a
point was reached wherein the forces of equality and the forces of freedom
seem to have attained an equivalent strength — each striving hard against
the other. It is this point in the history of regulation that we will call
phase two, or the current phase.

If the sum total of human relationships in American economic
life can be diagramatically represented by a rectangular area the original
coincidence between equality and freedom can be pictured as follows:

\[
\begin{array}{c|c}
\text{Freedom} & \text{Equality} \\
\hline
\end{array}
\]

\text{INDIVIDUALISM}

On the same general basis, the current conflict between the two can also be pictured:

\[
\begin{array}{c|c}
\text{Freedom} & \text{Equality} \\
\hline
\end{array}
\]

\text{INDIVIDUALISM}
The intended emphasis, of course, is not that the groups involved are constantly at each other's throats. The conflict — if it can really be called conflict — is still largely peripheral rather than basic. Thus there is no serious disapproval of the fact of regulation, only of the degree of regulation in some instances. Likewise there is no dispute as to the underlying reasons for regulation, only as to the application of those reasons in certain specific cases.

There has grown up in America over the years a very sharp line of demarcation in popular parlance between public interest (consumer) and private interest. It may be that such a dichotomy is helpful for some purposes. In other cases, however, it is very apt to be misleading. True the consumer group is the largest. Very properly the basic orientation is toward the consumer. But industry itself is likewise a part of the public. And in a democratic nation where every individual is considered important and where citizens have rights against the government it would be arbitrary to define the consumer as the total public.

Speaking in general terms business organizations are the forces favoring freedom, while the unorganized consumer and the only-recently organized laborer are the forces favoring equality. This alignment is almost obvious on its face. The strong (organized) would logically favor freedom. The weak (unorganized) would logically favor restraint of the strong. The ancient quip 'only he is conservative who has something to conserve' is a more striking way of expressing the same fact.

In essence, then, what we are currently witnessing in the relationships between government and business is the consumer and the
laborer arrayed against the business man in certain marginal but potentially far-reaching issues. And, considering that the ultimate stakes can only be stated in terms of equality and freedom, it can not but be concluded that the contest stems logically from basic philosophy. Through the instrument of (fair) competition, businesses in America have always been allowed to fight for profits. Thus it would be quite illogical if these same businesses were estopped from evincing interest in their fate when competition is supplanted to an important degree by regulation.

This sounds, perhaps, much like pressure politics and a justification thereof. In part that is a correct interpretation. For the most part, however, it is not. For the real fact of the matter is that the compromises now a part of the regulatory adjustment were written there, not by pressure as such, but quite logically, and this as a result of what might popularly be called the action of pressure groups.

The common understanding of the passage of a regulatory measure is that the affected parties merely fight restrictive segments of the measure. No thought is ordinarily given to how such a fight is conducted, or to the fact that "fighting", as such, is only a small part of the procedure.

It is to be expected that a pressure group composed of reasonably intelligent men would adopt first those tactics that meet with the fullest approval of the public as a whole. This invariably takes the form of arguing that the interest of the pressure group is the interest of the people at large. It may at first be thought by the reader that this
is said facetiously at best. It is not. There are cases where the
public interest is argued more effectively by a pressure group than
by the public itself. It is true, of course, that public interest
arguments by pressure groups are frequently extremely unconvincing
because ill-founded. The important fact to note here is that a public
interest argument is not to be automatically discarded because advanced by
a pressure group, and that a pressure group does not ordinarily resort
to 'lower' methods to supplement the public interest approach if at all.
This last is added to the writer's belief that there are many in high
places in America who prefer an honest compromise to victory through
trickery. This view is strengthened by the fact that there is really
little evidence that current public policy — involving the numerous
powerful interests that it does — contains major instances of pressure
unsupported by a convincing logic of public interest.

All of this is not to suggest that there is no conflict
between the interests of pressure groups and the public at large. It is
only to emphasize that arguments for legislation — particularly in a
democracy — are not spurious and false merely because they are advanced
by a person or a group who has an interest in the outcome. The minority,
in the first place, has a right to try to convince the majority; and in the
second place, the minority argues frequently the majority viewpoint, or at
least a portion of it.

