Searching for the True Constitution

Reviewed by Robert A. Levy

THE DELICATE BALANCE: Federalism, Interstate Commerce, and Economic Freedom in the Technological Age
by Adam D. Thierer
(Washington, D.C.: Heritage Foundation, 1998), 249 pages

Since the end of the new Deal, American conservatives and libertarians have railed repeatedly against the ever-growing federal regulatory state, especially as it affects economic liberty. In the process, they have often invoked federalism and the restoration of state power as a means of restraining federal intrusions in the marketplace. But all too often, especially among conservatives, the theory of the matter has been unclear. Is a revived federalism meant simply to give regulatory power to the states? How would that advance the cause of economic liberty? And is Congress supposed to initiate that process—the very Congress that has been aggrandizing its regulatory power for decades? Or are the courts supposed to effect that shift in power? If so, how would that square with the fear of "judicial activism" that has so driven conservative jurisprudence in recent years?

Those are some of the central questions Adam Thierer takes up in his new volume on federalism, interstate commerce, and economic freedom. Although not a lawyer but an economic policy specialist at the conservative Heritage Foundation, Thierer has a keen sense of the role of law—and of the Constitution, in particular—in framing the economic policy debate in America. Thus he begins with the Founders' vision of federalism, then examines nineteenth century commerce clause jurisprudence, the huge change in federal-state relations brought about by the Fourteenth Amendment, and the corrupting influence of the New Deal.

With that as background, Thierer takes up the modern debate with a discussion of two groups with opposing versions of federalism: "broad constructionists," who view the Constitution "not as a constraint on national authority, but rather as an open-ended document from which the federal government can construe numerous powers to carry out a higher 'common good'" (p.3), and "textualists," who are divided in turn into libertarian and conservative camps, about which more in a moment. Finally, Thierer offers his framework for the future, with practical applications in electric power, airlines, telecommunications, financial services, and environmental regulation.

Whether read primarily for its historical backdrop—Thierer includes a valuable appendix summarizing more than 50 key cases, starting with *Calder v. Bull* (1798) and ending with *Printz v. United States* (1997)—its legal analysis, or its public policy recommendations, *The Delicate Balance* is an important contribution to the perpetual debate about the legitimate functions of government.

THE COMMERCE CLAUSE

one such function, authorized by the Constitution's commerce clause, is the power of Congress to "regulate Commerce … among the several states." But what does that mean? Four years ago, following the Republican takeover of Congress for the first time in 40 years, the Supreme Court stepped back into the debate—very tentatively—after having stepped out almost 60 years earlier. In *United States v. Lopez* the Court found that Congress's commerce power is not plenary; it is not a power to regulate anything and everything. In fact, the statute at issue in *Lopez*, enacted by implication under the commerce power, had nothing to do with interstate commerce. Rather, it made it a federal crime to possess a gun near a school. In so acting, the Court said, Congress had overstepped its authority under the Constitution.

Drawing on *Lopez*, Thierer summarizes the three broad categories in which Congress may now regulate under its commerce power: the channels of interstate commerce, persons or things in interstate commerce (even if they are involved in purely intrastate activities), and conduct that "substantially affects" interstate commerce. Yet that regulatory scheme, however crabbed when compared with the Court's open-ended jurisprudence of the past six decades, is vast when contrasted with the framework that James Madison established. According to Madison, the commerce clause "grew out of the abuses of the power by the importing states in taxing the non-importing, and was intended as a negative and preventative provision against injustice among the states themselves,

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rather than as a power to be used for positive purposes of the General Government." Thierer, quite clearly aligning himself with the Madisonian approach, puts the matter this way:

> The Commerce Clause was intended—as its title obviously implies—to protect the free flow of *commerce* among the states; it most assuredly was not intended to be a *prescriptive* tool that social engineers could use to recraft the states in the image of the national government's preference[s]. Thus, the modern reach of the Commerce Clause ... has come to encompass almost every conceivable form of human activity. This sweeping power is without doubt a gross distortion of the Framers' original intent, and deserves no further consideration other than to say that it must be rescinded and the Framers' original concept restored. (p. 5)

Thierer is not exactly mincing words. Moreover, he proposes a concrete program by which those principles can be applied to specific cases. He suggests "three constitutional imperatives, or core values" (p.100) that comport with the federal legislature's power to negate impermissible state regulations: Congress may act under the commerce clause in those instances where a state or local government (1) erects explicitly protectionist barriers, like tariffs or quotas; (2) enacts statutes or regulations that discriminate against out-of-state interests, or (3) attempts to regulate commerce by projecting its lawmaking powers beyond the state's geographical boundaries. Thierer's "imperatives" are indeed helpful—both in understanding what federalism is all about and in the practical, case-by-case implementation of federalist principles.

