

The Citizen and the Government Panel
By Dr. Mason Gaffney, et al.

Article citation:
Gaffney, Mason, et al. "The Citizen and the Government Panel." American Society for Public Administration, Washington DC, 27 October 1972.

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Transcript of Proceedings

NATIONAL CAPITAL AREA CHAPTER

AMERICAN SOCIETY FOR PUBLIC ADMINISTRATION

THE CITIZEN AND THE GOVERNMENT

PANEL 7-C

GOVERNMENT AS A SOURCE OF INFLATION

Washington, D. C.
Friday, 27 October 1972

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Official Reporters

415 Second Street, N.E.
Washington, D. C. 20002

Telephone:
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New York Room
Statler Hilton Hotel
Washington, D. C.
Friday, October 27, 1972

The panel was convened at 10:25 a.m., by Mr. Bert Lewis.

PANEL MEMBERS PRESENT:

Charles E. Olson, Chairman

David D. Martin

William H. Melody

Mason Gaffney

Mark S. Massel

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PROCEEDINGS

MR. LEWIS: Good morning.

Before introducing Dr. Charles Olson to you this morning, I thought that I would simply highlight a few points that were made in yesterday's two panels.

Believe it or not, the whole track consisting of the eight panels was supposed to have some logical sequence to it, and so far it has been borne out.

I think in the morning panel yesterday on the appraisal of the stabilization program, many of you were here, but again I pick out several points that were made, not necessarily all in agreement with each other. But that the rate of inflation had decelerated in the last year. The rate of wage increase had decelerated in the last year. Real earnings certainly had increased over the last year in contrast to the past 5 years when they were relatively stable or actually declined.

And at least several of the panelists yesterday seemed to agree that controls in some form should be continued beyond this year. And a rationale that I derived from the discussion was that if for no other reason it should be done because this permits a more expansionary demand management policy which would permit lower rates of unemployment.

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The second panel yesterday on inflation and

unemployment was one where we got considerably less closure in that panel than we did in the first. However, the dilemma of the tradeoff between inflation and unemployment was clearly laid out on the table.

I think it was also clearly laid out that in modern industrialized societies, not just the United States but in many others, that it has not been possible to have low rates of inflation together with low rates of unemployment, and economists at least on that panel were really not able to come out with the precise reasons, but certainly a lot of structural causes were thrown on the table.

It was pointed out that the United States and Canada in particular had the worst tradeoffs between inflation and unemployment.

George Perry did go into a fairly lucid explanation of the structural changes in the labor market over the last 10 years or so with the shift to more women and youth which make up relative shares of the unemployment.

So today on the panel, Government as a Source of Inflation, this fits right in with some of the structural things that were only touched upon yesterday. And there are some people at least who believe that the unfavorable tradeoff between inflation and unemployment at least has something to do with structural problems, and many of these people think that government has something to do with those causes.

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This panel was thrown in to explore that. So we have another distinguished panel for you this morning, chaired by Dr. Charles Olson, who is professor of business administration at the University of Maryland. He received his Ph. D. at the University of Wisconsin. And, in addition, he has been a consultant to the Postal Rate Commission, the Price Commission, and several States and some environmental groups. His interest is public utility regulation.

So I turn it over to you.

DR. OLSON: One thing you can certainly count on with a panel of practicing economists is that they are going to be late. (Laughter) I guess this one was no exception.

MR. GAFFNEY: Oh, come on. (Laughter)

DR. OLSON: I must admit some of the panelists were on time.

Government can have a substantial impact on the amount and extent of inflation. It certainly is obvious that fiscal and monetary policies are of importance regarding govwrnment impact. But, in addition, there are at least eight other sources or ways in which the government can influence inflation through its action or its inaction, and briefly they are as follows:

First, government has an influence over the supply of certain factors of production, so policies relating to

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import and export quotas, manpower programs, safety legislation especially in the mining area, and government-sponsored R & D are important.

Secondly, government can have an influence over the prices of certain factors of production as well. Important areas here include minimum wage and other labor legislation, user charges, and special taxes.

Thirdly, government may have control over the way products are produced. Here polution control and reliability of supply may be important.

Fourthly, government may influence the output levels of certain industries. Agriculture, mining, petroleum are important here.

Fifthly, there may be government control over product standards in certain industries. Safety and quality are of importance here.

Sixthly, government certainly has an influence over market structure and conduct in various industries. Antitrust policies, direct price controls, and the possibility of government ownership are important here.

In addition, policies here may have an impact upon the efficiency with which certain firms produce and market their goods and services.

Seventhly, the government may have an influence in the procurement of goods and services by the public

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sector.

And, finally, government certainly has an influence in the way in which inflation is measured -- that is, in the construction of price indices.

So there are at least eight means beyond fiscal and monetary policies in which the government may through its action or inaction influence the extent and type of inflation that may exist at any time.

Certainly this panel will not be able in approximately 2 hours to cover all of these topics, but some of the more important topics will be covered by the speakers and the discussant.

I believe we have four very well qualified and able speakers that will effectively deal with the majority of these subject areas.

On my left is Dr. David Dale Martin who is Chief Economist, Senate Subcommittee on Antitrust and Monopoly, who is on leave from Indiana University's School of Business. He received his Ph.D. in economics from UCLA and in the interim has held temporary positions with the Antitrust Division of the Federal Trade Commission and the Cabinet Committee on Price Stability in the Departments of Commerce and Labor.

On my immediate left is Dr. William Melody, Associate Professor of Communications and Economics at the

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Annenburg School of Communications, University of Pennsylvania. Dr. Melody received his Ph.D. from the University of Nebraska, was assistant professor at the University of Iowa, then joined the Common Carrier Bureau of the Federal Communications Commission and about 2 years ago joined the University of Pennsylvania faculty.

He has consulted and written extensively in the area of public utility economics and regulation.

On my right is Dr. Mason Gaffney, economist with Resources for the Future. He wouldn't tell me a great deal more than that other than the fact that he was born in White Plains, New York, and Dr. Martin characterized him as being part of the "Eastern establishment." (Laughter)

Then on my right is Mark S. Massel, currently retired but not really retired. It has been 4 years since he left the senior staff of the Brookings Institution where he worked for 10 years from 1958 to 1968. He received both a J.D. and a master's degree in economics from New York University.

Formerly he was a partner in the law firm of Bell, Boyd, Marshall and Lloyd and was also associated with the National Industrial Recovery Board and the National Planning Association.

He has written extensively in the areas of law and economics and is and has currently been working on a book to

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be entitled "Public Interest Accounting."

I plan to give the panel members 20 to 25 minutes each on their respective topics, the discussant 20 to 25 minutes to discuss each of these papers, then each of the panelists another 5 minutes for comments, rebuttal, whatever they feel is necessary, and then there should be approximately 20 minutes to half an hour for questions.

As far as the presentations, I will again start on the left and work toward the right. The first paper will be Dr. Martin's on antitrust and inflation.

DR. MARTIN: Thank you, Mr. Olson.

Before I talk about antitrust, I'd like to say a word or two about inflation to give you some notion of my conception of the problem.

Inflation means to me year-to-year increase in prices in general. It is measured by some average, some weighted average, of particular prices, some chosen set of particular prices.

The sources or causes of inflation I think means anything that if taken away or changed, other things equal, would eliminate the year-to-year increase in that average price.

Now, the distribution of income, distribution of wealth, and the distribution of power in the society are much involved with our concepts and discussions of sources of

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inflation. We would each like those sources in which we have an interest to be among the other things held the same, while others make changes sufficient to stop the year-to-year increase in the price level.

We don't talk too much about this conflict of interest. It's not true that everybody is hurt by inflation and everybody has a common interest in stopping it. There is a great deal of conflict of interest. Everybody wants the prices of the things he sells to go up and the prices of the things he buys to go down. But what we are really talking about is conflict resolution mechanism.

Government is the only source of inflation in the sense that the government might take action to affect all the other sources and to change this conflict resolution mechanism. That is essentially what the government is all about.

My concern is with one particular aspect of government policy, that which determines market structure. Market structure I think is very important to the problem if you define inflation the way I have defined it, because inflation results from changes in particular prices, and therefore particular market structures are crucial to what is happening to particular prices.

Stability in particular prices from year to year is certainly not desirable. This is a crucial point. Some

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prices should go up to reflect increased scarcity and thus to properly motivate scarcity-reducing economic activity -- that is, entry into markets, discovery of new techniques of production, discovery of new ways of satisfying the same wants, discovery of new resources.

If some prices should go up, then other prices must go down if inflation is to be avoided. Inflation is caused as much by prices that fail to fall as it is by prices that rise. I think that is a simple proposition that follows logically from my definition of inflation. And yet it is one that is not dealt with at all by the Price Commission and the current price control mechanism.

The assumption is we want to stabilize all prices, particular prices, let those go up where there is justification, not push any down, let the market push those down where the market might if it will. And there is no reason in the world to suppose that that is going to result in prices going down enough to compensate for other prices going up and give us price stability.

Now, that's my major point I think about the nature of inflation. We must be concerned with the prices that don't go down as much as we are with the prices that rise.

My second major point is that particular employment decisions are necessarily intertwined with the inflation

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problem. Each employer who cuts employment, lays off workers, is usually laying off workers as an alternative to cutting prices. And, conversely, the raising of prices is an alternative to raising production and employment.

