Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Take Heart

TO THE EDITOR:

Your reference to Portland, Oregon's Union Gospel Mission and its program HealthBridge in "State Regulatory Measures" (*Regulation*, 1996 No. 2) deserves plaudits. That example provides an excellent picture of the *human* cost of well-intentioned, but counterproductive government regulation.

In brief, HealthBridge was prohibited from providing health care to the homeless because a government regulation required round-the-clock nursing personnel that substantially drove up the program costs, leading to the charitable endeavor's demise. Government officials apparently believe that the homeless are better off getting health care on the streets.

Policy organizations seeking to rollback regulations need to highlight the human faces and the human costs of federal, state, and local regulations. Tried-and-true arguments that focus on costs to businesses and consumers are important, but they are not enough. The negative effects of regulation must be given a human face.

To gain greater support for deregulation outside of the business community, policy writers should work on a reader's emotions while appealing to his intellect—mediating institutions such as private charities and other public service organizations are good vehicles for doing just that.

Kurt T. Weber
Program Director
Cascade Policy Institute

Making Congress Accountable

TO THE EDITOR:

As the primary sponsor and floor manager of the Unfunded Mandates Reform Act (UMRA), I appreciated Angela Antonelli's thorough review of the act and its impact (*Regulation*, 1996 No. 2). While I agree in many respects with Antonelli's assessment, I disagree with her general characterization of the bill as a "toothless tiger."

First, let me address a technical but important error in Antonelli's description of the law. It is not true that "the act applies only to bills that have been reported out of a congressional committee." While it is true that the Congressional Budget Office (CBO) cost estimates are not required for amendments, conference reports, or bills not passed out of committee, a point of order would *still* lie against any of these measures if they contain an unfunded mandate, regardless of whether they are accompanied by a cost estimate. The CBO indicated very strongly that it would be unable to perform quality cost estimates in the often short period between a conference report's filing, for example, and its consideration on the floor. Amendments are often considered without any advance filing or notice, and the volume of amendments alone would overwhelm the office. To insist on quality cost estimates in these circumstances would have required slowing the business of the House and Senate in order to give the CBO time. Therefore, our decision to exempt amendments, conference reports, and bills not passed out of committee from the CBO cost estimate requirement—but not from the point of order—is an effort to balance the demands of the legislative schedule with the need for a strong deterrent to new mandates.

UMRA is not and never was intended to be "no money, no mandates" legislation. I have always maintained that the act is about two things: information and accountability. Congress first must endeavor to know the costs of its actions on state and local governments, and second, must be accountable for passing any mandates that are not fully funded.

The only way legislation containing unfunded federal mandates may be considered by the House is if a majority of the House votes on record to override the point of order and proceed with consideration. This is not a "loophole" in the law—it is a provision which secures a recorded vote on the question of unfunded mandates while allowing the House the flexibility to consider a mandate without federal funding if there is a compelling reason to do so. Indeed, our commitment to accountability is precisely why the law prohibits the Rules Committee from waiving mandate points of order.

At this early stage in the act's implementation, the facts indicate that Title I is a success. There are numerous examples, many cited in the article, where legislation containing costly unfunded mandates was rewritten prior to floor consideration in order to remove the mandates or make them less onerous. This is precisely how the law was intended to work—to give states and localities a seat at the table, and where possible, to prevent mandates from ever reaching the floor.

Of the few mandate-containing bills that have been considered on the floor, only the point of order against consideration of the minimum wage increase has been overridden. While I may disagree with the minimum wage increase, the vote to override the point of order is not an example of a weakness; it is another example of the law working as intended to guarantee a recorded vote on the question of an unfunded mandate.

The article correctly notes that Title II of the act has not matched the success of Title I. At this point in our oversight of the act's implementation, it seems clear that this administration is not complying with the letter and the spirit of the law. Yet state and local governments bear some responsibility for seeing that UMRA is enforced. They have the ability to take agencies to court to compel regulatory cost analyses, and have not done so. This opportunity for judicial review should be as effective as anything Congress could do to ensure that federal agencies comply with the law—but only if state and local governments use it.

Also, let me note that while the expiring appropriation of the Advisory Commission on Intergovernmental Relations (ACIR) is unfortunate, it does not reflect a lack of commitment on the part of Congress to ACIR's study. I have been pushing for a review of existing mandates for four years, but the commission has been on the "chopping block" for at least as long. Its elimination reflects the Republican commitment to a balanced budget, rather than a lack of interest in the burdens of existing mandates. Instead, the blame of ACIR's failure to pass a quality final report on unfunded mandates lies squarely at the feet of the Clinton administration, which succeeded in sabotaging the final report to appease its core liberal constituency of labor, environmental, and other groups who believe there is no way except the Washington way.

Rather than "promises unfulfilled," the Unfunded Mandates Reform Act highlights both the strides we have made and the steps left to be taken. Two years ago, passage of UMRA would have been unthinkable. Today, we are moving past the question of funding mandates and asking whether the federal government should be allowed to impose mandates in the first place. UMRA has paved the way for our national dialogue on federalism and the scope of the federal/state/local relationship, which perhaps is its greatest contribution.