FEDERALISM TODAY

to see how far our national government has veered from those principles, we need only look at President Clinton's abortive executive order on federalism, which attempted to revoke President Reagan's executive order on the same subject. Both are reprinted as appendices to Thierer's book. Clinton adopts a handful of Reagan's insights: "The people of the States are at liberty, subject only to the limitations of the Constitution itself or in Federal law, to define the moral, political, and legal character of their lives.... Effective public policy is often achieved when there is competition among the several States" (p.43). But as Thierer notes, Clinton's language is camouflage for his expansive federal agenda. Imagine if the following criteria, actually proposed by Clinton, were to superintend the federal government's role in our lives. Federal action is justified, according to the Clinton executive order, whenever:

- Decentralization increases the costs of government, thus imposing additional burdens on the taxpayers.
- States would be reluctant to impose necessary regulations because of fears that regulated business activity will relocate.
- High costs or demands for specialized expertise effectively place the regulatory matter beyond the resources of State authorities. (p.44)

How can these guidelines possibly be squared with the Tenth Amendment's directive that "powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people"? Quite simply, they cannot; but the palpable conflict evidently does not bother the president.

On the other hand, revitalizing the Tenth Amendment is a necessary but not sufficient step toward restoring dual sovereignty. Federalism is not, of course, mere protection of states' rights. "Real federalism," as Michael Greve has written, "is a structural constraint on government." In that sense, federalism should be taken as a two-way check on government power. On one hand, the national government is constitutionally constrained from usurping powers that belong either to the states or to the people. But on the other hand, the national government has an affirmative obligation under the Fourteenth Amendment to see that the states themselves do not violate rights that are constitutionally guaranteed.

That vision of federalism as a two-way check can be identified with a group of constitutionalists that Thierer characterizes as "libertarian textualists," whose central purpose is to limit the power of government at all levels. According to Thierer, libertarian textualists regard "the protection of interstate commerce and individual liberties in general as the preeminent goal of the Founders' federalist system" (p.4)—especially, one might add, after the Fourteenth Amendment was ratified. National and state governments check and thus constrain one another; they do not collaborate to determine the optimal locus of power based simply on administrative efficiency. Conservative textualists, by contrast, stress "the benefits of state and local autonomy, devolution of power, and political decentralization as the primary objective" (p.4). Although the conservatives' approach to federalism ("50 state experiments") offers citizens a certain range of choices—in particular, the choice to move—it does not lead necessarily to economic liberty.

Although Thierer critiques both the libertarian (individual liberty) and the conservative (state sovereignty) camps, his libertarian leanings are evident. Still, as his chosen title, *The Delicate Balance*, suggests, he is reluctant to take a purely principled stand. Too often, pragmatism trumps principle in this book. That is why his synthesis of libertarian and conservative views is more a compromise than a reasoned search for first principles. "The truth lies somewhere between these two extremes," he hedges (p.76).

PUBLIC POLICY RECOMMENDATIONS

to be fair, the delicate balance is certainly not a muddled and murky collection of halfway measures. Thierer devotes considerable space to public policy recommendations that build on his textualist-cum-libertarian foundation. Although he cautions

that the libertarian model of federalism, taken to the extreme, "opens the door to overreach by national legislators and judges" (p.67) and might even "strip state and local governments of all policymaking power" (p.67), he then proposes a rather tight list of police powers that, in his view, state and local authorities can legitimately exercise.

Those powers include emergency health and safety precautions; immunization or quarantine procedures during epidemics; fire hazard regulations; police and law enforcement efforts; public works and construction programs; dam and waterway safety regulations; water quality requirements; environmental, sanitation, and pollution restrictions; and zoning ordinances, historical landmark protection, and land-use policy in general. Not everything in that list falls under the police power, of course. Nonetheless, it is a much smaller list of powers than state and local governments currently enjoy.

THE CASE FOR PRINCIPLED JUDICIAL ACTIVISM

as thierer's book suggests, then, conservative federalism may be moving in a libertarian direction. At a minimum, the book reflects how considerably the debate has changed. Until recently, the great fear of conservatives has been "judicial activism"—the discovery by courts of "rights" never imagined by the Framers. That concern remains—and properly so. Nevertheless, a new recognition has dawned as well: that the failure of judges to intervene can be as destructive of the Constitution as their intervening without authority.

"The Supreme Court should not shy away from its responsibility to safeguard the Founders' federalist model," Thierer observes (p.98). "It is wrong to claim that such actions represent unwarranted judicial activism, since such a judicial role is essential if the constitutional system of checks and balances is to remain intact and effective" (p.98). Coming from a Heritage Foundation fellow, in a book that the proudly conservative foundation has published, Thierer's statement is both revealing and welcome.

In essence, then, Thierer acknowledges that principled judicial activism is an important weapon in the battle to bind federal, state, and local governments with the chains of the Constitution. To do that, of course, judges must be clear about which rights the Constitution does and does not secure. *The Delicate Balance* does not address that question in any depth or detail, but it was not intended to do so. What the book does do, fairly clearly, is lay the foundation and raise the right questions.

Meanwhile, more than a dozen federalism cases have recently been filed at the Supreme Court. Most are not high-profile battles but, as *The New York Times* characterizes them, "day-to-day, bread-and-butter federalism, the federalism not of theory but of practice." The *Times* continues: "The Court has reached a moment of truth, the point at which the Justices will have to distill the loose and sometimes extravagant language of their recent decisions and show what they really mean to do." As that debate unfolds, *The Delicate Balance* should be required reading—not only for judges but for legislators as well.