What I am suggesting here is that the tradeoff between aggregate inflation and unemployment down on the particular market level has to do with the tradeoff in the minds of the managers as to whether in the face of changes in demand they respond with a price or an output or some combination rather than some other combination of price and output reaction.

Particular employment decisions aggregate to an overall employment and unemployment state of the economy that quite rightly affects government policy -- aggregate demand-managing policy, that is, monetary and fiscal measures, and, roundabout again, affects the particular pricing.

The aggregate of the particular price/output decisions gives an aggregate result that the government reacts to with monetary and fiscal policy which in turn again affects particular markets.

And we get this going on and on and on in a continuing system.

Put another way, one employer's decision to lay off workers causes other employers to raise prices.

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My logic there is that any time one employer makes let's just suppose an arbitrary decision, "I'll lay off workers and hold up my price rather than drop it, let my price drop, and continue to employ my workers" -- in other words, he decides to react to his forecasts of market conditions with holding up the price and dropping employment -- what does that do? It raises other firms' prices. Because it creates a need for aggregate demand measures to step up total spending in the economy, which in turn raises demands in all other particular markets, with the multiplier Keynesian effect that we are all familiar with, and that in turn results in other firms being faced with conditions that are likely to result in them increasing price.

Hopefully, the aggregate of prices would stay the same and they would increase employment and we would get a transfer of the employment from one firm over to another firm, but the way that process normally works, unless we have perfectly competitive markets, is that when one employer decides to lay off workers because he has the power to decide which reaction to make -- he has got monopoly power -- the consequence of that is a price effect some place else in competitive markets.

That's why you can't look at statistics on price increases in more competitive markets and more monopoly markets and say, "Look, the monopoly sectors aren't causing

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inflation."

You can't do that by just looking at the price increases. You have got to look at the prices that didn't fall and the unemployment that did fall, or, more precisely, the unemployment that didn't increase, that should have increased in terms of the general growth in the economy.

Well, one could get at this problem by getting the government out of that chain of causal forces. That is, the government could cease to attempt to regulate aggregate demand so as to sustain total employment. Many economists today seem to be advocating that course.

It's rather strange, if you think about it, in view of the Keynesian revolution, 25 years of discovering we can avoid depressions and so forth. But the advocacy of that course of abandoning the effort to maintain full employment, the abandonment of the policy embodied in the 1946 Employment Act, is disguised by the neat trick of calling full whatever employment level results from price stability.

You bring about price stability with restrictive monetary and fiscal policies, and then you accept the level of aggregate employment that results as full employment, and you attribute all other unemployment to imperfections in the market -- that at least can't be managed. We can't do anything about it at least within the next 4 years.

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And you postpone into some great future. "Demographic changes will take care of it. We'll get the women back in their place and we'll quit being uppity after we get over this little bit of women's lib efforts and that kind of thing, and then we'll cope with that problem."

But there is a strong move in the economics profession these days toward abandoning the 1946 Employment Act policy and replacing it with a policy that we will manage aggregate demand so as to create price stability and we'll define away whatever unemployment comes along to go with that.

To summarize my argument about the nature of inflation, inflation is caused by particular prices going up more than they should or going down less than they should or going up instead of going down when they ought to be going down.

Each price ought to change through time to reflect changes in relative scarcities of goods, services, and their underlying resources.

Employment changes are an alternative to price changes on the level of the particular firm as well as in the aggregate. Inflation results from full employment monetary and fiscal policies because particular markets are structured so as to allow employment rather than price to drop when demand falls and price rather than employment to

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rise when demand rises.

If the government does nothing to change the structure of particular markets, it must adjust aggregate demand through monetary and fiscal policy so as to get either inflation or underemployment or some of both.

Now, the easy way out is to take a little bit of inflation and some unemployment and define the unemployment out of existence somehow or another as frictional or structural or something that has to do with the behavior of workers rather than business firms.

The government today contributes to the inflation by tolerating market structures in which artificial scarcity is created and perpetuated. Artificial scarcity is that scarcity that results from decisions of firms to take advantage of the demand for the product they have control over to raise prices and profits rather than employment.

Now, that part of it is reasonably well dealt with possibly by price control, decision through time as technology changes, as relative scarcity of inputs changes, as supply changes to respond with prices stable rather than dropping.

But not only is government guilty by omission. The government has itself been the instrument through which such market structures were created. This is what I really

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want to stress.

I want to talk about two specific examples that I think are not just little examples but crucially important examples.

We aren't just talking about what has happened to inflation in the last year. I want to look at it from a little longer run standpoint.

The two examples I will talk about briefly are the role of the government of New Jersey between 1886 and 1893 in creating the problem we face today and the role of the Department of State in 1968 and again last year in negotiating this international steel cartel.

Now, first, the New Jersey legislative action. Just because it has been 80 years since it happened doesn't mean it's unimportant.

Prices in general declined during the 19th century. Except for a few wartime interludes in which the price level climbed and then came back down -- and it came back down in those days -- we had a century of deflation.

The Warren and Pearson Wholesale Price Index for all commodities which runs from back in the 18th century up to 1890 dropped between 1800 and 1890 from 129 to 82 -- on a 1910-14 base of 100. It dropped from 129 to 82 between 1800 and 1890. That is a general index of

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wholesale prices.

Can you imagine a hundred years of declining wholesale prices coupled with amazing industrialization, population increase, and economic growth in the aggregate and per capita? Booming economy. Successful industrialization.

All of that took place in a period in which the price level was declining.

The big political problem that resulted in the Greenback Party, for example, was the problem of deflation, declining price level. Some people were hurt by that. It affects the distribution of income and the distribution of wealth and the distribution of power.

Well, it was not just that that was an agricultural economy and that agriculture is different from modern industrial societies. No modern industrial society, Mr. Lewis reports from yesterday's session, is without this problem. No modern industrial society is without cartelization of markets, without giant firms, without all sorts of devices to prevent a free competitive market system from functioning.

When you say "modern industrial society," you are loading the whole question, in a way, by sort of implying that industry, something good, technology, something good, brings on this problem rather than people and their laws.

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It was not just the agricultural character of the economy that accounted for the downward price level trend in the 19th century. Farm product prices it is true dropped to 99 between 1871 and 1890. Food prices dropped from 157 in 1800 to 86 in 1890. Fuel and lighting dropped from 159 to 72. Chemicals and drugs dropped from 427 to 90. Metal products dropped from 322 to 123.

What was happening was the improvements in productivity were being passed on to the people at large through price reductions rather than through income increases.

And I say income, not just labor, because they are being passed on today not just in income increases to workers but in salary increases to executives and capital gains to property owners.

That index ends with 1890. The BLS WPI picks up with a figure of 56.2 for 1890 on a 1926 base. That index reached a low of 46.5 in 1896. 1896 was the low point.

Can you think of any great technological innovations that occurred in 1896? Any great transfer or transformation into modern industrial technology? Is that what happened in 1896?

No, that's not what happened in 1896. What happened was that in 1895 the Supreme Court decided the

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E. C. Knight case which said it's unconstitutional for the Federal Government to interfere with what the State legislature does with regard to concentration of economic power in the whole world.

That's what the E. C. Knight case said in 1895. And there was a great dissenting opinion by John Marshall Harlan who also dissented in Plessy v. Ferguson, the grandfather of the more recent John Marshall Harlan.

E. C. Knight case was the first major decision under the Sherman Act, and it decided that the Sherman Act was an ineffectual effort by the Federal Government to undo what was being done by the State government of New Jersey.

What did New Jersey do?

People think that modern great big, giant corporations somehow or another resulted from technology. They didn't result from technology. They resulted from members of the legislature of the State of New Jersey acquiescing in the efforts of the business interests to get them to change the law, and they changed it.

They changed it several dozen times between 1888 and 1893 in crucial ways. And our inflation problem began at that point. From 1895-96 on up, we have been trending up. Before that we were trending down.

Something happened. What happened was a revolution

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in the structure of control of the particular markets of the economy.

Between 1886 and 1895 we had a large number of changes in the statutes, most of them concentrated between 1888 and 1893. The Sherman Act meantime was passed in 1890, but it was completely counteracted by what the legislature was doing before and after.

I will briefly describe a few of these changes which made possible the forthcoming turn-of-the-century revolution in the structure of the Nation's markets.

Most of the big corporations we know today were created between 1896 and 1904 except General Motors which was created in 1908.

First, there were changes enabling world-wide operation by New Jersey-chartered corporations. In 1889 the legislature changed the law by saying:

"Any company may carry on part of its business out of State and have one or more offices or places of business out of this State and may hold, purchase and convey real and personal property out of this State the same as if such real and personal property were situated in the State of New Jersey."

Now, think about that. Did it ever occur to you that it took an act of the legislature, the people's representatives in assembly, to make it possible for

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Standard Oil to own property outside of New Jersey? It did. And presumably they bore a burden of proving that it was in the public interest.

In 1892 the floodgates were opened wide. The legislature said that:

"It shall be lawful for any corporation of this State to carry on and conduct its business outside the State of New Jersey although not provided for in the act or certificate of incorporation."

They made it retroactive to all corporations ever created by the State of New Jersey.