A specific example may be helpful at this point. The railroads
are a large vested interest in the United States. When regulatory measures
are under consideration their emphasis will be upon that part of the
declaration of policy calling for avoidance of destructive competition, and
the part demanding a strong transportation system in the interest of
national defense. Motor trucks, on the other hand, will stress 'inherent
advantage*, which policy largely calls for cost pricing. The characteristics of rail transportation are such that capacity operation is necessary. Every source of freight tapped by motor trucks and thus taken from rail carriers tends to reduce the 'inherent advantage' of the railroad in carrying every ton of freight retained through increasing average unit costs. Thus every ton taken from the rails by motor trucks (or by air, for that matter) increases by that amount the susceptibility of all other rail freight to loss to another agency.

In short, the railroad industry consists of such a high percentage of fixed costs that a small margin of traffic means the difference between profit and loss, or whether the railroad system — or certain important segments of it — can continue operating or not. If it be granted that the railway system is necessary on any abstract basis public policy can justify leaning over a bit to keep the rail plant operating at capacity. In this case inherent advantage seems strongly in conflict with other parts of our transportation policy.

The significance of the above example is that when policy is being debated the railroad "lobby" and the motor truck "lobby" will both be present. Both will emphasize their side of the case. The decision will be a compromise. But cognizance will be taken of the position of the railroads and the motor trucks not because of the power these pressure groups can bring to bear but because of the reasonableness of the logic on both sides.

It may be helpful at this point to distinguish between 'particular' logic and 'universal' logic. Universal logic is that situation in which the arguments advanced are such that all reasonable
men with the same basic values (for example, belief in equality, etc.) will reach the same conclusion. Particular logic, on the other hand, is that situation in which the arguments advanced are such that reasonable men with the same basic values (although not with the same peripheral values) will reach different conclusions equally well supported. The logic of regulation of transportation, as such, is universal to all men who believe in the American way of life. The difference in opinion is not whether to regulate or not, but how far to go in regulating. On many points relative to this latter problem, students can only produce particular logic for those with vested interests to advance in the process of evolution of regulation.

Where peripheral aspects of a large problem can be defined only 'particularly' rather than 'universally', it is characteristic of men with common basic values to compromise the peripheral problems. The spirit of compromise is no more than placing community harmony higher in one's scale of values than victory by resort to means 'lower' than the use of logic, particular though this latter may be. Transportation regulation is compromise on a tremendous scale. It is no wonder our declaration of policy is said by many to be inconsistent.

To summarize the argument immediately preceding, the logic upon which regulation is predicated stems from the value-orientation of interested parties. A common value produces a universal logic, since the value is the premise and the method is contained within the premise. Variations of values produces conflicting (particular) logics, each
oriented to one special emphasis at the periphery of value-scales. The spirit of harmony that prevails where the basic values are held in common produces a compromise between peripheral interests. In transportation regulation in America these forces have produced an adjustment consisting of elements that have to be carefully proportioned in the process of control. Stated differently, to be very certain that the point is not missed, our current public policy is not integrated for the reason that there does not exist a unanimity of opinion on the proposition that one particular objective must be held above all others under all circumstances.

If this discussion were concluded at this point the result would be an unwarranted emphasis upon complete harmony in the process of government and an exaggerated denial of "politics" as distinct from healthy argument. Briefly, now, the problem of politics in regulation will be explored.

What is normally called politics in government arises from interest — group or individual. But it has been noted earlier that not all activities of an interested group or individual can be classified as political in the 'undesirable' sense. In the first place interested parties do argue as much of the public interest as it is to their advantage to argue. And in the second place such parties are — in terms of the larger issues of regulation — a part of the public itself. Our task here is to seek out the practices of interested groups that can be classified as political in the sense of being contrary to public interest.

For this purpose we will define a non-political decision
as one made under the conditions that every interested group participates in the decision, and that each group participates in proportion to the extent of its interest; that every argument presented is a true argument, even though not wholly consistent with other "true" arguments; that every vote cast is oriented toward the issue itself rather than some irrelevant matter; and that the area of fundamental disagreement is compromised.