It may be too much to expect that federal lawmakers will follow the author's advice and confine themselves to the enumerated powers plainly laid out in Article I, section 8, of the Constitution. But if any should wish to do so, Adam Thierer has provided a valuable blueprint for them and for limited government. At the least, he has shown us how far we have strayed from the Framers' design, and how great has been the diminution of our liberty. ■

An Anti-Zoning Warrior's Partial Retreat

Reviewed by Robert H. Nelson

PROPERTY AND FREEDOM: The Constitution, the Courts, and Land-Use Regulation
by Bernard Siegan
(New Brunswick, N.J.: Transaction Publishers, 1997) 291 pages

Bernard siegan is a genuine hero in the wars against the excesses of government regulation. In 1972, Siegan published *Land Use without Zoning*, finding that the one large city in the United States without zoning, Houston, seemed all the better for it. The absence of zoning meant that more land was available for more types of housing, lowering the price of housing in Houston relative to the price of housing in Dallas and other cities. Where residential neighborhoods needed protection from the entry of incompatible uses, the residents were able to achieve such protection in Houston by means of covenants and other private devices.

There had been many strong critics of zoning before Siegan, especially critics of "exclusionary" zoning to keep poor and lower middle class groups out of the suburbs. Virtually all the critics wanted to fix zoning, however. Siegan instead argued, as he put it in 1972, that "it is time that we apply the clear and unmistakable lesson of the past fifty years: zoning has been a failure and should be eliminated" (p.247).

ZONING BY THE COURTS?

siegan has now returned to the subject of zoning with *Property and Freedom*. Perhaps it is the wear and tear of 30 years of struggle but Siegan no longer seeks the abolition of zoning. Instead, he argues now that the courts

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should review zoning case-by-case according to legal standards developed by the Supreme Court in the 1980 *Agins* decision. The Court there upheld the five-acre zoning of the City of Tiburon, California. However, Tiburon's zoning was sustained only after surviving a new, higher degree of judicial scrutiny announced for the first time in *Agins*.

The "*Agins* rules," as Siegan characterizes them, are threefold. First, a zoning or other land-use regulation "must have as its purpose a 'legitimate state interest.'" Second, a zoning authority must be capable of demonstrating that its actions will "substantially advance" that interest. And third, the land-use regulation "must not deny the owner 'economically viable use of his land'" (p.114). Although the strict application of these rules would not abolish zoning, Siegan believes that their full and consistent application would work a virtual revolution in zoning practice in the United States. Many actions that the courts have historically approved under the guidance of the 1926 *Euclid* case—the original Supreme Court decision upholding the basic constitutionality of zoning—would now be invalidated. The overall purpose of *Property and Freedom* is to spread the message of the new legal doctrines being applied by the Supreme Court and the potentially subversive impact that that new thinking could have on traditional practices of land-use regulation in the United States.

A RETURN TO PROPERTY RIGHTS?

after 1928, the supreme court went more than 40 years before it heard another zoning case. The federal courts in effect declared that zoning, as a legislative act, could be given a broad presumption of constitutionality. For Siegan to succeed in his mission, he must now persuade the federal judiciary—and American society will have to go along as well—that the historic laissez faire outlook of the courts has been misconceived. The courts, as Siegan notes, have been vigilant over the past half century in their protections of free speech, rights of assembly, and other individual freedoms such as newly created rights of "privacy." Siegan wants to reinstate property—once the most sacred of rights—to the status of another right actively and regularly defended by the courts.

Although he has a few allies, such as Richard Epstein, Siegan recognizes that many of his potential supporters will wonder why the Warren Court activism was so bad but the new round of judicial activism will be so much better. Siegan at times argues that the courts have no choice; they are morally bound to defend property. Here Siegan is making an old-fashioned natural-law argument. At other places in *Property and Freedom* Siegan relies on a utilitarian or consequentialist argument: the firm defense of property rights will promote a free society that will stimulate greater economic growth and advance general well-being. The courts should return, Siegan argues, to the role they played in earlier times in American history when they routinely applied "due process" standards to curb the unprincipled acts of legislatures, bodies usually dominated by rent-seeking behavior.

Siegan at times goes beyond advocating that course of action to suggest that it is already underway. Since 1987, the Supreme Court has decided a series of five prominent property right cases: *Keystone* (1987), *First Lutheran* (1987), *Nollan* (1987), *Lucas* (1992), and *Dolan* (1994). The net effect, Siegan suggests, is that the Court already has "placed property rights among the liberties to which it accords heightened scrutiny as a protection against arbitrary and capricious legislation" (p.230). Siegan is optimistic that the outcome of "these cases [has] imposed stringent limitations on the powers of government to regulate the use of land" (p.2).

Whether or not Siegan is correct about the evolving legal theory, it is wishful thinking to believe that court actions have thus far led to any major changes in the practice of zoning. Indeed, the passage of "smart growth" legislation in Maryland and other states and strong pressures throughout the United States for tighter growth controls suggest almost the opposite. Even the Supreme Court cases mentioned by Siegan involved rather special circumstances. The Court has not taken a case that posed a basic challenge to large-lot requirements or other elements of zoning as it is practiced across the United States.

A FLAWED STRATEGY

moreover, siegan's brief is that of a lawyer who looks to the legal system to solve the problems of zoning. Although much of Siegan's book is admirable, it may be that his strategy is flawed. His prescription for close judicial oversight could put the federal courts in the position of overseeing the details of land-use regulation in many thousands of communities across the United States. To the extent that zoning reflects broad community goals, judges would be put in the position of making political decisions on behalf of communities. The judiciary understandably is reluctant to accept such a burdensome role that could involve a comprehensive second-guessing of local legislative acts throughout the United States.