In 1892, two days later, the statute was changed to say:

"It shall not hereafter be necessary for more than one director of any company, corporation or association incorporated under the laws of this State by special or general act to reside in New Jersey."

In other words, New Jersey was creating the multi-national corporation.

A second change legalized merger -- a whole set of changes.

The law was changed in 1888 to say that:

"It shall and may be lawful for corporations of this State for the improvement and sale of lands and construction, maintenance and operation of hotels," etc., "to

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consolidate and merge such companies."

In 1893 the door was opened wide with a more general statement that:

"Any two or more corporations organized under any law of this State for the purpose of carrying on any kind of business of the same or similar nature may merge or consolidate such corporations into a single corporation, which may be either one of the said merging or consolidating corporations or a new corporation."

They did it in little "itty bitty" steps, one right after another, over a period of 4 or 5 years. It all added up to removing centuries of public policy that were aiming toward decentralized market system of economic control.

But that was not enough. It wasn't just enough to legalize it. You had to give them the money-creating power to really bring about the revolution. And the money-creating power was given.

Early corporate law amounted to a 100 percent reserve requirement. Capital had to be saved or raised from individuals who were saving in order to expand a firm, and increased capitalization had been authorized by the people's legislature.

But the money-creating powers were granted by the legislature of New Jersey in 1886:

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"Any company shall have power to increase the amount of its capital stock and any additional capital stock shall be paid for in cash or shall be issued in payment for land and other property."

When a corporation today wants to acquire another corporation, it doesn't have to raise capital for that purpose. It prints it up. Brand new money.

You say, "Ah, stocks aren't money." Well, they'll buy you the Philco Corporation if you're fortunate. That's pretty good. I'll take that kind of money. I'll take common stock in payment any time. Common stock is essentially money, and it can be created by corporations. It doesn't get counted by the Federal Reserve Board. But that's a big part of our problem.

Well, my point is that we through positive government action delegated power to the corporate managers to manage the economy on a highly centralized basis, and they do not choose to manage it so as to bring about pull employment and price stability.

Sure, they'd like to see that. They'd like to have other people bear the burden.

That's at the root of the problem. Not labor unions.

Just one word about the steel cartel. All those years from 1904 when the Supreme Court reversed itself and

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said the Sherman Act is constitutional, can be applied to a New Jersey-chartered corporation, in the Northern Securities case which involved merger of two railroads that the ICC allowed to merge -- when was it? -- in the last year-- In 1904 we got some life in the Sherman Act, but by then it was too late. We had already revolutionized the structure of controlling of the economy, and we have been grappling with that problem ever since.

There has not been a single year any time since 1896 in which we had both full employment and price stability except one or two years as we were running by on our way to one or two other great problems and had direct controls temporarily working, such as in World War II or in the Korean war.

The problem has been with us from that time, and it stems from the fact that inflation is the result, aggregate result, of particular markets, and in particular markets we have granted the power to manipulate the prices and the output level so as to serve the best interests of the corporations.

The steel cartel negotiated by the State Department in 1968 and renewed in much more detail this year is a very, very good example of the government stepping in and furthering the interest of a small group of corporations that want to protect their markets from

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competition. It is a radical change in policy for the Federal Government. At least it is if you assume we haven't been so hypocritical all along as to have been espousing competition but really promoting cartelization.

I think there has been a fundamental change. I think we are on the verge of abandoning the antitrust policy, going to the sort of economic organization that Mussolini brought to Italy in 1922 and which Hitler brought to Germany. And we're about to get it.

I'm not talking about killing Jews in gas chambers. I'm talking about managing the economy out of the central government with a planned system that is planned to work in the interest of the propertied people and the wealthy people.

It's socialism for the rich. That's what we're moving toward.

We still have a chance in my opinion to move back to a market economy. But it will require a radical change in public opinion, the real decision that we shouldn't let the government do it, that we should have the market do it, and a recognition that you don't have the market do it unless you really have competition, which means undoing what was done by the legislature of New Jersey around 1890 and somehow or another restructuring the basic core of the economy.

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Thank you.

Did that use my time?

DR. OLSON: That's fine. Thank you very much.

The next panelist is Dr. Melody. The title of his paper is "The Effectiveness of Public Utility Regulation as a Curb on Inflation."

DR. MELODY: Dave, I wish I had known you were going to talk about the 1890's. I would have brought my public utility horror stories along to complement the New Jersey case.

When we look at the public utility sector, we are, of course, looking at a sector of the economy that has been taken out of the market in a sense. The market force is still working to some degree, but we have permitted undue monopolization in terms of traditional market forces, and to counteract that we have created a government organization generally called a public utilities commission or a public service commission which is supposed to substitute for the force of the market in affecting prices.

Professor Martin's discussion of the New Jersey case brought back some reflections on some earlier research that I had done on the development of public utility regulation.

It is the conventional wisdom that public utility regulation was brought about by reactions of the

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people through the legislatures to create regulation to stop exploitation by monopolies. If you look at the history of the 1890's and the early 1900's, you will find in most public utility industries the public utilities were actively out recruiting regulation. It was generally desired for the purpose of preventing competition from new entrants to those industries.

If you look, for example, at the annual reports of the Bell System from about 1893 on up into the 1900's, back in the days when annual reports really told you something because they were rather confidential reports to a relatively few number of stockholders, they were very candid in what the policies really were and what the corporate objectives really were.

And year after year you can see the claim that, "This year we have three more States that have established regulation, and we're really working on it, and before long we will have them all."

And so when we look at the public utility sector, we are not looking at a sector in which the government is applying some general macro policies which we hope somehow will have an effect on our general macro indices. We have specifically recognized that these are markets that are heavily monopolized and for which the government must bring to bear a force on the determination of price.

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And public utility commisions at Federal and State levels are specifically assigned the responsibility of determining prices and determining prices that are reasonable.

When we look at the development insofar as the treatment of inflation is concerned, we find the case, again referring back to Professor Martin, of conflict resolution.

Inflation is always discussed as if it were a general problem for which no one is really responsible, neither the regulatory commission nor the regulated public utility, and it is something which must be dealt with in some general kind of way.

For public utility regulation this has meant for the most part that both the commission and the public utility can ignore it because that's part of the national macro policies, not part of the policies that apply to a specific industry.

This creates the rather anomalous logic that what we need is macro policies without any micro effects and somehow that will solve the problem.

We have classified public utilities as specifically businesses affected with a public interest. This reflects not only the monopoly power, it also reflects the fact that they are supplying crucial public services and

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they form the essence of the infrastructure of the economy and the effects of changes in these industries frequently are multiplied many times.

If we look at the focus of regulatory activity, although it does address questions of service, questions of investment policy, and many other things, the focal point is on the regulation of price.

Since we have regulatory commissions to specifically regulate the prices of public utilities, one might ask why did the Price Commission earlier this year get very concerned about public utility prices?

Well, in a way, it was a partial reaction to that problem that for so many years public utility prices had been going down, so if we looked at indices of prices we found that although the overall index indicated a generally acceptable inflation rate, the inflation rate for the industrial sector was higher than the generally acceptable rate, and in the utility sector we had rates generally pulling the overall price indices down.

Well, in recent years public utility prices have changed drastically. Instead of going down, they are going up, and going up rather sharply.

In fact, it has been recognized from the very beginning that the Price Commission standard of 2.5 percent price increase was pretty much of a "laugher" so far as

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the public utility industries are concerned. We're talking about price increases on the order of 20, 30, and even higher percentage points.

When we look at the effects over the last several years, we have found that we have already had increases in the electric industry of about a billion dollars, in the telephone industry of more than a billion, in gas half a billion or more. And if we look at the applications before regulatory commissions, they are asking for as much or more as that which has already been granted, and many utilities are back for the second, third, and fourth time.

It looks like it's going to be an annual occurrence for a while.

Well, what this really raises is the function of the public utilities commissions insofar as a macro policy such as controlling inflation is concerned.

It has been generally presumed in the past that the public utility commission has no specific responsibility in dealing with questions such as inflation and employment. In the past it has been raised on occasion generally by the public utilities.

Going back to the Employment Act, they have argued that, "We can have more employment if regulatory commissions allow higher profits and therefore the

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regulatory commission could help implement the Employment Act by allowing higher profits for public utilities." Generally this was not accepted.

In the current debates before public utilities commissions, the entire concern has been on the effects and not on the causes of inflation. The focal point has been: How can we compensate the utility and insulate it from the effects of inflation? -- without addressing the question of how does it cause inflation.

When we look at the methodology of regulation, we find this is very conducive to this kind of approach. Although all the laws say that regulatory commissions must determine the reasonableness of prices, it is a rare occasion when a regulatory commission ever looks at prices. Rather, it looks at profits. And as long as profits meet a test of a reasonable rate of return on a net investment valued rate base, then that becomes the standard for price.

The Price Commission hearings I think brought this out very clearly. This is the Price Commission's specific hearings on public utility prices.

It brought the public utilities forward arguing that existing regulation was very, very tough and could handle these problems. It brought the existing regulatory agencies forward defending their right to regulate rather than seeking solutions to the inflation problem.

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When we look at the effects upon regulatory procedure, I think there are several which have brought specific changes in the approach regulatory commissions have taken, in the arguments that have been raised by the public utilities, and these changes have tended to compound inflationary effects.