The problem of participation by the interested groups is a problem of publicity and organization. Any gap in either organization or publicity results in an incomplete representation and thus ignores a portion of the total argument. This result can be termed political in the present sense, whether or not the failure in organization or publicity is the result of the deliberate efforts of other groups. It becomes political in a much more extreme degree if opposing interests block representation.

The stipulation that every argument be a true one is perhaps the most usually violated in practice. It is extremely difficult to prove many contentions, until after the passage of considerable time, and the proof is often not clear cut even then. On the other hand, however, arguments that are too fantastically unreal are a dangerous tool because other groups are always anxious to point up such things. What is really important here is that political elements are not involved as such unless an interested group attempts to establish coincidence between the interest and public advantage where in fact no such coincidence exists.

The requirement that every vote cast be oriented toward the issue itself introduces the most insidious element in political activity.
Violations of this requirement may take any one of several forms. First, it may take the form of bribery, or a vote oriented to the receipt of extraneous reward unrelated to the issue involved. Second, it may take the form of charisma, or a vote oriented to faith in another person rather than the problem at hand. Third, it may take the form of coercion, or a vote oriented to a fear of an artificially produced misfortune rather than the immediate issue. All of these represent a situation in which maneuvering is substituted for debate. In such a situation a decision will be made placing too great an emphasis upon one or a few segments of the public interest and largely ignoring other segments.

The final requisite for non-political decision-making — that fundamental disagreement be actually compromised — is an outgrowth of the others. If the other conditions are fulfilled this last follows as a logical result. This will not be true, of course, if every vote is cast by a member of one out of two actively interested parties. In that case, compromise would be minimized by the technical fact that one group must win the vote. Necessity for more than simple majority will increase the degree of compromise, as will the existence of more than two groups.

A quite normal situation, however, is one in which the active interests are a relatively small part of the total group voting. This will be the case except in connection with the largest issues. Here the larger group that has no ulterior interests will compel a compromise of the conflicting issues. The obverse of this is the case in which the larger group having no personal interest does not vote at all.
If this outline of conditions leading to political decision-making seems to de-emphasize this type of 'legislation' unrealistically in favor of its opposite, the writer will plead as a defense the fact that non-political decision-making is so frequently de-emphasized in popular discussion. Whereas a typical approach has been to throw all decisions of uncertain classification into the political class, the present procedure is rather deliberately to throw the uncertain category into the non-political class. The result is a more extreme position than the writer would take if the scales were not already tipped so pessimistically in the other direction.

Relating, now, the discussion of the last few pages to the general problem of social integration, it seems desirable to present the evolution of the regulatory adjustment in yet another way. Where values are had in common — where, in short, a solid community exists — the area of non-community interests (to be distinguished from anti-community interests) is small, the sphere of government is correspondingly small, while spontaneous freedom is large. On the other hand where the area of non-community interests is larger, the sphere of arbitration of interests is larger, while spontaneous freedom is reduced accordingly. Thus, whereas in phase one relationships obtained as follows:
In phase two — the current phase — the following relationships obtain:
The process of goal setting becomes crucial in the direction of certain outcomes expected to emerge in order to satisfy the least temporary needs. The pressures of a social organization begin to feel more than have an effect. Whether individual or societal, goals may not be anticipated and interpreted. These tendencies are not without limits. Exaggerated emotions, desire for perfection, and the interpretation of the law and the interpretation of patterns and stereotypes are taken subject to spontaneous reinterpretations, and extreme steps are taken by certain groups to control and maintain their positions in society. When they see the threat, they act. As men are prone to do, and become frightened at the change, they interpret them in terms of the broken tree, exaggerate the facts, and bring to the conscious level some of the more basic tenets of community. Throughout a much wider range of relocations, the broken tree is a lesson to some and a warning to others. The tendency toward a cessation and weakening of the tree of values -- are interpreted in a complex and cumulative way. Once a tree is planted and sturdy, human motivations depend on its health. The tree is a symbol of the health of the economy and the stability of society. The tree is a symbol of the health of the economy and the stability of society.

Taken here for only a glimpse into the more important of the problems, the will be suggested could be developed at great length. The will be what Phillips of the existing research to this point. All of the consciousness that which now is well spent in suggesting some of the untested and unanalyzed philosophies of reorganization in society. However, a little space and energy
minimum compromises and a more solid foundation for community is thus built. This foundation once more sinks to the unconscious level and relationships become more spontaneous.