The problem for the courts is aggravated because the *Agins* rules recommended by Siegan leave wide latitude for judgment and interpretation. What is a "legitimate state interest" in zoning, what would it take to "substantially advance" that interest, and what would be an "economically viable" use of land? Siegan himself is never really precise. The *Agins* rules are essentially legal weasel-words that paper over the reality that their general acceptance would amount to a wholesale grant of discretionary judicial power. The problem is compounded by the fact that the official legal rationales for zoning often differ significantly from its actual functioning. Like many previous land-use laws, zoning is surrounded by myths and fictions. Siegan exposes some of the popular illusions, such as the idea that planning provides a benchmark for zoning actions "in the public interest." But in other respects even Siegan fails to realize fully the extent of mis-

conceptions about zoning.

Although there is little or nothing in the legal theory of zoning to justify it, zoning in existing neighborhoods has actually amounted to a de facto collective property right to the neighborhood environment. The zoning gives the neighborhood the same power to exclude that a conventional property right gives an individual owner. The segregation by economic class that results from neighborhood zoning is analogous to the segregation by income for other forms of consumption. The rich live in fancy neighborhoods with two-acre lots and drive Mercedes Benzes; the poor live in less-attractive, higher-density neighborhoods and drive old Chevrolets. With zoning, a poor person can no more move into a rich neighborhood than he can drive off with a rich person's Mercedes Benz.

In that way, zoning accomplishes the same purposes that more and more are being accomplished privately by condominium developments, homeowners associations, and other forms of "residential community association."

However, a community association is feasible only when it is created before the fact of community development. Every new purchaser can then be required to become a member of the association. That is not possible in existing neighborhoods. In effect, zoning can be seen as a device by which government power redistributes rights retroactively to form a new neighborhood property-right regime. Failure to understand this central role of zoning could lead courts badly astray.

Siegan also adopts a legalistic understanding of zoning that leads to a questionable diagnosis of the best remedy for municipal zoning of undeveloped land (a circumstance much different from zoning in existing neighborhoods). The reality is that municipalities all over the United States have used zoning to confiscate development rights from owners of undeveloped land. For better or worse, the courts have gone along. That has created a major social problem because it has allowed many municipalities to hold out of development land that could be used to meet important housing requirements.

MARKET-BASED SOLUTIONS

although ethically unfortunate, one economically beneficial practice that has kept the zoning system from breaking down has been bribery of local zoning officials. More recently, municipalities have been spreading cash payments more broadly by requiring that developers pay large impact fees and other exactions to the municipal treasury or to other municipal accounts. In effect, municipalities have been selling the development rights they acquired through zoning.

Those useful practices would be stymied if (which seems unlikely) the Supreme Court's *Nollan* and *Dolan* rulings were widely and strictly applied. (*Nollan* and *Dolan* blocked attempts to impose large municipal exactions where there was insufficient "nexus.") The courts seem to be ending up in about the following position: it was permissible for municipalities to take the development rights of landowners; it would now be wrong for the same municipalities to turn around and try to sell zoning rights. A cynic might say that the courts regard stealing as legal but selling the stolen goods as illegal.

Although Siegan would like to curb the underlying zoning abuses, his proposals are unlikely to achieve that end. In a second-best world, the de facto sale of zoning may therefore be the best we can do. Siegan's legalistic approach poses an obstacle here.

The work of Ronald Coase tells us that the most important thing is to fix firm property rights. If property rights are well-defined, the parties at interest will work out a solution with a minimum of transaction costs. Siegan's proposal for zoning reform would instead leave many property rights in land subject to wide judicial discretion, based on a vague standard sure to vary greatly among judges.

An approach to zoning reform based instead on a Coasian strategy might reflect the following principles:

First, allow the residents of neighborhoods to substitute a collective private property right for zoning in order to privatize zoning of existing neighborhoods. That is, the residents (presumably a supermajority of them) could vote to form their own private residential community association. That association would assume the municipal administrators' task of zoning to maintain the neighborhood's environmental quality.

There are two main options for zoning undeveloped land. Zoning could be abolished outright and the development rights returned to landowners. However, that remedy is almost certainly politically impossible and beyond the power of the courts as well. A more promising approach is to allow the uninhibited sale of zoning, thus making municipal development rights (previously confiscated by zoning) readily available to all sorts of potential purchasers and land uses. The differences between economic and legal ways of thinking about zoning are illustrated by the fact that the open-ended sale of zoning would be directly contrary to the Supreme Court rulings in *Nollan* and *Dolan*, which Siegan endorses so enthusiastically.

IN SUMMARY

property and freedom provides a valuable review of recent court jurisprudence about zoning. As one would expect of Siegan, he offers many trenchant observations with respect to the failings of zoning and the popular illusions that have helped to sustain such a dysfunctional system.

As a strategy for reform, however, *Property and Freedom* falls short. It would prescribe an open-ended judicial review of a wide range of property-rights transactions associated with the zoning system. The legal criteria for determining the acceptability of zoning transactions would be vague and open to wide variations in judicial interpretation.