It used to be, for example, that regulatory lag was a very desirable part of the entire regulatory process. That was when prices were going down. And so a lag meant that profits went above whatever profits standard existed and then eventually were brought back.

Now that the trend has shifted the other way, the responsiveness of regulation has been pushed up substantially, and regulatory lag all of a sudden has become a burden rather than a benefit.

I think it is clear to say at this time that as far as the direct application of price regulation in public utilities is concerned that the treatment has always been that the utilities have been the victims of inflation and never the causes.

Now I'd like to address a couple of points dealing specifically with the rate-making formula. The way regulation is applied is through something known as the determination of a revenue requirement. That is, a utility's expenses are added to a rate of return applied to

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a rate base, a rate base being some measure of net investment.

Well, when this is applied in an environment where we know the utility has the market power to raise the price because regulation is supposed to keep the price below what the market would determine or presumably we wouldn't need regulation in these monopoly markets, we find that the application of such things as the measurement of the rate base and the measurement of the overall rate of return has changed in such a way that we have an immediate alteration in the method of regulation, an alteration which forces prices to be higher than they would have been had the standards been applied in the traditional ways.

A good example is the simple period for which one selects data. The standard approach has been to look at a test year, a test year guide, as the basic element for determining whether profits have been reasonable or not.

Until very recently, both regulatory commissions and utilities argued and treated as a test year the most recent accounting period, so if a commission were looking at data they would look at the most recent year annualized. Known changes were incorporated into this formula.

Therefore, if a wage contract was entered into to

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increase wage contracts next year beyond the test year period, these effects were factored in.

If a fuel contract was negotiated to begin later, if it was fully contracted, it was frequently negotiated in.

But what was never negotiated in was any increases in productivity that were supposed to be taking place over this time.

Well, in the last several years, with the concern of utilities for rate increases and inflation and fast responses from the regulatory commissions, we have seen a shift in the data that is used as a source. More and more commissions that were using measurements as of the beginning of the test year moved first toward the middle of the test year and then toward the end of the test year, and many are looking toward forecasted test years, and again with emphasis on the forecasted test years in terms of the cost effects upon the utility, not in terms of the revenue effects, not in terms of the productivity changes, but simply in terms of the cost effects.

It has been carried to its furthest extreme in Canada. Canada's public utilities, at least many of them, are operated much the same way ours are in this country. And Canada Bell has made a specific proposal to the Canadian Government by which it would factor in future inflation into the existing rate-making formula to be sure

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that they can be compensated.

Other areas which have brought significant changes include the actual measurement of the rate base itself. For a little more than half the commissions and most Federal commissions, the rate base on which the allowed profit is calculated is the net investment base taken from the accounting records. The other regulatory commissions measure something called a fair value of the investment, frequently called reproduction cost new.

Well, in these jurisdictions what this valuation base does is it takes current prices, and it is generally donw tih the very indexes we use to measure prices, and the current prices are then applied to all of the old investments to determine a current valuation on which to allow profit.

So the higher the inflation in the price index, the higher the rate base, and, of course, the greater the cause for future inflation.

Here again technological change and productivity is not factored in. The valuation of the rate base is not valuing the economic cost of reproducing the capacity that is there. It's the reproduction cost of reproducing the asset that is there, including assets that people don't make any more and assets that would not be put in by a management replacing that capacity today.

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This clearly has had a snowballing effect upon inflation. And to my knowledge not one State commission has addressed the question of inflation. And prior to the Price Commission warnings of earlier this year, they did not address the question of productivity.

Federal commissions on occasion addressed the verbiage of these terms but in practice did not bring them to bear primarily because in the traditional ways of doing things they never had.

Well, with the Price Commission hearings-- I will review a couple of historical events in case some of you are not familiar with it. The Price Commission froze all public utility price increases early this year. Hearings were held, testimony was taken, and guidelines were suggested for public utility regulatory commissions.

Now, when a regulatory body certifies a rate increase, it must send a certificate of compliance to the Price Commission indicating that it has complied with a number of general guidelines. A couple of the most important of the guidelines are that they must indicate that they have considered productivity as an offset to inflation in the rate-making process.

There has not been any formalized method for considering productivity in public utility regulation today, so it has been mostly evaluating data submitted by

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the company, the public utility, indicating what it thinks its productivity changes have been and then reaching some kind of judgment.

Another aspect of inflation where public utilities have played a major role is in the capital markets themselves. Again the cost of capital is used as a base for determining the so-called reasonable rate of return that is applied to public utility rate bases. When one looks at the supply and demand for capital and what has bid up the prices of capital, we find public utilities at the forefront.

In fact, it has become generally accepted in capital market analysis that when A. T. & T. is coming to the capital markets, everybody gets out of the way. And, in fact, the Federal Government did go to A. T. & T. when it was going to issue a monstrous public issue during I guess it was a year or two years ago and asked them to specifically hold off.

In addition to these problems, when we look at the particular rate structures of the public utilities, we find these are tending to accentuate the problems and encourage misallocations of resources.

Most public utility rate structures were designed under the belief that public utilities operated under continuing economies of scale, that they were putting

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in continuing new technology, and this is what explained rate reductions. Therefore, we have block rate structures in which the lowest block is a very, very low rate which is generally applied to industrial users. We have vast discriminations between general monopoly users and competitively-oriented users.

Well, with the change in the force of inflation, we have not seen a change in the philosophy of determining the rate structure. No utility has come in and proposed to invert the rate structure and say that now costs are going up we would propose to instead of having the steps go down in the block, we will now have the steps go up in the block.

The rate increases have been concentrated for the most part almost entirely on the monopoly services, the monopoly services being those markets for which the market forces have already been recognized as being ineffective.

If you look at State commissions today, you find that in communications the situation is probably worst. The Bell System is now applying before virtually every State commission in the country for increases in revenue requirements on the order of 20 to 30 percent, which are generally accompanied by no increases in the competitive areas where their own cost studies indicate

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that the rates are not covering the costs -- and in many cases rate decreases to thwart competition.

One area where regulatory commissions have enormous powers in the law but where they never apply any effective constraints is in the area of investment policy. Nearly all commissions have power to certify investment, but for the most part it is a rubberstamp procedure.

Now, clearly, with the inflation problem as it is, utility commissions could exercise substantial controls over investment policies to be consistent with inflationary control objectives. This has not been done.

One other change which has affected the process and promises to affect it in the future is that dealing with the very accounting for costs themselves. When we look at our price indices and when we look at the basis on which we set rates, we find that our standards are all based upon some kind of accounting information. In public utility regulation this is based upon the books of account that the utility keeps.

In the good old days when utilities had lots of monopoly power and were not confronted with inflation the way they are today, the incentives were to capitalize all costs, put them in the rate base, because that would give you larger profits over the longer term.

And so we find that whereas a lot of expenditures

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which in more competitive industries would have been expensed as an economic cost of current periods, they were capitalized.

Well, with the current pressures, there has come a tendency to take some of those costs, which one would have treated as an investment cost and put in the rate base and therefore spread over many years, and recognize it immediately, to do this if you can do one thing, if you're sure you can pass that cost on to the consumer.

The best example I think again comes from the communications industry. The Bell System has been capitalizing costs of station connections. Station connections are those costs which are incurred when you move and your telephone is connected or disconnected.

Now they are talking about and getting ready to propose changes in the accounting for station connection expenditures to treat that as an expense. If it is treated as an expense, they would propose to increase the charge for station connections to residential consumers to something on the order of $50 to $60.

Now, the reason this is being proposed, of course, is because station connection charges have generally been treated as really not part of the regulatory process -- that is, not your monthly rate. That is kind of separate. And so this would be one way of simply through an accounting mechanism changing prices substantially, and generally in

an environment where regulatory commissions would not view it as a price where they have specific responsibility to exercise controls.

But I think the fundamental point that I have to say about the whole nature of public utility regulation is that there is a fundamental problem about the applicability of the macro policies on inflation to public utility regulation at the micro level. Public utility commissions have not viewed their job as implementing national policy or even necessarily being consistent with it.

And I think until the public utility commissions come to grips with that problem and recognize that they have a role in the process, things are not likely to change very much.

Thank you.

DR. OLSON: Thanks, Bill.

Dr. Gaffney will now examine the cost push effects of ecological safeguards and consumer protection standards on price inflation.

DR. GAFFNEY: Thank you, Charles. And I want to thank you for the introduction that you gave me earlier. That's one of the nicest introductions I have ever had -- perhaps the second nicest.

The nicest of all was once when the M.C. was sick

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and I had to introduce myself. (Laughter)

However, I feel that on this occasion the introduction was so minimal that I should add to it. I do feel that the Eastern establishment should be heard from -- after we have heard from the Southern populist and the Nebraska populist. It's only fair that White Plains have a whack at it. (Laughter)

However, unfortunately, I don't qualify since we moved to Aberdeen, South Dakota close to George McGovern when I was 6 months old. My father proceeded in a kind of Brownian motion -- random walk I think they call it nowadays -- throughout the country. There was a flight into Egypt and then we went back to New York, that is. And then I suffered under Pontius Pilate at the University of California where I got my degree, and since then I have taught in the South and the Midwest.