Rep. William F. Clinger Jr. (R-Pa.)
Chairman
House Committee on Government Reform and Oversight

Factoring the Freedom Quotient

TO THE EDITOR:

Thank you so much for the article "State Regulatory Measures" by Edward L. Hudgins *(Regulation,* 1996 No. 2). The idea of creating an index for state regulations is an excellent one. It will be inexact because of the subjective nature of cost assessment; however, it is still well worth the effort since it will intensify the debate about the impact of mandates and regulations on income creation and personal freedom.

There are large costs associated with land-use regulation in Florida and many of them result from the state's Growth Management Law. While most would agree that the intentions behind growth management are fine, advocates and opponents of the system also agree that it has not produced the desired results. Thus we have had increased costs without the desired benefits. I would advise weighing elements other than regulatory takings in the land-use arena. Takings occur only in a handful of cases, but lawyers, engineers, lobbyists, botanists, transportation consultants, hydrologists, and accountants can be very costly in most cases. In addition, the length of time required during the predevelopment process increases risks and costs.

In terms of tort law, caps on noneconomic damages and joint and several liability would be two examples of legal doctrine critical to assessing a state's regulatory climate. On the positive side, you might consider measuring the number of cases resolved by mediation and arbitration. I have been told that Florida leads the nation in noncourt dispute resolution.

The use and quality of water are becoming increasingly important areas of state regulation. It is ironic that our state receives an average of fifty-four inches of rainfall annually but water shortages occur regularly and water-use is rationed. The state water-management boards' power to tax and regulate should be measured.

What about health care? Florida has a costly certificate-of-need system which adds millions of dollars to health-care delivery costs. There are hundreds of state regulations, mandates, and reporting requirements that make this industry the most regulated in Florida.

I wish you well with your project. Like the state tax and spending ratings prepared each year by the Cato Institute, your index can play an important role in the fight for economic and individual freedom.

Jeb Bush
Chairman
Foundation for Florida's Future

Who Controls Workers' Compensation?

TO THE EDITOR:

The list of categories used to rate state regulations in "State Regulatory Measures" seems comprehensive. My comments are on workers' compensation insurance since this is the issue we have been working on at the Pioneer Institute.

As with many other topics, one finds a broad range of approaches to insurance regulation across the states. The amount of state interference in the workers' compensation insurance market runs the gamut. There are some states, such as Ohio, that do not allow private insurance companies at all and that pay workers' compensation from a state fund. At the other end of the spectrum are Texas, New Jersey, and South Carolina which allow employers to opt out of the state system.

Of all state systems, Texas's is perhaps closest to a market-based approach. Some 39 percent of Texas employers—accounting for 20 percent of the state's work force—do not subscribe to the state system. Over half of the state's employers have never joined the system since participation has always been voluntary. In many other states participation was optional in the early decades of the century and compelled in recent years. Some states fall between the two extremes. For example, Massachusetts allows private provisioning of insurance but regulates the rates. (Our forthcoming study by James Chelius and Edward Moscovitch argues for deregulating workers' compensation rates in Massachusetts.)

The question one could ask is: Does the state allow voluntary participation in the state-run system? Other highly regulated aspects of the workers' compensation system are lawyer fees (although the system was designed to keep lawyers out), medical provider licensing, and medical fees.

Of course there are plenty of regulation stories that people could tell. Yesterday during lunch hour, I went to a café that just opened around the corner and ordered a sandwich and a glass of milk. As it turned out the store did not have a "milk license," so even though the manager gave me some milk, he was unable to charge me for it. There is such a thing as free regulated milk.

Gabriela Mrad
Research Director
The Pioneer Institute

A Laborious Union

TO THE EDITOR:

I am intrigued by the proposed index to measure state regulatory freedom in "State Regulatory Measures." In particular, I think any measure should consider a state's relationship to its labor unions.

My own state Maryland has long been a jurisdiction where sympathies of the powers that be lie with the employee, not the employer. For a start, a business contemplating a move to Maryland needs to look no farther than the state's congressional delegation to ascertain that the Free State is unlikely to pay more than lip service to freedom of employment. In 1994 the ten-person delegation had an AFL-CIO rating of 77 percent (Democrats 95.8, Republicans 39.3). In 1995 the rating dropped to 66 percent (Democrats 86.5, Republicans 26), although this scarcely makes the delegation business friendly. (These figures exclude Representative Bob Ehrlich and include then-Representative Kweisi Mfume.)

Perhaps the most obvious demonstration of employee sympathy is Maryland's prevailing wage law that ensures that public construction projects cost more than necessary. Sections 17.201-17.226 of the *Annotated Code of Maryland* require that all construction projects costing $500,000 or more where the state funds 50 percent or more of the cost must pay workers the prevailing union rates. Deprived of their cost competitiveness, nonunion companies are effectively shut out.