A better strategy would be to define clearly the holders of property rights in the land market and then let that market work. If municipalities then act as if they own zoning rights, that becomes a problem for legal theory, not a hindrance to the beneficial workings of land-market transactions. ■

Privatizing Public Transportation in the Public Interest

Reviewed by Filip Palda

ALTERNATE ROUTE: Toward Efficient Urban Transportation
by Clifford Winston and Chad Shirley
(Washington, D.C.: Brookings Press, 1998) 120 pages

ROADS IN A MARKET ECONOMY
by Gabriel Roth
(Brookfield, Vt.: Ashgate Publishing Company, 1996) 292 pages

America is a nation in a hurry. Income and employment are accelerating. The shelves of Barnes & Noble groan with books about how the busy executive can save minutes a day. Advice abounds as to how the humblest of us can stop putzing about and start using the lease on life God gave him. Even the president has set an example by showing the nation how to combine work and pleasure in the office. How is it, then, that Americans spend more and more time commuting on congested roads, without complaint, like Russians passively queuing for meat in the bad old days of the hammer and sickle?

It is hard to imagine these as the same Americans who, by the best estimates of transport economists, value the time they spend in rush hours at close to 50 percent of their wages. Maybe the reason for their forbearance is that in the United States, just as in the Soviet Union, users of public roads and transit have not, within living memory, sampled the alternative. Almost no roads in the United States are privately owned, tolls are known mainly by hearsay, and urban bus and rail are the fiefs of public-transportation commissars. U.S capitalism is rolling on a carpet laid in the best socialist traditions.

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THE SOURCE OF THE PROBLEM

how much better things would get if government privatized its roads, charged user fees, and got out of the transit business is the question Clifford Winston and Chad Shirley ask in their remarkable book *Alternate Route: Toward Efficient Urban Transportation.* The theme of the book is that the current routes to managing urban transportation are dead ends. Adding lanes to highways, charging for downtown parking, subsidizing transit, and managing traffic with high-tech monitors and electronic billboards are approaches to congestion that miss the point.

Roads are congested at peak hours because access at peak hours is either free or charged at the same price as non-peak access. We will get the transportation we deserve when transportation services are produced at minimal cost and when the prices for those services reflect their costs and the pressures of congestion. Charging user fees and privatizing roads and transit are the alternate routes to efficient urban transportation.

AN EMPIRICAL APPROACH

had i written this impressive piece I would have chosen the title *The Thirteenth Labor of Hercules.* While others ruminate on the benefits of privatizing urban transportation and charging user fees for city roads, Winston and Shirley set out to quantify the benefits. To get that number they use a database on the largest 116 urban areas in the United States to form an idea of how consumers change their commuting patterns in response to changes in transit fees and commuting times.

Knowing how travelers will react to changes in the cost of travelling allows Winston and Shirley to see how traffic and transit patterns would change if buses, urban rail, and roads charged riders the "marginal cost" of their travels. Marginal cost is jargon for the cost an additional traveler imposes on himself and others in society.

In the case of automobile commuting, the main marginal cost is the delay a driver imposes on his fellows when he zooms off the feeder lane into a budding traffic jam. On untolled city roads the traveler does not worry about slowing down everyone behind him. An optimal toll forces each driver to consider the costs he imposes on others, which encourages intelligent reflection: Do I really need to be on the road during rush hour or could I wait until the evening to go shopping? As drivers answer that question, they sort themselves between the group that really needs to be on the road during peak commuting hours and the group that can wait.

Winston and Shirley do not stop there. They impose a toll road on their model to examine how such a road would affect the demand for bus and rail services. By an iterative process, they determine the optimal congestion-reducing toll and the bus and rail fares associated with that optimum.

Their intellectual exercise is fascinating not just for the glimpse it gives into the ambitious and sophisticated methods of transport economists. It also shows that if governments insist on managing transportation policy they have to take a broad view that recognizes how closely tied to each other are different modes of transportation.

POLICY IMPLICATIONS AND BENEFITS

if i were a government official gazing into this spaghetti bowl of transportation complexity I would reach for the red phone and give the order to privatize the whole thing in a competitive fashion. Running city transport efficiently and charging efficient prices is beyond the knack of central planners. City officials do not

try to coordinate the food supply; they allow an informal network of specialized wholesalers and retailers to sniff out demand and coordinate their efforts through the decentralized workings of the price system.

I suspect that the same wonders could be worked for city transportation, which is the feeling one gets from Winston and Shirley's treatise. In the final chapter of their book they explain how reforms ranging from public ownership of transit (with optimal pricing) to privatizing transit and road and rail fees could bring net benefits to travelers and taxpayers ranging between $10.8 billion a year to $13.9 billion a year. That works out at the high end to roughly $50 per person, per year. Those estimates seem low absolutely and compared with other recent estimates of the value of relieving congestion. But we should keep in mind that these are two economists who are tinkering with computer models to answer the grand what-ifs of transport privatization and user fees.

The best imagination of economists cannot predict the ingenious uses to which entrepreneurs would put a privatized urban transportation network. For example, who can predict the value of assigning curb rights to cab and bus companies? A curb right gives a cab driver the exclusive right to pick up customers at a specific location. The cab owner's bid would depend on his expected long-term returns because ownership of the curb right would encourage its owner to do his utmost to attract clients by building a solid reputation. There is no easy way to predict the value to travelers and entrepreneurs of such innovations, and so it is an understatement to say that Winston and Shirley's estimates are an understatement of the benefits of privatizing city transport.