So I really don't qualify as Eastern establishment, but I'll try to represent that point of view.

I am also struggling with a virility complex, trying to prove that I don't need these (indicating glasses), but in this dim light I may have to put them on.

And that worried me considerably. But last night I turned on Henry Kissinger, and I figured if he could get away with that manner of address and get where he is, I'm not going to worry if I mumble or don't look at you.

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(Laughter)

Now, we're talking about government as a source of inflation. Let me first do what David Martin did and say what is inflation.

It has something to do with the Consumer Price Index as conventionally measured. However, this measure is overloaded with material goods and services too but things that sell in the market place, and it understates the importance to our standard of living of things that don't sell in the market place, common goods and environmental goods.

Now, some of these environmental goods are indirectly measured in the market place through real estate values. That is, if we take steps to alleviate air pollution around Gary, Indiana, that should increase the value of property around Gary, Indiana.

This would not, however, be an inflationary factor because the increase in value in this case represents an increase in the quality of the good, and that is not inflation. Inflation is when the price goes up and the quality remains the same.

As a matter of fact, it's the other way around, by and large. The improving of the quality of air and water will tend to increase the quality of real estate out of proportion to the increase in its price.

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Indeed, if this were a nationwide effect, there might be no increase in the price at all. There would simply be increase in the effective supply in the sense of the quality of residential real estate and other amenities that people buy and sell in the market place would increase.

So this is something to keep in mind when we are concerned about the possible effect of environmental control measures on the cost of living. Even if they increase the CPI as conventionally measured, they might not increase the real cost of living at all. They might even bring it down.

And, indeed, if they were well administered in the sense that the benefits of each measure were greater than its costs, they would almost unavoidably bring it down.

I think they should be thought of as rectifying biases that exist rather than creating new biases that don't now exist.

Now, let's face this question: Does effluent control and pollution control add to the cost of living in the Consumer Price Index? The argument in favor of it would be essentially that these costs are shifted forward to the consumer. Frequently this is an ex parte argument, of course, and its ultimate absurdity is found in the argument that if these costs are imposed on us, "we will

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shift them off over to the consumer, and, furthermore, it will force us out of business."

And you do, of course, hear both arguments. And I really call your attention to the fact that they are mutually contradictory. It's either one way or the other but not both.

Now, this forward-shifting argument, the assumption that all of these costs will be passed on to the consumer, might be evaluated in the same way that we evaluate arguments about taxation. It's easy to assume that all taxes are shifted forward to the consumer.

However, if you stop to think a minute, these assumptions are just conventional and arbitrary. As a matter of fact, for some reason that isn't entirely clear to me, it's conventional and arbitrary to assume income taxes are not shifted forward to the consumer but rest on the income taxpayer, whereas sales taxes, which are not too different in their economic impact -- they're different but not as different as you might think -- it's conventional to assume that they are shifted forward to the consumer.

Economists now are agreeing more and more that this is kind of a convention that was established on an arbitrary basis that went something like this:

The first analysis of the sales tax was based on what is called in the trade "partial equilibrium

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analysis." That is, you assume the tax was imposed on one commodity and other commodities were spared. And so it tended to drive resources out of production of that particular commodity, whatever it might be, and thus reduce supply and thus push up price.

And this is how the forward-shifting idea got started.

Now, if you look at a kind of tax that is applied nationwide and impartially to all commodities, it won't have that effect. It will chase resources of of certain industries and chase them into certain other industries, so that it will affect the allocation of resources but it will not necessarily on balance be shifted forward to the consumer.

For example, the property tax isn't necessarily shifted forward to the consumer. It falls heavier on industries that are more capital-intensive, and, by the same token, it falls less heavily on industries that are labor-intensive. So the overall effect is to chase capital out of capital-intensive industries and into labor-intensive industries or outside the country. Let's rule that out for the sake of simplicity.

But to the extent that we are talking about a closed economy, it won't necessarily be shifted forward.

Now, the same thing is true of effluent controls

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and any costs that are imposed on industries in the name of effluent control. They will indeed tend to chase resources out of industries where the cost of control is very high relative to the value of the product or relative to the net income of the industry, but these resources, assuming they aren't held out of use altogether by the cartel machinations, will move into other industries, and so you will get a reshuffling and reallocation rather than a net reduction in supply, which indeed is the purpose. This is what we have in mind.

Now, as I say, the only way this argument could be wrong would be if the effluent controls destroyed the resources or if they were held out of use altogether.

Now, on the contrary, the tendency of effluent controls, assuming once again that they are wisely imposed in the sense that I specified earlier, would be to create new resources, and these new resources are the ones whose service flow was previously impaired by the effects of the pollution.

For example, there is the phosphate processing operation in Florida. Effluent from this carried through the air threw out of production large citrus groves. Now, to control that effluent would be to let those citrus groves come back into production, produce more oranges, and push down the price of citrus.

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So that's what I mean by the creation of additional resources by effluent control.

And the effect here would clearly be deflationary rather than inflationary.

Now, the same line of reasoning applies on a much more general scale to almost all the residential land in the United States. We don't think of residential services in quite such graphic terms as we think of oranges, but the same general principles apply.

You have a market. You have supply and demand. And if you improve the area of land in which people can build residences, and real estate salesmen can peddle it to the consumer, and he can feel that he has got a good place to live, you're going to increase the supply of land which is available for this purpose, and that will tend to bring down price, and that will be deflationary.

Now, another reason why I feel that pollution control measures wisely imposed will not on balance have inflationary effects is the byproducts matter.

Some years ago I was talking to a man in the coal industry about removal of sulfur dioxide at the stack and the possibility of selling the sulfur in the market. And he looked rather shocked. He said, "Do you realize there is more sulfur going up the stacks in coal-burning plants than there is being sold by the entire sulfur

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industry? Now, what would happen to the price of sulfur," he said, "if we threw all that stuff on the market? That's unthinkable. We've got to solve this problem some other way."

Well, I merely call your attention to what would result if the problem were solved in what you and I might consider the reasonable way of dumping that sulfur on the market. It's an enormous source of supply.

Now, another point is that many effluent controls -- in fact, probably most of them -- are things we should be doing anyway for other reasons. That is to say, much of the pollution that bothers us today does not result from the operations of the free market. Rather, it operates from institutional biases that are preventing the market from operating the way it does in theory.

So, the solution is not to bias the market, as is often assumed in discussions of effluent control. The solution is to stop biasing the market in the way that we already are. And a double gain should be achieved by this, the reduction in pollution and also the benefits that would flow from getting rid of the other biases.

I just notice that I forgot to tell you what causes inflation, but I'll get back to that.

Now, to make this more specific, the three biggest sources of pollution in quantitative terms and impact

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terms -- and almost any terms you care to mention -- are, first of all, automobile transportation, both directly and indirectly through its demand for petroleum and all that that implies; secondly, primary extraction as opposed to recycling of materials, and the primary extraction and primary processing lumped together; and, third, warfare.

Well, now, there are very good reasons for doing something about all three of these problems anyway. All the social biases that we care to name are in the direction of giving us more of these three things than we really need.

Now, take automobiles. I don't think any economist has ever locked at this who wasn't employed by the automobile industry or the petroleum industry. And that's a shrinking number, but still --. And anyone who has any claim to objectivity in this field, among whom I would include all those present, feels that the automobile is the spoiled darling, spoiled child, of the subsidy system.

Almost everything you can think about connected with automobiles is subsidized or undertaxed or in some other way supplied excessively. And I won't even begin to try to itemize all of the things.

Just to mention one or two, we have the pattern of urban sprawl which is brought on by policies of snob zoning, low density zoning, which artificially inflates

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the amount of land people are required to spread themselves over and thus increases the demand for automobile transportation, reduces the high densities which are necessary to make mass transit viable.

We have all kinds of zoning requirements limiting the height of buildings, which means limiting the use of vertical transportation which is directly competitive with horizontal automobile transportation.

We have the fact that automobiles themselves are barely touched by the property tax. So that if you see two lots side by side, one covered with automobiles and one with a building on it, the building is being taxed and the automobiles are not under the property tax, which creates a clear bias in favor of the parking facility that the authomobiles require.

And, of course, all the autos on the streets are using valuable land -- I mean parked on the streets -- and not paying any taxes for it.

And, of course, all the gasoline that is pumped into those automobiles is produced under the most outrageous kind of tax subsidy that we know about.

I wonder what they think about that back in White Plains. (Laughter)

Well, anyway, that brings us to-- Well, I haven't said anything about the cement highway juggernaut,

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the highway lobby, the most potent lobby we have in town, the highway trust foundation and the enormous over-allocation of resources to highways, interstate expressways, and so on and so forth, and without any constraint whatsoever imposed on the automobiles other than the gasoline tax which is almost nominal compared to the social costs that are being imposed.

Well, you add it all up, and it goes on and on. And there are lots of good reasons for substituting mass transit for automobile transit and vertical transportation for horizontal transportation without even getting into the question of pollution.

And then when you add that factor, there would be a quadruple-barreled benefit from substituting a less polluting form of transportation for the automobile.