It is true that in 1994 the AFL-CIO only represented 16 percent of Maryland's workers; 10.8 percent in the private sector and 32.4 percent in the public sector. Nonetheless union activity must have contributed to Maryland's relatively high employment costs. From 1980-90 state employees' inflation-adjusted average wages grew 25.2 percent; those of local government employees grew 22.1 percent. Private-sector wages increased 9.3 percent. Moreover, last spring Governor Parris N. Glendening astonishingly saw fit to issue an executive order extending collective bargaining rights to state employees. For years legislation to the same effect routinely was voted down by the general assembly.

In November bargaining agents for state personnel will be elected. The powerful American Federation of State, County, and Municipal Employees (AFSCME) is expected to do very well in the election. Because Maryland is not a right-to-work state, state employees who are not currently affiliated with AFSCME will have no defense against paying union dues when the inevitable follow-up request comes from AFSCME—the request for a closed shop workplace. For the record, this is the same AFSCME that in 1992, after lengthy litigation, agreed to refund more than $8.6 million to fifty-seven thousand Pennsylvania public-sector employees. This represented the amount of mandatory union fees AFSCME had spent for political and other non-bargaining purposes.

AFSCME has long been associated with Governor Glendening. In his previous incarnation as the county executive of Prince George's County, his generosity to the union's wishes resulted in absolute, no-furlough job security for county employees. Wage scales in P.G. County for public employees are the highest in the Maryland/Virginia area. If the same perks are extended to state employees, the latter's compensation can be expected to increase and/or productivity to decrease. Either way, taxpayers will be expected to finance this beneficence.

It is hardly as though Maryland's long-suffering taxpayers are underburdened. They may have little idea how benevolent they have been to state and local employees, but they do know they live under a high-tax regime. In fiscal year 1991 state and local combined income, property, and sales tax collection was $2,284 per person—the 9th highest rate in the nation, and 9.6 percent above the national average $2,083. The corresponding figures for Maryland's immediate competitor states were: Delaware $2,081 per capita (18th); Virginia $1,962 (22nd); Pennsylvania $1,888 (29th); North Carolina $1,673 (38th); and West Virginia $1,628 (41st).

Not to be outdone, Baltimore City recently increased the cost to taxpayers of the city's approximately five thousand low-skill service workers. Despite having to retreat from his proposal to increase city income taxes last April, Mayor Kurt L. Schmoke is progressing with his plan to pay janitors and similar workers a "living wage" instead of the federally mandated minimum wage. The living wage ordinance, Council Bill No. 716 passed in December 1994, increased hourly wages for affected employees from $4.25 in 1995 to $6.10 in 1996. The hourly wage will increase to $6.60 in 1997, $7.10 in 1998, and $7.70 in 1999. The law applies to city employees and to the employees of public-sector contractors and subcontractors. This means that private contractors forcibly lose their competitive edge. Thus the living wage law is a form of prevailing wage law.

To be sure, this is a move that the city should not have made. The old port loses about 15,000 individuals every year, a staggering population depletion. From now until the turn of the century this rate of loss will be enough to fill the Baltimore Ravens' new, publicly funded stadium with ex-Baltimoreans. It is far from clear just why the city administration thinks the added tax costs of this plan will stem the exodus of the middle class to the suburbs.

The question arises, how does this affect the state's business climate? The answer is simple: Maryland's citizenry, broadly speaking, may be divided into net revenue providers and net revenue consumers. Employers and would-be employers are found within the ranks of the revenue providers, not the revenue consumers. Requiring them to provide even more revenue with little obvious benefit to themselves can only serve as a disincentive to providing further employment. In the case of Baltimore City, employers move out. In the case of the state overall, they decline to come in the first place. As long as Maryland bows to every union whim, it will continue to stranglehold the goose that lays the golden eggs.

Douglas P. Munro
Codirector and CEO
The Calvert Institute

Conflicting Authority

TO THE EDITOR:

As your article "State Regulatory Measures" makes clear, the need for measuring and minimizing the regulatory burden is extremely critical. One particularly serious problem is that many regulatory agencies have power and authority that overlap those of other agencies. Often an attempt to comply with the directives of one agency can be blocked or run afoul by another.

A tragic example of this problem concerns the now operationally defunct Braddock Water Company Inc. of Frederick County, Maryland, for which I have been a business consultant. This privately owned and operated company, established around the turn of the century, has been under current ownership since 1956. With an exclusive state contract to serve approximately 330 users, it delivered safe, high-quality drinking water for forty years without a single violation of health rules.

But the past several years saw Braddock caught between regulatory agencies. In Maryland, the state's Department of the Environment foisted a laundry list of unfunded mandates on Braddock that was supported by the Public Service Commission and the Office of Peoples' Council. Meanwhile, the Department of Natural Resources lost paperwork that was not found until an attorney for Braddock visited its offices. By this point in time, the costs to comply exceeded $30,000.