The pertinence of all this to our discussion is that the real threat potential in our present community rift is not the rift itself but the possibility that it will become much deeper. Diagrammatically speaking it is the following situation that endangers a society:

Out of that kind of a situation totalitarianism may arise. When action is necessary, but impossible under existing organization, when the rift is so wide and deep that
essentially nothing can be accomplished, an upheaval is inevitable. If society can not be integrated on a community basis it will be integrated (as best it can) on a dictatorship basis. Otherwise, of course, civil war will ensue.

There will be attempted here no prediction as to the ultimate extent of the rift in the American economic community. This much, however, should be said. When a community is effectively isolated a rift may proceed further without resulting in either civil war or totalitarianism than is the case in a period of internationalism and national insecurity. The threat of outside domination makes a situation intolerable sooner than it would otherwise be.

The second important implication of the conflict between freedom and equality here delineated is that it is clearly a conflict between property rights and human rights -- property rights on the side of freedom, human rights on the side of equality. In saying this it must hastily be emphasized again that the line of demarcation is by no means absolute. The average proponent of freedom will readily grant much of the premise of the proponent of equality, and vice versa. But both groups argue in terms of the overlapping interests of the other, and no doubt a great deal of such overlapping does exist. Thus it is argued that economic rents (profits) are necessary to assure the progress that results in material betterment. Likewise, and in opposition, it is argued that the inequities resulting from untrammeled enterprise operate to reduce economic rents. In this way -- a way typical in this type of controversy --
both groups focus their attention upon a part of the relationship and argue in terms of the values held by the opposition.

At first glance it might seem that human rights are now being found after having been lost for many years. A more realistic interpretation would seem to be that human rights are now in danger of being lost after having been taken for granted for many years. Actually those values that are most secure in a community are those values that prevail at the unconscious level. As soon as it is necessary to consciously pursue a value, the value has become insecure. When a human body finds it necessary to consciously pursue health, the body must be unhealthy.

As long as business in America remained traditionally small, and as long as the land frontier persisted (it will be recalled that John Locke — the famous English exponent of property rights — assumed throughout his philosophy that every family owned and operated a small farm) human rights were never really in danger. For many years the real land frontier has been disappearing. Today it has been estimated that in the average manufacturing establishment an investment in machinery, buildings, etc. of $5,000 per employee is a prerequisite. In the light of this evolution it would be unrealistic indeed to claim that we are just now finding human rights. Rather, the problem is that of redefining human rights in a new world.

As evidence of the fact that human rights have always been implicitly paramount, it is significant that when America first began to adjust itself to the corporate form of business organization the
corporation was defined as a person. Regulatory law has continued to consider the corporation in that way. It was, in fact, this development that brought the problem of the human being into the focus of consciousness. The law was prone to match one person (corporation) against one person (individual) and call it equality. It is only recently that a collection of individuals has been allowed a status before the law equivalent to that long allowed a collection of buildings and a various assortment of machines. This development is possibly the beginning of a concerted attack upon the legal fiction of the corporate personality. If so it can confidently be expected to continue until we have succeeded in thoroughly orienting the individual into modern capitalistic society.

A third major consequence of the rift in American community, and the final one to be discussed here, is the apparent revolt from reason that will characterize the social scene as a result. When a community is predicated solidly upon a single principle social relationships proceed in logical conformity to the principle. The faculty of attention of the individual is oriented by his 'apperceptive mass' which is the community principle. Thus problems are interpreted and solved in accordance with the principle. The facts upon which decisions are based are accepted because there is agreement upon the frame of reference to be used.

But when, on the other hand, a community principle splits into opposing factions, the solution of problems and the rendering of decisions proceed on the basis of compromise rather than outright agreement. Since each faction has a somewhat different frame of reference it focuses its attention upon a different portion of the situation. As a result adjustments lose the appearance of following the pattern of premise and
conclusion. In short, government begins to look arbitrary rather than reasoned.