Now, turning to the extraction and primary processing of raw materials, once again we have the same story. The tax subsidies are a familiar story now. The effects of depletion allowance in artificially increasing the economic desirability of exploring for primary minterals in contrast to recycling, which is a labor-intensive operation, the labor input being fully taxed -- that is, it is income taxed -- compared with the virtual tax exemption of resources devoted to exploration and primary extraction.

Once again it is becoming a familiar story in the

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last couple of years that recycling which is competitive with the extraction of primary products suffers from severe tax penalties relative to primary extraction.

So that in terms of simple efficiency without even getting into the question of pollution, it would be socially desirable to substitute recycling for primary extraction and processing.

Now, we also have something called the rule of capture in the administration of natural resources, which in all its ramifications -- and there are very many -- creates another sort of bias in the direction of using primary products as opposed to secondary products.

Now, just to take one example, in respect to water resources which are allocated in most of the Western States by a principle which is known as the doctrine of prior appropriation, which is a modification of a rule of capture, the rule is "first in time, first in right," which means that if you stick your pipe in the water before anybody else does, you establish a history of use and the right to continue using it in the future, which is to say you establish your property right over this resource by using it.

It doesn't take very much imagination to visualize that this leads everybody to grab water prematurely before he really needs it in order to establish his claim to

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the future.

This results in premature invasion of the wilderness, people building dams or getting the government to build dams for them -- which is more common, to not only grab the resource but get Uncle Sam to foot the bill while we do it.

But, at any rate, this leads to vastly premature development of water resources, invasion of the wilderness, deterioration of the environment, to say nothing of enormous capital requirement, which competes with A.T. & T. and Federal bonds and everything else and tends to push up interest rates which are also part of the cost of living.

Now, this leads to and quickly disposes of the third point, which is warfare.

The rule of capture is also applied on world-wide scale and has a lot to do with the behavior of American mineral-owning firms in their dealings with less developed nations, and it has a lot to do with the necessity of maintaining a large military establishment to maintain police protection over these acquisitions. And this is polluting and it is also inflationary.

Well, Henry Kissinger disposed of the rest of the topic last night.

Now, another point. To the extent that effluent control uses labor as opposed to capital and to the

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extent that there is unemployed labor -- this is kind of an old fashioned concept today -- essentially it uses inputs which are free since they are not producing anything and therefore doesn't reduce the production of anything else and is not inflationary.

That's kind of olf Alvin Hansen argument. I almost feel ashamed to dredge that up today, but it's kind of being forgotten.

Now, there are ways in which pollution control might be inflationary if it were badly handled. And whose law is it? -- Riley's law or somebody? -- if a thing can go wrong, it will. Well, Congress, of course, instinctively gravitates to the wrong way of controlling pollution, and they do this by legislating particular ways of controlling pollution.

They say the way to do this is to invest money in a tail-end Charley which is a change that you put at the end of the process after you have done the damage in the way you processed the commodity and the specifications of the product that you're producing. Then you put on the tail-end Charley to clean the effluent up before you discharge it.

And this is inherently capital-intensive. Anything which is inherently capital-intensive is likely to be inflationary, because when you produce capital which lasts for a long time before it yields a flow of services

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commensurate with the cost, you create incomes that are disproportionate to the ripe goods that come to the end of the pipeline, and this tends to be inflationary in that respect, and also in the second respect in that you tie up a great deal of the Nation's capital in forms which don't give it back to the investor very rapidly, and this tends to push up interest rates.

Now, in some commodities, and utilities and housing would be two of the most obvious, the rate of interest, or the interest that you pay, is the larger part of what you pay for the commodity. Well, I'm not so sure about utilities. I'm more sure about housing. That's the larger part of what you pay.

In other words, the rent that you pay on a dwelling unit returns the cost of construction in less than 10 years. The rest of what is paid over the 60- or 70-year life of the house is interest.

Of course, if interest rates go up, service charges on debt go up and rents go up.

Now, this is the end, but there should be a wrap-up. Well, as a wrap-up, let me just say what does cause inflation.

The primary cause of inflation I'm still old fashioned enough to believe is the debasement of the currency, to use an appropriately old fashioned expression.

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Secondly, there is cost push inflation such as the gentlemen were talking about.

And, third, there is the factor of creating incomes without creating products at the end of the line for those incomes to buy.

These are three basic causes of inflation as I see it, and effluent control is not among them.

Thank you.

DR. OLSON: Thank you, Mason.

Bill Melody has observed that he sounds like a White Plains populist. (Laughter)

I have been referring to all of these presentations as papers, and that's really very unfair to our discussant, because they aren't at all papers in the sense that he had them ahead of time. They will be papers I take it after the record is made available.

MR. GAFFNEY: You shouldn't have saved that announcement until after I spoke because it got so obvious. (Laughter)

DR. OLSON: But, in any event, I will leave it to our discussant to comment on the three populist speeches.

MR. MASSEL: Well, I think that the major point of unfairness here is not that I have not received copies of papers but that I was prepared in true academic style to disagree with all of these populists in a general

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thesis or in specific parts of a general thesis so that I could have some fun here in the process either of arguing policy or nit-picking, and here I am in the unfortunate position of agreeing with all of them, with some slight questions, with regard to whether Dave Martin's concentrated effort on one phase is well taken or whether it doesn't fit into a larger structure and also with a question that I think would require some research, and I do not know the answer to it, but I have by and large a general amateur impression that those areas which have suffered most from pollution are the areas in which real estate prices have gone up more.

And, therefore, I trust that some questions might be raised with regard to some of the causal effects which have been implied here.

But, overall, in a spirit of frustration, if you will, without taking a position of attempting to sum up three very excellent talks, and without taking a position of seeing what could be done about pointing at deficiencies in the three talks, I come out of this with a very distinct impression that overall, by and large, there is a very reasonable case to be made especially with regard to this topic.

That is, that by and large the primary contributor to inflation and to inflationary forces in the economy has been and continues to be government, and that

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from that standpoint the possibilities of drafting a specific, forceful, clear indictment with regard to the ranges of our governmental policies and public policies emerge quite clearly.

I will attempt in the process of outlining this indictment to stay away from the populism which has been referred to and to try to look at some of this a bit more dispassionately, trying to indicate or illustrate the type of structure which is involved in this indictment.

To begin with, in the areas of fiscal and monetary policies, we had this experience of a reduction in taxes by the Federal Government at precisely the wrong time. At precisely the time when the government was just about to start pouring more purchasing power into the economy, at precisely the time when the government was getting itself wound up to push more purchasing power into the economy which did not produce goods and services which in turn could absorb the purchasing power, we had the reduction in taxes.

And we since that time have seen practically nothing done about the possibilities of increasing taxes except -- and here I think the government should be congratulated -- in one area the government has increased taxes. It has gone in for a regular program of increasing payroll taxes, and in the process of increasing payroll taxes we have this rather ironic spectacle of a government

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which pushes for full employment, which is concerned about unemployment rates and what can be done about them, and which at the same time insists on increasing taxes on payrolls, a phenomenon which is somewhat difficult to accommodate.

And, of course, by taxes on payrolls I mean the social security taxes as well as other types.

We have, in addition and tied in with this, the whole phenomenon of government purchasing -- government purchasing which suffers from the same types of problems that Mr. Melody has outlined to us, government purchasing which is based upon the concept of profit limitation not on the concept of efficiency and not on the concept of low prices.

If a government contractor shows up with low profits through the processes of negotiation and the processes of renegotiation, he is applauded. If he shows up with higher profits, he must return those profits. Meanwhile, nobody is concerned about the possibility that the prices are too high. Nobody is concerned about the possibility that cost plus percentage purchasing simply encourages inefficiency and the wastefulness of resources, including the resources of labor and the resources of material, in addition to which it encourages the easy capacity for being able to pay higher prices for the materials and the labor which is purchased.

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On top of this, in terms of government policy, we have the development as we did during the depression of an agricultural policy to see what could be done about increasing agricultural prices. That policy which involved increases in agricultural prices has now been converted, in talk, in terms of agricultural incomes. But the main thrust of our agricultural policy in the direction of holding up agricultural prices has not been discontinued.

And in line with Dave Martin's point about what inflation is and the need for having reductions of some prices while other prices go up, here we have an agricultural machine which in terms of increases in productivity has outstripped the patterns of increases in productivity in manufacturing and in the services, and we do not see a pattern of agricultural prices which are going down in response to the increases in productivity.

We do not see this because of the governmental policy and the many and varied governmental programs for maintaining and recently for increasing agricultural prices.

Now, in the area of competition I should like to add to the indictment that Dave Martin gave us. By and large we see remarkably little development in governmental policy-- And we have seen this for some time. We see very little, remarkably little, development

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along the lines of encouraging competition.

For example, at the very time that a decision was made that inflation was going too fast and that something had to be done about controlling inflation, we increased import barriers. And the possibility of having international competition introducing phases into our inflationary situation which can come about has been a possibility which by and large we have been ignoring in terms of national policy.

As an illustration and an indication of the kinds of things that can develop, taking one industry and a rather strategic one, the machine tool industry, there are signs according to certain reports that the cost level of what we regarded as an industry which engages in workable competition in the United States -- that their cost level may be reduced to something in the neighborhood of 65 percent of what their cost level had been previously, and that the reason for this reduction has been because of foreign competition in terms of imports and in terms of competing with foreign manufacturers in our export sales.