Many of the regulations had little or nothing to do with protecting public health, and one mandate alone had a price tag of over $400,000. Yet private water companies are regulated by the Public Service Commission. Among the restrictions placed on companies like Braddock is they cannot borrow money or have debt in excess of one year's duration without approval from the commission. Further, rate hikes to pay for higher operating expenses or capital improvements must be approved by the Public Service Commission, even if the expenses are mandated by state agencies. And the rate case procedure itself is a long and expensive process for which costs must also be recovered.

Meanwhile, as Braddock fought for higher rates and long-term loan approval and assistance through the commission in order to pay for mandates, the Department of the Environment levied fines and sanctions on Braddock for failure to comply with their mandates. Thus, it became impossible for Braddock to comply with one set of regulations without running afoul of mandates from another agency. This conflict between agency jurisdiction, of course, led to legal actions by the agencies through the courts and administrative law procedures. Once this began, the legal bills for Braddock skyrocketed. Braddock had no means to meet or recover legal and/or court costs.

The massive costs to comply with the demands of each regulatory agency, regulatory restrictions on borrowing and raising rates to meet these costs, and the legal costs to defend the company made the company's survival impossible. At the final administrative hearing that was attended by representatives of Braddock, the head of the Office of Peoples' Council who had brought the revocation procedure against the company commented (off the record, but before witnesses) that it is a shame that "mom and pop" size operations just cannot survive anymore. This was ironic since a Maryland statute requires that the Public Service Commission keep regulated companies financially viable.

The Braddock case is not unique. Over the past few decades, the state of Maryland has seen the number of privately owned water companies fall from over five hundred to a few dozen. And the demise of these companies is not without costs and inconveniences to customers. For example, the meter reader for Braddock was an Eagle Scout who did his job part-time for $200 per quarter while pursuing a college degree in engineering. Now that Frederick County has taken over the operation of Braddock, the county employs a team of meter readers costing more than $1000 per quarter.

A review of this regulatory process that has driven hundreds of Maryland's private water companies out of business reveals a number of problems that must be addressed. First, regulatory agencies often make demands that are unconstitutional. Although such demands usually are dropped by the time condemnation proceedings are taken against an enterprise, the enterprise still is burdened with huge legal bills. But the agencies enjoy civil immunity from damages, and the individual agents involved claim to have "acted in good faith." There is strong incentive for agencies to act irresponsibly.

Second, the administrative procedures that an enterprise must endure to balance the contradictory policies of state agencies are costly and slow, dragging out over months or years. During such delays, enterprises usually incur higher capital or operating expenses without receiving offsetting compensation. Many companies simply cannot endure long enough and are forced to shut down.

Third, the number of attorneys and the legal fees required to proceed through administrative remedies render the process expensive and inefficient. At the final administrative hearing on the Braddock case, there were attorneys from the Public Service Commission, the Office of Peoples' Council, the Office of the Attorney General of the State of Maryland (representing the Maryland Department of the Environment), and Frederick County—five lawyers from government agencies alone.

Regulatory agencies primarily should operate on the state level. The federal government should be responsible for alleviating overregulation, sorting through problems raised during administrative procedures, eliminating immunity issues from prosecution, and restoring the balance in government that was such an important incentive for founding our country and Constitution.

Harold Comstock
Business Consultant

Cost Recovery before Competition

TO THE EDITOR:

My mother taught me not to challenge my betters and Bill Niskanen is certainly the better of any utility executive when it comes to outlining the principles of free market economics. Yet his article titled "A Case against Both Stranded Cost Recovery and Mandatory Access" (*Regulation*, 1996 No. 1) cannot go unanswered. It must be answered because mandatory access to utility transmission systems is now an irreversible part of many regulatory agendas, and because stranded investment recovery is the only practical antidote to the taking of utility wires that will result. It must be answered because people who do not share Dr. Niskanen's aversion to this taking will ignore the second half of his message and gleefully quote the first half.

Let us be clear about the makeup of the stranded costs for which utilities are required to grant their competitors, including other utilities, access to their transmission and distribution systems. It is this mandatory access that creates nearly all of the stranded costs for which utilities seek recovery. To be sure, we believe that Supreme Court cases like *Hope Natural Gas* and *Duquesne Light Company* establish constitutional rights that amount to, and have amounted to for decades, a regulatory compact. But the core position of my companies is to accept the inevitability of mandatory access and seek recovery of the costs stranded thereby. We would cheerfully abandon our stranded investment argument if the pressure for mandatory access could be eliminated as well.

Apparently this strikes Dr. Niskanen as clever rather than principled. I had not thought that accepting the inevitable was especially clever and hardly believe that helping to develop a competitive market place for electricity is unprincipled. At the New England Electric System our position is simple: We will implement the public demand for competitive market places if we are allowed to recover our stranded costs and if we are not, we will fight mandatory access to the wall.

We believe the Federal Energy Regulatory Commission (FERC) has it right. It has developed policies that foster competition and created real markets where monopolies once existed. In doing so FERC has delivered to the public many of the benefits of competition that have long been promoted by the Cato Institute and Dr. Niskanen. But FERC has also recognized that the unusual regulatory act of mandating open access requires just compensation for those utilities whose properties are subject to the new rules. Recovery of stranded costs will work for the benefit of all. Not only will prolonged litigation be avoided, but the financial stability of the entire industry will be preserved during the transition to a new regulatory paradigm, thus preserving for consumers the reliable and universal service upon which they depend.