Even though I sympathize with the authors' conclusions, the final chapter of *Alternate Route* is not likely to win crowds of devotees to the cause of user fees and privatization in urban transport. Important case studies of the benefits of privatization come from abroad, but Winston and Shirley have tucked that information into vast footnotes, as if developments elsewhere were a sideshow. Even though the authors come out strongly in favor of the benefits of a free market, they skip over how to guarantee competition on seemingly monopolistic bus and transit routes.

OVERCOMING INERTIA

where the authors are most original, they also seem to be most timid. Their splendid empirical analysis shows how the greatest improvements in city transportation would come from charging tolls on city roads. But they argue that although tolls and privatization will have to come sometime, the time is not now. They fear that government regulators will set tolls too high. Are they afraid that tolls would be set so high that the situation would be worse than the present lack of tolls? Even tolls set above the optimum are bound to be better than the present free-for-all on streets. Winston and Shirley's empirical model would allow them to calculate by how much a city could exaggerate tolls and still improve the benefits derived from our streets.

Economists cannot predict the ingenious uses to which entrepreneurs would put private urban transportation.

Whether we can attain the benefits of privatization and optimal user fees in city transport is a big question. Winston and Shirley's empirical analysis shows the strong tendency of various layers of government to meddle in the pricing and availability of city transit services. With that tendency comes a powerful resistance to change. Citizens may resist a rational pattern of user fees out of ignorance and fear. In the United States we have few examples of transit privatization and road-user fees to boost our confidence in market-based ways of tackling urban congestion. We also fear that user fees will simply come as an addition to our taxes; it is hard to believe a politician's promise that higher user fees will be offset by lower property taxes.

The public might gain confidence if it could bind politicians with a contract. The strongest contract seems to come from direct democracy. When the people give a direct order, there is little that politicians can do to resist. American cities are stunted in their use of direct democracy because subsidies from higher levels of government give those levels a say in the running of cities.

In spite of the obstacles to reforming urban transportation, I do not share the authors' pessimism that "political forces are sufficiently powerful to prevent society from realizing the benefits of a more efficient urban transportation system, so that it is fruitless for economists to advocate efficient solutions to improve these systems" (p.19).

CAUSE FOR OPTIMISM

my optimism comes in part from reading *Roads in a Market Economy* by Gabriel Roth, a good complement to *Alternate Route*. Roth's book is a treasure chest of examples that show how road privatization and user fees can be put into practice. I was surprised to learn from Roth that from the mid-seventeenth century to the nineteenth century the United States and the United Kingdom relied heavily on private firms to build roads (put that down to my public school education). In the UK of the 1830s, 1,116 turnpike trusts maintained 22,000 miles of roads. The cost of the 10,000 miles of privately built roads in the United States of 1845 was, relative to the size of the economy, greater than the public's entire investment in the interstate highway system since the Second World War.

Although the federal government took charge of road construction in the

twentieth century, its hegemony ended in 1991 with the passage of the Intermodal Surface Transportation Efficiency Act (istea)—a dubious piece of work that funds up to 50 percent of private road construction costs. But istea is a step in the right direction because it encourages states to pass laws allowing the private sector to provide roads. That we need the states to pass such laws shows the sorry state to which private road building has sunk since the middle of the last century.

One of the first private roads built under istea is California route 91, which carries 200,000 passengers in and out of Los Angeles every weekday. Route 91 is reputedly the only road in the world with a variable toll designed to maintain a free flow of traffic. Rich and poor alike enjoy the opportunity to pay for the convenience or necessity of fast travel.

Roads in a Market Economy describes in detail how an electronic system for billing cars on city streets would work. Particularly interesting is the example of Singapore, which has been charging congestion tolls since 1975 and has succeeded in beating congestion while other Asian cities grind to a halt in the confusion of rush hour traffic. Since the book was published in 1996, electronic road pricing has taken off in several other cities. Trondheim, Norway, now has a ring of tollbooths around its center that helps keep the downtown core functional. In Toronto, a private-public partnership built Highway 407, which is at the forefront of electronic billing technology in its ability to bill occasional users and deter violators.

On finishing *Alternate Route* and *Roads in a Market Economy* I felt like an explorer who has just straddled the last mountain ridge before Shangri-La and gazes into the fruitful valley below, not knowing whether his legs will carry him to the promised land, whether the natives will accept him, or whether the paradise will be to his liking. Privatization and user fees offer tantalizing solutions to America's transportation problems. These two books give their readers the taste to explore those solutions. ■

The Insider's Upside-Down View of Deregulation

Reviewed by Richard L. Gordon

DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: The Competitive Transformation of Network Industries in the United States
by J. Gregory Sidak and Daniel F. Spulber.
(New York: Cambridge University Press, 1997) 631 pages

The decisions to restructure by regulatory fiat first telecommunications and then electric power have produced enormous problems and acrimonious debates. The more persistent and visible debate thus far is in telecommunications. The baby Bells continuously battle long-distance carriers and television cable services over how much each may expand its operations.

As usual in such debates, an army of noted economists has been enlisted to serve the contesting firms. Some, notably the consultants for the baby Bells, have moved from testimony to publications that are more accessible to people outside the debate. The Sidak and Spulber book is an example of the latter. The authors' ambitious goals are both to inform policymakers and to provide principles of interest to scholars.