And, incidentally, it is rather dramatic that in all the information that has come through with regard to these cost reductions there is nothing that goes along the lines of the great breakthroughs in modern technology, through electronics and computers and such. The

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breakthroughts have come through the simple process of looking seriously at costs and efficiencies in order to find out ways and means for reducing costs.

And I think in this connection, looking at Dave Martin's general thesis, that one should not overlook the tremendous importance of the competitive pressures, not in terms of profits, not in terms of monopoly profits, but, rather, in terms of the utilization of greater efficiency, a pattern which it seems to me emerges very clearly through Mr. Melody's evaluation and examination of our system of regulating rates.

Also through our antitrust patterns, our antitrust policies, we have not pushed entirely in the direction of competition.

To cite two kinds of forces without going into them, under the Robinson-Patman Act we have effectively removed pressures for competition in certain trades and industries. Under the aegis of our general antitrust laws insofar as they have been enforced, we have created forces but have not been willing to go beyond the forces which we have created in terms of counterforces.

For example, under the threat of antitrust prosecution, it is perfectly clear that the General Motors Corporation is deathly afraid of increasing its percentage in the automobile market. Obviously, when one

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looks at General Motors' profits and when one looks at whatever manifestations we have, whatever evidence we have, with regard to General Motors' costs and the costs of its competitors, General Motors could reduce its prices still operating at a good level of profit, but if it did it would simply be in a position of squeezing others out of the industry.

And so there you have the frustrating effects of antitrust. On the one hand, antitrust is supposed to encourage competition, and on the other hand, getting into a competitive position such as in the automobile industry, the antitrust laws themselves -- the fear of them -- result in restraining competition.

Query, therefore: Have we gone far enough in our antitrust laws? Or do we have to start thinking of policy in terms of antitrust, policy in terms of capital markets, policy in a whole range of governmental functions which will end up in making it profitable for some of our larger corporations to break up into smaller parts where they in effect can afford to compete?

Is it possible, for example, that in the development of the antitrust policy which Dave Martin has described, even taking it from the standpoint of enforcement-- Have we come to the point in our antitrust policy in which, insofar as it is effective, it becomes

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clear that we have to move further ahead and we cannot stand at where we are today?

Then, of course, under the general heading of competition, without repeating some of the excellent presentations you have heard here, we have this whole area of rate regulation, rate regulation which helps to avoid competition and rate regulation which depends not on an examination of rates, not on any consideration of efficiency, not on any consideration of ways and means of injecting competition such as we had through the VA, but, rather, on the simplistic approach of: "Let us control prices."

And here, as a footnote, I'm not at all sure that part of this problem may not be a heritage from what we economists have been feeding out in general theory, and that is the concept of monopoly profits, the concept that the most important features that come about through monopoly are profits, and, therefore, if we have public utility commissions which are regulating monopolies and avoid monopoly profits, we have accomplished something.

Then in the general area of wages and prices we have a number of highly significant problems. Without taking the time to go into the whole pattern of our present price control, I think it is fair to say that due

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to a number possibly of political forces we have price control which by and large -- which has a tendency I should say to focus on profits and on profit controls rather than focusing as much as might be expected on examinations of prices and rather than focusing as much as might be expected on stiffer regulations which may actually hurt somebody's profits if they have not been energetic enough to be able to work within the range of the stiffer regulations.

We also have such problems still with us as the consideration of Walsh-Healy which was developed during the depression and which we insist upon continuing with administratins which in various places push up labor rates and such.

And we have a phenomenon which I find rather ironic. We have an administration which because of inflation believes that labor should voluntarily agree to holding wages down and to move along with the pattern of wage controls, and yet we see before us and have seen before us the simple phenomenon of increases in salaries for the members of Congress, the doubling in the salary of the President, with a pattern which it seems to me is quite significant looking at a general inflationary psychology of making it quite difficult emotionally and politically within the structure of the labor framework to

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get labor to think that government is really looking at these problems seriously.

The net effect, it seems to me, in terms of this general structure and in terms of the specifics which we have heard laid out here this morning, is that when it comes to the issues of public policy with regard to inflation that governments have accepted and have utilized -- I mean administrations have accepted and have utilized -- the rhetoric of the populists without taking the rhetoric itself too seriously and without worrying too much about any thorough analysis or examination of the economic consequences of a wide range of policies, none of which in themselves may be terribly important but which in terms of a collective structure is it seems to me a pattern which has stimulated inflation in our economy and which at the present time looks as if it will continue to stimulate inflationary forces.

Now, as I have said, I have gone through this description of pattern entirely out of frustration because I haven't been able to use a good academic technique of being critical about the three papers before me.

Thank you.

DR. OLSON: Thank you, Mark, for some very perceptive and far-reaching comments.

I think I will ask the panelists to limit their

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remarks as much as they can in the second round so that those of you who have been patiently waiting to ask some questions for the last couple of hours will get that chance.

Dave?

DR. MARTIN: The one comment that has occurred to me from listening to all the other speakers is that we have discussed the whole thing within the context of the implicit assumption that the term "government" has some meaning to us. And out of what has been said, several things that have been said, there arises in my mind a notion that we are talking about things that affect the very nature of government itself.

When you say the government causes inflation or is the source of inflation and you ask what you mean by the "government," I don't think you mean just the President or just the Congress. And if you look at what is the Presidency and what is the Congress and you look at the role that is played by the business community in the government and the role played by the government in the business community, I would just leave with you the thought that this dichotomy between government and business that we draw for purposes of thinking about things is itself a creature of our mind.

If you could really back off and sort of look objectively at the social structure in our society, you

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wouldn't necessarily have to analyze it within the framework of thinking of some things as government and some as business.

When the corporations are chartered by the legislature and granted great powers, and when those powerful corporations in turn have great influence over governments, it doesn't make a whole lot of sense to hold onto the notion that we do that sort of treats I. T. & T. or I.B.M. or General Motors with all the civil liberties of a natural-born person and acts as if they are a firm both in the law and in economic theory.

We have absolutely failed to take into account the implications of the transformation that took place in the early 1890's to a corporate form of organization of our economy. We treat them as persons at law and we treat them as single proprietorships in economic theory.

That's the only comment I want to make.

DR. OLSON: Bill?

DR. MELODY: A related comment. In sitting down and preparing for today on the role of government, I found the classification between government and industry rather an artificial one for purposes of dealing with the question, because I think the more proper split would be one between market and nonmarket forces.

And if we draw that split, we find that much of

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the regulation which we generally talk about as government responsibility and being done by government is in fact price regulation by industry.

We see this particularly in the public utilities sphere with which I am most familiar -- that most of the regulation is not done by the assigned regulatory bodies but is done by the industry in imposing extra-market influences on what the market price will ultimately be.

Mark's discussion brought back a recollection to me about the whole economic analysis of markets. It's very fashionable for economists to concentrate on resource allocational effects and not to worry too much about operational efficiency and the impact of competition on that. Yet I think if we survey all of the studies that have been done in all of the disciplines, we will find that the biggest impacts have clearly come on questions of operational efficiency. At least that is what studies have been able to demonstrate.

And then, finally, I think the whole question of inflation, to go back to a point Dave Martin made at the very beginning-- I think it's time we got away from the notion that inflation is somehow a burden for all of us.

Inflation is something in which there is just as much an adversary interest among different groups of all of us as there is in any other policy question, and until

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we start recognizing that there are gainers and losers to whatever happens, we won't really be coming to grips with it.

That's all.

DR. GAFFNEY: Well, I have one short comment on the needle that Mark pointed in my direction, and then I have a question for Bill Melody.

On the question of the effect of air pollution on real estate values, this is one of those difficult questions where other things never remain the same, and they invented the multiple regression analysis to handle problems like that. But it's still an underdeveloped art.

But there have been three or four studies of this question. (Rimkirk and Henning) did one in St. Louis, and Tom Crocker did one in Florida in the phosphate case. And the finding of these studies was to the effect that there was an effect within a small market area. The presence of pollution tended to lower real estate values.

And I think this might be confirmed on the basis of casual empiricism by looking at real estate ads in the Los Angeles Times where the absence of smog is very much of a selling point.

But it is also true, of course, that you find high land values at the centers of cities, and that is where you also find pollution.

In terms of increases over the last 20 years,

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however, the percentage increase in real estate values has been higher the farther away you get from the center of the city -- until you get beyond the influence of the city altogether, that is.

But then this is a pattern you find in every real estate boom, so it would be difficult to attribute that altogether to the pollution variable.

So this is still a moot point, but I think the early returns are trickling in.

I have a question for Bill Melody. Henry Schechter wrote an article about 10 years ago which he called "The Cost Push of Urban Sprawl," and he attempted there in a fragmentary way to add up some of the inflationary effects that urban sprawl imposed on public utility systems basically.

Now, in a typical public utility system, the total costs are pooled, and any increase in cost in one segment is imposed on everybody regardless of whether he is responsible for that increase in costs or not.

Now, in the pattern of extreme urban metropolitan fragmentation which has occurred since the second world war, the cost of distributing most utility services has escalated more rapidly than the other parts of the operation.

Now, I checked specifically on sewer and water

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a couple of years ago and discovered that in these cases the distribution cost of water and the collection cost of sewage were more than 50 percent of the total cost.