John W. Rowe
President and CEO
New England Electric System

Michaels Responds to Baumol and Sidak

TO THE EDITOR:

William J. Baumol and J. Gregory Sidak's response (last issue) to my review of their work on stranded investment is largely devoted to discussions of legal authority. They dispute none of my historical or statistical material. As expected they start with the "regulatory compact," a metaphorical agreement that consumers will supposedly break if they fail to pay utilities the recorded costs of uneconomic contracts and plants inclusive of a fair return. Instead of examining how the compact was formed or how it operated, Baumol and Sidak argue the law. However they would surely agree that consumers kept up their side of the agreement—taking service from monopoly utilities at whatever prices they charged even when neighbors serviced by other utilities were enjoying lower prices. As for suppliers, Baumol and Sidak chose to resist the temptation to discuss the "virtues and vices of the electric utility firms and the goodness or sins of their past behaviors." Their belief that utilities should not receive stranding recovery "as a reward for exemplary conduct" begs the important question: Should utilities get every dollar of the estimated $200 billion regardless of their performance from consumers who had no choice but to watch them perform?

Baumol and Sidak's apparent answer is that the facts should not get in the way of legal issues. Their chosen authorities range from nineteenth century Supreme Court decisions to the 1996 *Annual Report* of the president's Council of Economic Advisors (CEA). They trust the CEA because it cannot "be plausibly accused of having been coopted by the electric utilities." Even if this is true, the CEA's economic theory may be disputable, its facts may be wrong, and its views may not transcend politics. (The *Economic Report of the President* has never predicted a recession for the coming year.) One critically wrong "fact" is the council's belief that regulation has kept returns to utility investors below those earned by investors in riskier firms.

Amidst their legal citations Baumol and Sidak justifiably criticize my database search for the "regulatory compact" or a similar term. Such a simple search for a complex concept can scarcely be conclusive. The issue of regulatory commitment has been to court so often, however, that the utter absence of its literal appearance from 1789 to 1983 might be significant. It is easy to find cases and scholarship contrary to Baumol and Sidak's citations. In *Market Street Railway v. Railroad Commission* (1945) the Supreme Court held, "The due process clause does not insure values nor require restoration of values that have been lost by the operation of economic forces."

Some cases support both sides. In 1837 the Supreme Court decided *Charles River Bridge v. Warren Bridge* that allowed the defendant to compete with the plaintiff. The plaintiff Charles River Bridge was a decades-old chartered monopoly whose shareholders earned returns far above competitive levels. Legal historian Stanley Kutler notes that the decision kept numerous owners of toll roads, bridges, and ferries with ancient monopoly charters from exacting "stranding" compensation from railroad builders. The dissenting justices in *Charles River Bridge*, however, provided contract and constitutional arguments that advocates of stranding recovery have found attractive.

Economists can judge for themselves the relevance of Baumol and Sidak's citation of Professor George Priest's *Journal of Law and Economics* article on early, nonexclusive municipal franchises as precursors of today's regulation. Priest settles on no single explanation for why state governments took over most electrical regulation from cities early in the century. The answers to why and how the takeover happened, however, are critical for believers in a regulatory compact. In my reading, utilities sought state regulation to protect themselves against competition and to stop cities from extortionately using franchises. If the only demands for state regulation came from sellers, where was the meeting of the minds that was needed to form a contract? Back then electricity was competitive, service obligations were sketchy, and politically dissatisfied consumers were conspicuously absent. If all of today's rationales for a compact only came along after regulation began, could there have been an implicit agreement?

Readers of the *Journal of Law and Economics* should read Professor Martin Zimmerman's "Regulatory Treatment of Abandoned Property: Incentive Effects and Policy Issues" (1988). There readers find an evenhanded discussion of theoretical issues and an interesting case study of an abandoned nuclear power plant. One will also learn that state regulators for decades have limited investor recovery in stranded and abandoned plants. They have typically allowed no more than dollar-for-dollar recoupment of the amounts that were spent, unadjusted for inflation, and with a zero return on the investment. If there really was a compact, either regulators have consistently broken it or its fine print denies investors the recovery that Baumol and Sidak recommend. If there was no compact, is incomplete recovery an indication that regulators knew so all along? In examining nuclear disallowance proceedings of the 1980s, I found no judicial or regulatory citations to the nineteenth century cases that Baumol and Sidak cite as evidence of a compact.