Although the book makes many interesting points, it fails to meet its goals. The authors show awareness of all the critical issues but fail adequately to integrate their insights. Indeed, the impression that the book produces is of a report by and for insiders in the debate.

The book has at least three themes. First, imposed restructuring adds to, rather than reduces, restraints on competitors, particularly existing utilities. Second, allowing existing utilities to recover the "stranded" costs of investments devalued by restructuring is legally and economically essential. Third, an optimal method of cost recovery can be defined and readily implemented. The first theme is the most interesting and most convincingly presented. Unfortunately, the authors quickly drop the argument to deal massively with the other two themes and then make further observations in the last two chapters.

To their credit, the authors actually describe managed competition as "that Orwellian oxymoron" (p. 545). However, the development of that point is depressingly timid, a characteristic of many books in regulatory economics. Worse, much of the other material in the book seems to ignore the error of continuing to regulate utilities. The kindest thing that can be said is that the book contains a brief, admirable discussion of the folly of managed restructuring that is buried by unconvincing arguments on the other two themes.

The discussion of regulatorily imposed inefficiencies is followed by a much more massive initial treatment of the justification for cost recovery. After a five-chapter pause to present and defend their method of attaining cost recovery, the authors devote two more chapters to the desirability of cost recovery, regulatorily imposed inefficiencies, and a few other matters.

WHY REGULATE AT ALL?

sidak and spulber's discussion of regulatorily created burdens starts with the assumptions that the cross-subsidy of local household service must be retained and that the burden of Internet access for schools must be added. Even more critical for their subsequent arguments, they spend a chapter decrying the severe restrictions placed on the entry of the baby Bells into long-distance service. Among their arguments is that new

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technology has eliminated the natural monopoly in local service.

If they believed the last assertion, they would have radically altered their analysis. Managed competition should be considered at most an evil whose harm should be minimized and more properly a curse to exorcise. Without natural monopoly, the pricing method they propose is unneeded under true deregulation or managed competition.

The book is full of complaints about bad policy decisions, but following a hallowed tradition, it avoids the logical conclusion that the defect is inherent in regulated markets. (The book cites but ignores Posner's classic 1969 demonstration of the defects of regulation.)

The authors' treatment of "libertarian" objections is another bizarre component of the book. Rather than respond to the cogent libertarian arguments in the 1996 issues of *Regulation*, they develop (p. 442-3) their interpretation of the case presented to them by "a prominent libertarian economist" who is unnamed because his comments have never been published.

The essence of the unnamed economist's argument is that breach of the implicit regulatory contract is desirable because it will discourage future faith in government. Sidak and Spulber attack the case as "utopian" (a much less negative characterization than appropriate), unheedful of residual regulation (again illustrating their confusion), and undemocratic. They ignore the main weakness of the "libertarian" argument; that is, the cultural and political pressure to protect individuals and businesses from risks of all kinds is so strong that government regulation is pursued even though many recognize that that government is inherently untrustworthy.

STRANDED COST RECOVERY IS LEGALLY DEFENSIBLE?

the authors' defense of compensation has both legal and economic bases. From the legal viewpoint, Sidak and Spulber argue that there is ample evidence that the courts have long believed in an implicit contract between public utilities and the state, a contract that implies the need to compensate utilities for regulatorily imposed but not market-created losses. The economic argument is that failure to compensate will discourage future investments in electricity and other markets affected by regulatory change.

Sidak and Spulber's fatal mistake, however, is to apply the concept of contract to relationships with the state. The state is not an ongoing business that has revenues available to meet its regulatory contractual commitments. The regulatory "contract" is in fact an understanding that taxpayers will bail out regulated firms when government breaches the "contract." Reflecting Coase's classic argument that political practicality dictates that deficits of decreasing-cost industries be covered by charges on individuals as consumers rather than as taxpayers, Sidak and Spulber call for consumer rather than taxpayer charges.

> Sidak and Spulber's fatal mistake is to apply the concept of contract to relationships with the state.

Given that the United States has deregulated many sectors of the economy, such as trucking and airlines, without compensating incumbent firms for their subsequent wealth losses, why should telecom and electricity be treated differently? Sidak and Spulber's attempt to defend special treatment for electricity and telecommunications largely ignores most of the criticisms that have been leveled at their argument, and even their own qualifications of the argument.

There is an important line of argument that the regulatory contract was broken long ago and that the resulting wealth losses have already been capitalized in prices of the stocks of the relevant companies. The book has a chapter whose title ("Deregulatory Takings and Efficient Capital Markets") and content indicate the authors' failure to grasp that argument. The chapter mainly restates the theoretical case for compensation and mentions only one relevant empirical study. Sidak and Spulber drop hints that they recognize the objections to compensation, but they do not develop those objections.

A second criticism of the Sidak-Spulber argument is that many of the cost burdens for which the utilities want compensation arise from unsound practices imposed by regulators. Eliminating unwise regulations removes the need for special assistance. However, the treatment of regulatorily imposed inefficiencies by Sidak and Spulber is largely unconnected to their discussion of compensation. Thus they fail to consider the extent to which regulatory relief would lessen the need for compensation.