Individualism was originally predicated upon reason. In implementing what was intended to be 'a government of laws not men' great emphasis was placed upon principle. In an environment consisting of opposing forces actual adjustments will range all the way from the adjustment directly favoring one or the other of the forces to the adjustment representing a precise compromise between them. Principle is thus lost in a flurry of compromise, except, of course, in so far as the compromise itself can be considered a principle for analytical purposes.

In such an environment objectivity must be rare. In fact the individual who seriously attempts real objectivity becomes an object of suspicion by all concerned. Government is no exception to this rule. The premium placed upon political activity makes it certain that every sizable force will have its representation among public officials. Thus the real integration of government can never be found, under these circumstances, in any isolated incident of government. Rather the integration of government exists only theoretically as a mental matching of extremes against other extremes and thus arriving at what may be considered the mean approach of government to its problems of adjustment. Note, however, that to the individual the important fact is not the mean approach but the approach in the case at hand. In the light of these facts it is not surprising that the philosophy of absolutes has appeared to give away before the philosophy of relatives. No other practical approach is possible when the community that makes objectivity possible is substantially lacking.
This trend, too, can be expected to continue until a broader basis for agreement on fundamentals exists. Until that time one can only urge patience with the apparent arbitrariness of everyday adjustments, and understanding that these little incidents that seem askew are part of a larger pattern of compromise. — a compromise made necessary by an evolution that only the utmost in patience and understanding can aptly integrate in a way consistent with human values.

Every social condition has its own history, not only retrospectively but prospectively. The social condition in America resulting from a split of philosophy into two parts is no exception. A phase three in this history is already in the making. This phase can be called the Social Minimum phase. The thesis of this compromise is that government should take whatever responsibility is necessary to guarantee every individual a minimum standard of existence while allowing enterprisers freedom to have for themselves a higher standard to whatever degree that standard is consistent with the social minimum.

It must be emphasized that this adjustment does not destroy the conflict. But, of course, social conflict is not of such a nature that it can be destroyed in one fell swoop by acts of men. It can, to be sure, be rather effectively covered up for a time through dictatorship. A real disappearance of conflict, however, depends upon a process of social conditioning in the direction of successive compromises.

Already the fact of government restraint has been universally accepted. The provision of a social minimum requires in addition government responsibility for full employment, as well as other
positive norm creations through formal authority. We are now well along toward universal acceptance of this step.

These necessary directions for government action set the stage for future evolution. For, to a large extent positive controls operate in conflict with negative controls. Full employment depends in the last analysis upon the attitude of business, while government action operates in part to adversely affect business attitudes. Thus government must either minimize negative regulation or accept at first a lesser responsibility for full employment. Either alternative adds up to the provision of a lower social minimum.

Meanwhile the forces of equality will also be actively at work endeavoring to raise the minimum. They will very possibly attempt to bring about a higher minimum than is consistent with the optimum exercise of positive and negative controls by government.

Fortunately, it is easy to be optimistic. In a society that is primarily cohesive, and in which war is not an imminent probability, the forces of compromise will normally triumph over the forces of totalitarianism. It is believed by the writer that these conditions describe America, although by a narrower margin than is thought to be the case by many.

In conclusion, it seems proper to say a brief word on the subject of freedom, particularly since the preceding pages appear to add up to more government activity rather than less. When a child complains of restraint by his parents one is led to suspect that the child has strong inclinations in disapproved directions. Similarly when a nation is subjected to a large measure of control one can not but reach the conclusion that disunity exists.
Where community prevails and social action is spontaneous freedom is the rule. Where differences prevail resting upon a strong underpinning of community, control is the rule to the degree dictated by compromise between opposing factions. Where differences prevail to the extent that they cut through the community underpinning, control will again be the rule, but this time extending to the degree dictated by the extreme position of the ruling faction.

To the writer the problem of understanding freedom and restraint is as simple as that. And with that thought he closes.
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MISCELLANEOUS


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Howard Ross Smith was born July 6, 1917, in Des Moines, Iowa. After attending the public schools in Iowa, he entered Simpson College in Indianola, Iowa, from which he was graduated in June, 1938. In September, 1938, he entered the Graduate School of Louisiana State University as a Teaching Fellow in the Department of Economics. In June, 1940, he received the degree of Master of Arts.

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