Baumol and Sidak (and the CEA) note that a well-functioning compact must limit investor returns to levels commensurate with the low risk that franchised monopolists enjoy under cost-of-service regulation. The real behavior of investor returns is appallingly inconsistent with the compact. Most of the power contracts and nuclear plants now called "stranded" were put in place during the 1970s and 1980s. The National Association of Regulatory Utility Commissioners, the state regulators' trade association, calculated 1972-92 total returns to investors (capital gains plus dividends reinvested) in Standard & Poor's 400 unregulated industrials at 713 percent. During the same interval, total returns to an investor in the average electric utility were 868 percent. Some utilities with large stranding claims performed stunningly including Detroit Edison (twenty-one year total return of 1,003 percent), New England Electric System (1,337 percent), and Southern California Edison's SCEcorp (1,517 percent). The figures are not peculiar to recent times. Writing in the 1993 *Journal of Economic History*, Harvard University economist William M. Emmons III found that between 1924 and 1941 returns to investors in nonholding company electric utilities also beat the market while carrying lower risk. Any assumption that utility investors generally enjoy a limited upside is simply untrue.

Baumol and Sidak's demeaning characterization of some utility investors as "little old ladies in tennis shoes" is poor rhetoric and misleading to boot. A clear supermajority of utility shares is held by knowledgeable individuals and institutions—stranding recovery that benefits the hardship cases will benefit far more people who should have known better. The elderly are as heterogeneous as the young and we must presume that they are as capable of managing their investments as they are of evaluating social security policy. Numerous individuals specialize in holding stocks of single companies, both regulated and unregulated, regardless of well-advertised risks. By the tennis shoe standard they all should be as worthy of protection as utility investors. Until quite recently utility investors of all ages often made better investments than professional portfolio managers, making strong capital gains and receiving high dividends from power users who had no choice but to pay up.

Baumol and Sidak's main economic argument is that without stranding recovery "new investment will be discouraged, thus injuring consumer interests." First, denying compensation will quickly lower power prices and encourage investment in electricity-using capital goods. More speculatively, denial of stranding recovery may discourage efforts by unregulated industries to seek regulatory protection. Utilities that recover strandings will be receiving cash flows whose reinvestment need not be approved by the capital markets. Their officials might choose to invest excessive amounts in inappropriate projects, knowing that since they got away with one stranding recovery they can probably do it again. (Possible examples are the recent investments by cash-rich utilities in telecommunications and foreign power distribution systems.) Baumol and Sidak's summation of investment disincentives is "once bitten, twice shy," but competition is desirable precisely because it bites people who make bad investments. Critics of stranding compensation might as well say "once recovered, twice wasted."

In electricity, generation has become a competitive market, and it is there that the bulk of strandings will occur. Baumol and Sidak correctly note that transmission will probably remain a natural monopoly function, parceled among the individual transactions of wheeling users. As time passes, most utilities (or at least their regulated units) will become transmitters, leaving the generation business and procuring power on the market to serve the remaining retail load. The transmission lines will carry the same or greater volumes of power, some dedicated to direct access transactions. A regulated transmission utility will thus have a steadier income and be smaller than one whose fortune also depends on a fluctuating power market. Investors will see that the regulated transmission-only system is a lower-risk investment than one that also generates for the market, and they will supply it with capital on appropriate terms. It is important that investors be the capital suppliers. As I recently noted in *Public Utilities Fortnightly*, the retreat from generation has consequences for the compact. That agreement is between consumers and investors, not consumers and utility managers. To properly terminate the old contract, management must return recovered strandings to investors rather than fund risky projects that investors hoped to avoid when they first bought their shares.

Baumol and Sidak's restatement of the Efficient Component-Pricing Rule (ECPR) does not respond to my comments. Assume that a vertically integrated utility provides generation whose variable cost is $3 and transmission whose variable cost is $2. Together they produce delivered power the utility sells at $9. The $4 difference between variable cost and price may be a contribution to fixed cost or it may be monopoly profit. Assume an unintegrated competitor can generate for $2 but needs utility-owned transmission for delivery. According to the ECPR, the utility should charge its competitor $6 for the transmission. At $6 the independent generator enters the market only if its costs are less than the utility's, as economic efficiency demands. If the utility takes an extra dollar of monopoly profit and sells delivered power for $10, the efficient transmission price becomes $7. Absent a showing that regulation compels the utility to minimize costs and to sell delivered power at the competitive market price, the ECPR protects utility monopoly and inefficient production. The more a utility strands, the more it gets. The ECPR is justified only if retail service and utility-owned assets are priced at competitive market levels rather than levels that recover accounting values.

Any policy that will transfer billions of dollars from consumers to utilities must be grounded in facts. The very range of stranding estimates (from zero to $500 billion) probably shows that the concept is as much political as economic. All of these estimates, however, are amounts that customers will pay in the future. Those customers have already paid billions by being denied access to the market and compelled to take service from utilities. Elsewhere I have suggested that states individually investigate the differences between recent utility prices and market prices before they choose a stranding policy. They can allocate future payouts intelligently and justly only if they know how much their citizens have already overpaid for power that could not be sold in competitive markets.

Robert J. Michaels
Professor of Economics
California State University, Fullerton

Stranded Costs Cut to the Quick

TO THE EDITOR:

After all the articles and letters in *Regulation* about electric power, we still have not adequately delineated the critical issues. The problem is that a century of convoluted regulations has produced a deformed, inadequately adaptable electric power industry. The central questions are: What is the best new structure? How should we attain it?