That oversight is especially notable for the sector they emphasize: telecommunications. The only wealth loss in that sector that is not the result of bad regulation stems from capacity idled by new competition. However, the Sidak-Spulber principle of not compensating for losses that result from market forces would seem to argue against recovery of displaced capital because, in the absence of bad regulation, capacity could be displaced only if it were uneconomic.

A third criticism of the Sidak-Spulber plan is that the market limits the amount of cost recovery. Cost recovery depends on extracting monopoly rents, which are finite. And the limits to feasible cost recovery are glimpsed only fleetingly in the book.

Fourth, even if an industry possesses assets that can recover stranded costs, that may not true for a particular company. If, for example, the basis for cost recovery in the electric power industry is transmission capacity but nuclear plants are the source of stranded costs, companies with large

nuclear plants might not own large amounts of transmission capacity.

Fifth, effective cost recovery requires overcoming the same drawbacks of regulation that necessitate reform. Regulators must measure the unrecovered investments and predict the incomes that would be earned without special measures. Failures in cost accounting and prediction are major sources of the crisis in regulation.

OPTIMAL COST RECOVERY

although, in general, sidak and Spulber's review of the rationale for cost recovery is merely incomplete, their treatment of an allegedly ideal method for cost recovery seems a failure. The development starts with an unclear exposition of their basic principle, then presents a modification overlooked by the Federal Communications Commission in its response to market changes in asset values. The authors then "answer their critics" by citing the many prominent economists who agree in whole or part with their proposal. Sidak and Spulber return to the pricing issue with a chapter arguing that their rule is superior to a long-run marginal cost rule.

A large part of their discussion (three chapters) faults the Federal Power Commission for misunderstanding the Sidak-Spulber proposal. They neglect the possibility that misunderstanding may arise because of inherent problems with their concept. Similarly, Sidak and Spulber fail to sense that abandoning managed competition may be more feasible than getting a regulator to set efficient prices.

Even more disconcerting is the authors' review of attacks by—and apparent support of—many distinguished economists. Many economists completely reject Sidak and Spulber's pricing method. Other economists who are sympathetic in principle object to the formula proposed by Sidak and Spulber. The most salient case of the second type of objection is that of Baumol, Ordover, and Willig. Baumol and Willig are credited with originating the concepts advocated by Sidak and Spulber. (Baumol collaborated with Sidak on earlier work.) Nevertheless, Baumol, Ordover, and Willig are listed as disputing the applicability of Sidak and Spulber's approach to at least one case.

Sidak and Spulber try to dismiss Baumol, Ordover, and Willig's objections as a matter of confusion about the facts of the case. That defense should be taken as a warning that the authors' proposed method of cost recovery is far less feasible than they claim.

Sidak and Spulber criticize marginal-cost pricing because it would not allow utilities to recover "stranded costs." Given the idiosyncratic nature of their commentary, it takes much familiarity with the prior literature, several readings of the Sidak-Spulber critique, and some inferences to guess at Sidak and Spulber's argument.

Yes, if natural monopolies price at marginal cost, they will not produce enough revenue to cover total costs. However, economists have devised alternatives to marginal-cost pricing under such circumstances, and explicit recognition of those alternatives would remind the reader of their purposes, which are to allow a natural monopoly to avoid bankruptcy and yet price its products efficiently. Although Sidak and Spulber argue that natural monopoly is absent in telecommunications, their exposition suggests that they want it both ways. They offer a vision of both the absence of natural monopoly and the problems of recovering common costs. Presumably they mean to imply that economies of scale in each product are exhausted but that economies of scope (i.e., of combining different activities into one firm) are not. However, they do not state, let alone defend, that proposition.

Instead of directly confronting pricing issues, Sidak and Spulber introduce, modify, and defend a rule to solve the cost-recovery problem that they assume to exist. The rule is to price services at the sum of incremental and opportunity costs, where opportunity costs are a pro-rata share of stranded costs. The initial analysis of the rule departs radically from conventional economic principles, and Sidak and Spulber's full exposition only belatedly and incompletely resolves the problem. In their initial presentation (p. 287), as elsewhere, they offer as a "marginal" rule the total efficiency rule that revenues must cover costs. In contrast, the many efficient-price discussions in the literature worry about efficiency at the margin as well as on the whole.

As the authors' own citations make clear, opportunity cost is normally considered part of a broad definition of marginal or incremental cost, not an addition to marginal cost. That is, in modern economic theory, the concept of marginal cost includes the cost of sacrificing alternative uses of the input. In a reply (p. 360) to their critics on that point, Sidak and Spulber create the impression that they are only defining a measure of required total payments and leaving open the question of how the service is priced. They say that their critics are attacking constant prices per unit sold and that the Sidak-Spulber method allows the use of charges independent of purchases to recover fixed costs. But they never address the problems inherent in designing a set of charges to a heterogeneous set of customers. In any event, even if their concept is sound in principle, it seems too difficult to implement.

Four years ago at a Cato conference, I argued that true deregulation was preferable to an imposed restructuring of electric power. Cato chairman William Niskanen, whom Sidak and Spulber cursorily cite, presented the related position that a policy without either cost recovery or forced access was preferable to access with cost recovery. A major basis for my argument was the insight that regulators could not design a satisfactory cost-recovery program. As I have noted, there is evidence for that insight buried in Sidak and Spulber's book. Unfortunately, they largely ignore its policy implications. ■