And my question is, Bill, is there a comparable effec in respect to other utilities, the private utilities, telephone service, that you are aware of?

DR. MELODY: I think the effects go two ways. I think the forces you speak of are at work. The problem particularly in the communications field is the growing intensity as additional services are added at the same locations.

So I think that your point would have more validity in gas and electricity. But even here we have had so much increased usage at each individual location, and in communications, whereas in the old days it used to be everyone had a black telephone, now particularly with business locations additional services are growing quite rapidly.

But let me disagree with the point that the inflationary costs are distributed uniformly over the system. The public utilities use uniform tariffs, and what that means is that uniform tariffs are applicable to whom the tariff says they are applicable to. So we have uniform tariffs applicable to one person and one customer, and particularly if they are discriminatory low

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tariffs.

So one of my points with regard to inflation that I intended to make -- maybe I forgot to make it -- was that when we look at the changes in prices that are being proposed by public utilities today, particularly in the communications field, that they are falling all on the users who are in monopoly markets who don't have alternatives.

And we are in a situation in the communications field where competitive forces are greater than they have been in the past. That's a very relative statement. Because in the past they were virtually zero. And A. T. & T. still has enormous monpoly power.

But the FCC in recent policy decisions has permitted others the opportunity to do such things as enter certain communications markets, particularly in the equipment field, for attaching terminals to the system.

And you can look at just about any state and you will find an application by the Bell System in for increases in its overall profit level and revenue requirements, on the order of 20 to 30 percent, and in many cases decreases in the prices of specific lines of competitive equipment well below their own costs.

And so that answers your question as well as some other things.

DR. GAFFNEY: Well, I think you are mistaken

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in one respect, in that you think there is a disagreement between us, which leads me to think I may not have asked my question clearly.

You are saying there is a discrimination among consumers based on value of service or what the market will bear. And I was saying that there is differential cost of service which is distributed uniformly.

Now, the uniform distribution doesn't imply that there isn't discrimination of other sorts. It implies that the discrimination is not based on differential costs of service. And I have a feeling that we agree about that.

DR. MELODY: Oh. Well, what I thought I was disagreeing with was the uniform distribution of the increased costs.

DR. GAFFNEY: Let's just say they are pooled throughout the entire system and that the system discriminates but it does not discriminate on that basis.

DR. MELODY: Yes, I agree. They are put into a pot. That goes back to the point I just made. The regulator in this case, the company, decides how they will be distributed.

DR. GAFFNEY: There are a few cases -- I think Pacific Gas and Electric is one -- where they do make some effort to discriminate on the basis of differential cost of service. But on the whole you seem to have this other

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pattern.

MR. MASSEL: That's right.

DR. GAFFNEY: Where the elasticity of demand -- or you phrased it monopoly power -- is given more weight.

DR. MELODY: Yes. I think when you look at the general approach taken by utility regulatory commissions when it comes to determining price, or, more appropriately, allowed revenues, the monopoly portion of the business tends to be the residual. So the utility sets the rates in those markets for which there is some competition or for which it has some concern, and then whatever is left that needs to be recovered is assigned to the basic monopoly market, usually residential telephone, electric, gas, or, in interstate communications, long distance, which creates the ironic set of circumstances that for something like 60, 70, 80, 90 percent of the utility services the rates are set without regard to the specific demand or cost characteristics of that service. It's whatever is left and is necessary to pick up total revenue requirements.

DR. MARTIN: As a tax?

DR. MELODY: Oh, yes. Well, this becomes almost the view of the utility in many cases -- is that it is a kind of tax, that there is a simple right to levy it on the basis of whatever is needed.

DR. MARTIN: Corporate medievalism.

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MR. MASSEL: I feel impelled to answer two imputations that the others have found in my remarks.

First, Mason Gaffney has imputed into my remark about inflation and real estate values a causal relationship. The only defense I have with regard to the causal relationship he has imputed can be found in an old story involving a psychiatrist.

A man came in to see his psychiatrist and he just kept waving his hands around. And after they had some discussion and he kept waving his hands, the psychiatrist said, "Sir, what are you doing?"

"Oh," he said, "I'm keeping the elephants away."

And the psychiatrist said, "Keeping the elephants away? What in the world makes you think that you're doing anything about keeping the elephants away?"

"Well," he said, "Doctor, I don't think you've seen an elephant within 500 miles of this point, have you?"

(Laughter)

I was not trying to impute a causal relationship. I was simply raising this in terms of a question of correlation.

Now, with regard to the point that Dave Martin raised -- and I'm glad he raised it -- I was not referring to government in the sense of government as an impartial eunuch hovering above us in the sky making its separate and

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independent decisions.

There is no doubt whatsoever that governmental decisions come about as a result of a series of pressures which we call political, social, and economic, but, on the other hand, the results of these pressures come about through the forces which government as government can apply and does exert, and one does not have to go in for the qualification of market and nonmarket forces with regard to this.

In modern societies, governments play a role. In modern societies, governments even if we take the totalitarian form of government do not represent separate insulated fountainheads of power. But at some point or other this amorphous mass which is the result of all of these pressures has to be looked at, even though it is a mass, as a function, as an important function, in modern society.

And it was in those terms that I used the expression "government."

But I think that if one moves away from that or a similar expression, it becomes all too easy to see the distribution of power all through our society in such an amorphous condition that we really have no place to go, and I am naive enough to think as a society we still do have a place to go, and I hope we find a way to get at it.

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DR. OLSON: Do you have any questions?

QUESTION: I have a couple I guess directed to Mr. Melody and yourself, since I know, Charley, you have some knowledge in the utilities area.

You mentioned two points. First, productivity -- something the utilities have traditionally not taken into account. They claim under Price Commission certification programs, as you pointed out, they will do this.

One of the problems that they claim they have though is in actually developing measures of productivity. You hear the telephone companies talking about certain measures, all of which from an economic point of view seem inappropriate.

I was wondering if you have some in mind that you feel are appropriate that could be suggested. See, I'm at the Price Commission, and it's an area of interest.

DR. MELODY: Let me comment first on the general problem. I think that cuts across the whole field of rate regulation and the applicability of regulatory standards -- that whenever you attempt to apply any standard and ask for information, you can never get the information.

Up until a couple of years ago I spent a lot of time with the FCC, and there we simply dealt with the question of costs and just getting relevant costs to deal with specific problems, quite aside from productivity

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questions.

QUESTION: Well, in some instances -- and I might add a minority -- some of the State regulatory bodies have asked for guidance. Now, most of them are not interested in guidance, but some have, believe it or not.

DR. MELODY: New York and California. New York and California are two leading lights. Most of the other commissions I'm sure would not be interested at all.

But I have found that the best-- My advice for a regulator would be to do something to indicate that it was in the company's incentive to come up with relevant information here, that the whole process seems to be one in which the company has an incentive that if it doesn't come up with the kind of information that is necessary for regulation the company benefits, such as if it doesn't come up with its costs by service then it has infinite flexibility in how it will choose to price, and on productivity I think we are going to have to see the same thing, that the Commission is going to have to indicate that it is going to use whatever standard it can in such a way that it is rough on the company, and then you will begin to get some developments on specific productivity standards.

As far as kinds of productivity that I would recommend that we use in regulating the Bell System, I

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think you just have to start with capital, labor and total, factor productivity given the information you have, and if you are going to incorporate forecasted information at least incorporate forecasted effects on revenues, on the introduction of new facilities, and on the impact of that on price and cost per unit.

The difficulty, of course, is that none of this information gets translated back to the cost per unit.

With regard to A. T. & T., I know there is some of this information existing because they brought it in to justify some low prices to some special users in cases in recent years. That is when they brought out the very latest technology and even argued that it would be used at a hundred percent of its capacity for its entire life to get nice low unit costs.

I think if a commission were to take those unit costs and say, "All right, we'll use these as our standard until we get the kind of information we are really looking for," that you will begin to make some progress.

I think there is a real serious problem that the way the regulatory system is structured the utility has a very definite and positive incentive to supply absolutely no information at all.

QUESTION: You spoke of the investment policy and

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examining that with respect to the utilities. More specifically, what would you like to see?

DR. MELODY: Virtually all regulatory commissions have this power in the law. They rubberstamp virtually everything, primarily because they do not have the staff or resources to review it in any kind of detail anyway.

But I think clearly on the question of inflation the commission could begin to examine the whole question of lead times, why the utility is investing the way it is.

In communications we have a particular problem with regard to the use of the radio frequency spectrum, in which the cost is effectively zero. Well, as a result of the FCC's policies in recent years letting other people use the frequency spectrum, there is a big rush on to bank it, to get there before other people get there.

So I think by a review of investment proposals and particularly market justifications for the investment proposals, the FCC in recent years could have cut back on the entire investment in the communications field.

Now, I can't cite as good examples as that in other industries, but that's the kind of thing I think should be applied.

DR. OLSON: It is past 12:30. I think I had better end the formal question and answer period. I'm sorry we didn't have time for more. I'm sure the panelists

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will be available for a period of time for any questions that some of you might have.

It's my understanding that all or most of them will be staying for lunch so that might be a place you could corner them as well.

Thank you.

(Applause)

(Whereupon, at 12:37 p.m., the panel discussion was concluded.)

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