The dominant approach is to develop and propose an optimal structure that some regulator will be entrusted to impose. This procedure, however, overlooks two basic concerns. First, it is presumptuous for outsiders to dictate how to reallocate billions of dollars in assets. While this is an example of F. A. Hayek's stricture against pretense of knowledge, Paul Joskow and Richard Schmalensee's 1983 defense of limited changes in regulation was grounded in a similar uncertainty about what was best.

The second concern is a familiar one applicable to all regulations: It is undesirable to trust reform to the agencies that caused the problems. An obvious way to avoid all of this is simply to deregulate totally. Control by the Federal Energy Regulatory Commission, the state public utility commissions, other state agencies, and probably even the Nuclear Regulatory Commission should vanish. If the industry were deregulated, public power should be privatized and cooperatives should lose access to below market loans and favored access to power supplies. Companies then would be free to develop whatever structures seem appropriate.

Alternative proposals dominate the discussion simply because of a reluctance to recognize and deal with long-standing challenges to the "natural monopoly" argument that is used to justify the prevailing regulatory structure. In the single best treatment of the issue Richard Posner analyzes why regulation is inappropriate even if some monopoly power exists. The basic arguments are that true natural monopolies are unlikely to cause major economic problems and regulatory agencies are unlikely to remedy any of these monopoly problems. The second part of the case applies to electricity regulators: They are not devoted to efficiency and, even if they were, lack the ability to determine and implement the efficient outcome. Posner uses the economic theory of natural monopoly to show that natural monopolies can (and do) use the textbook-hallowed complex pricing systems that produce efficient output levels. To be sure, such pricing maximizes company profits and enriches stockholders. Posner notes that this income effect is too small to justify regulation. Others have suggested that monopoly power is so limited that deregulation would not induce price increases.

I have recalled this argument to explain my primary reason for fundamentally disagreeing with William Baumol and J. Gregory Sidak's article (*Regulation*, 1996 No. 2). They apparently assume an imposed reorganization of the operation of the power grid and offer a remedy for the confiscation of property rights that such reorganization would probably entail. Among the virtues of the voluntary deregulation reorganization model is that nothing is confiscated. Thus, I was pleased that William Niskanen shared my long-standing concerns over imposed restructuring.

Moreover, serious problems exist with Baumol and Sidak's proposal even as a compromise approach. Regulators cannot reasonably quantify the economic losses different regulatory reforms might produce or how much extra profit might be extracted by regulation. Advocates of stranded cost recovery appear certain that deregulation will produce major losses that can be properly recovered by maintaining the regulatory contract.

Information on stranded costs is anecdotal, self-serving, and in the worst cases based on questionable analyses. The long-run price structure of electricity will lie some-where between a price that is sufficient only to repay the costs of modest capacity additions of gas combined-cycle plants and high enough to allow adding plants using coal or possibly nuclear power. Gas plant costs are low because the electric power industry has not tried totally to replace coal and nuclear power with gas. Clearly, the level of stranded costs depends critically on what regulators cannot predict—the actual deregulated price structure.

Another factor in the stranded cost calculation is the economic loss imposed by contracts for independent power. Yet contracts are made to be broken—economic reality often overrides legal sanctity as with many fuel supply contracts. Surely the same will occur with contracts giving too high a price to independent power producers.

Further questions arise about the distribution of these burdens among different utilities and particularly, whether those bearing the largest part of the loss of transmission network value also have the largest amount of stranded generating plant costs. Further difficulties arise in implementing a sensible stranded cost recovery program. The amount of money recoverable from the rate base is limited to returns from the prices that maximize returns to the seller. The profit maximizing prices necessarily set a limit on how much stranded cost can be recovered. Regulators are incapable of setting prices at the point where profit maximization occurs. Thus, Baumol and Sidak propose an unworkable solution to an ill-defined problem.

Finally, Irwin Stelzer has pointed out most of the limits of the compact concept. He correctly noted that the compact never was intended to protect against all losses, and practice for several decades has denied recovery of substantial parts of what Baumol and Sidak apparently believe are protected investments. In contrast to Stelzer, Baumol and Sidak used the bulk of their space to assert that a compact existed, and they failed to respond satisfactorily to Michaels's other explanations for why stranded cost recovery is bad policy.

A broader point can be made. Baumol and Sidak come close to suggesting the attainment of what a long out-of-fashion literature dubs the "compensation principle"—that is, do not change things unless everyone is a winner. Baumol and Sidak are too knowledgeable to believe that this is a feasible or desirable rule for policy. What they do suggest validly is a limitation of the argument that efficiency should govern decisions about regulation. They suggest that arbitrary, and unanticipated, takings adversely affect efficiency by chilling future investments. As Stelzer argues well—it is unclear that current investors in electric power are a herd of naive widows and orphans unaware of regulatory risks.

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Industrial Policy Revisited

TO THE EDITOR:

Lawrence Reed's "Time to End the Economic War between the States" (last issue) is a refreshing critique of state-level economic development policies. Reed's analysis rightly points out the limited benefits targeted incentive programs provide to state economies and local communities. While these programs provide good press, policymakers too often ignore their negative impacts on the business climate.

More importantly, Reed correctly notes that targeted economic development incentives are a form of industrial policy. Unfortunately his critique of incentive programs as industrial policy stops short. The remainder of his article focuses on research that shows that tax-incentive programs are politically driven and generally ineffective. Targeted incentive programs, however, have other significant drawbacks that make them fundamentally antimarket and ultimately antigrowth. Most importantly, these policies have played an important role in establishing and expanding industrial policy on the state level and distorting efficient market outcomes.

In pursuit of economic growth, policymakers of all political stripes have sung the mantra of the tax-incentive to show their "commitment" to economic development. This has created a climate of interventionism that undermines free markets and property rights. In fact in the long run, the most detrimental impact of targeted incentive programs may be their use as a tool for establishing government-centered economic development policies on the state and local levels.

Unlike broad-based tax reductions which treat all businesses equally, targeted incentives focus on specific companies. This means that the selective benefits of government policy are doled out based on the government's assessment of local "needs" and the potential "contribution" each firm will make to the local economy. For example, Ohio gives firms a tax break from the state's corporate income tax if they expand investment and the labor force in-state. But the tax credit is not applied evenly to all firms. Some firms might get a 50 percent abatement, others might get 65 percent. Some firms might receive a ten-year abatement while others might receive five or eight years. Of course the state is under no legal obligation to grant a credit if it does not believe a firm will add a "sufficient" number of jobs.

The Ohio Job Creation Tax Credit Authority, the agency that administers the program, determines which firms "deserve" a tax credit, how much, and for how long. The state's economic development director openly admits the programs are designed to target high-paying, high-value-added industries. Thus not every firm can qualify for the tax break—that's the purpose of the program. By conferring benefits on specific types of companies, the state hopes to influence investment and expansion decisions.

This process is not unique to Ohio. Anytime a firm asks for a tax break from a government agency—whether a city council, county government, state or federal agency—the government picks the winners, and by default the losers, by choosing the program beneficiaries. Some firms will get tax breaks, new roads, and new sewer systems—others will not. The very nature of the process puts government in the driver's seat of economic development.

Under the guise of creating a "better business climate," governors and other public officials are inevitably engaged in interventionist industrial policy. They consciously attempt to manipulate market outcomes by changing the "bottom line" for individual firms. If all firms received the same tax treatment, state policy would not necessarily distort market outcomes. The problem with targeted incentive programs is that they treat all firms as unique cases even if they are the same.

Targeted tax-incentives make industrial policy politically attractive. When a tax break is given to a company, elected politicians and policymakers can cut ribbons and the firm's CEO can publicly applaud their efforts to create a favorable climate for business. (Indeed, the business climate dramatically improves for participating firms.)

In the end the political nature of the programs means that intervention will beget more intervention. This is already evident in the growth of targeted incentive programs across the nation as state governments promote them as the cornerstone of "successful" economic development strategies. Under the current wave of tax-incentive-based industrial policy, every business expansion conceivably could be subject to review by a state agency as officials decide which companies "deserve" low taxes and which ones do not in the name of creating a "good business climate."

In the long run state policymakers will be unable to use industrial policy any more effectively than economic planners in the former Soviet Union, France, Great Britain, or even Sweden. As F. A. Hayek and Ludwig von Mises explained decades ago, the information requirements of a market economy inevitably swamp attempts to plan or direct market activity. State and local policymakers are not privileged with the information or wisdom needed to make targeted incentive programs more effective than market-driven development. Of course this is why empirical research shows that these programs have little (if any) positive impact on economic growth.

State and local policymakers would be better off abandoning targeted tax-incentives and letting the market work on its own. They should ensure broad-based tax reductions, regulatory streamlining, a quality labor force, and a high-quality infrastructure that will create the kind of business climate that will fuel real long-term economic growth and development.

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Editor's Note

In "Free the Ranges" Richard L. Gordon's criticisms of Robert Nelson's policy proposals should have read: It is inappropriate for policy analysts to guess at what is politically feasible—this is not an area in which they have expertise. Moreover, what is feasible is often unclear and temporary. Thus, analysts should stress the soundest policies. If one wishes to provide alternatives to the soundest policies available, one should admonish that such alternatives are inferior political compromises.

Dom Armentano, professor emeritus of economics at the University of Hartford, kindly directed our attention to an editing error: "In printing my letter 'Keep Electricity Free from Antitrust' (last issue) your editing of my first paragraph distorted my criticism of Vernon Smith and my own antitrust views. I do not favor a policy 'under which all parties would be subject to the ordinary antitrust laws.' That is precisely the policy which Smith favors that I am criticizing—as the rest of my letter makes clear. I have been on record since 1972 as favoring the complete abolition of antitrust law. I have not changed my views."